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Transaction Avoidance in China's New Bankruptcy Law: Perspectives and Problems

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Introduction

There may be a period of time from when a debtor realises that it is insolvent or is facing impending insolvency to the time when formal insolvency proceedings are initiated.¹ During this period, a debtor may enter into certain transactions with other parties such as transferring property at an value below market value or making donations. Or, the position of certain creditors may be improved by granting them security subject to collateral by the debtor, or the claims of certain creditors may be satisfied by the debtor during this period. In contrast to those creditors who obtain an advantage from these transactions, other unsecured creditors in the same rank remain unsecured and/or unpaid. Transaction avoidance laws can provide an effective legal framework to prevent the illegitimate reduction of a debtor's property and ensure the equitable treatment of all creditors in the same rank.² Transaction avoidance may be more effective in realising the collective approach of insolvency laws enabling the maximum realisation of the debtor's assets than a system where creditors pursue their claims by initiating civil litigation individually.³

The first bankruptcy law since China was founded in 1949, the Enterprise Bankruptcy Law 1986 (for Trial Implementation) (the 'EBL 1986'), established a number of provisions relating to voidable transactions.⁴ However, this simple legislation was not sufficient nor adequate to deal with fraudulent or preferential

transactions which harmed the common interests of creditors.⁵ A more efficient legal framework in relation to transaction avoidance has been established by the coming into force of the Enterprise Bankruptcy Law 2006 ('EBL 2006').⁶

This article provides an overview of the Chinese transaction avoidance legislation under the old regime, an analysis of the new provisions of the EBL 2006 and a critique of the new legislation identifying the potential weaknesses.

Conceptual factors

The term 'transaction' refers to a wide range of conduct which may result in the reduction of a debtor's assets or the incurrence of liabilities including by transferring property, the making of a payment, providing security, making a gift, advancing a loan or giving up credits.

The most significant issue to consider is whether such a transaction takes place in the ordinary course of the company's business. If this is not the case, such transactions may be subject to possible avoidance in an insolvency situation. For instance, where a debtor is encountering financial difficulties, the debtor may dispose of its property and obtain proceeds from the sale in order to enable it to continue trading. It is clear that such disposal falls within the legitimate transactions entered into in the ordinary course of business. By contrast, if a debtor transfers its property at an unreasonably low

Notes

- 1 United Nations Commission on International Trade Law (UNCITRAL), *Legislative Guide on Insolvency Law* (2004) p. 135.
- 2 *Creditor Rights and Insolvency Standard*, Revised Draft (December 2005), the World Bank, p. 35.
- 3 For more knowledge of the British and Australian avoidance laws, see R. Parry, *Transaction Avoidance in Insolvencies* (OUP, Oxford, 2001); A. Keay, *Avoidance Provisions in Insolvency Law* (North Ryde, NSW: LBC Information Services, 1997).
- 4 A translation of the EBL 1986 is available at D. Boshkoff and Y. Song, 'China's New Bankruptcy Law: A Translation and Brief Introduction' (1987) 61 *Am. Bankr. L.J.* 359. The EBL 1986 only applied to state-owned enterprises (SOEs).
- 5 M. Simmons and J. Jiang, 'A New Insolvency Law in China' (2007) 4 *International Corporate Rescue* 10, 12-13.
- 6 A Translation of Enterprise Bankruptcy Law 2006 of PRC, available at (2008) 17 *International Insolvency Review* 33. For more details, see C. Booth, 'The 2006 PRC Enterprise Bankruptcy Law: The Wait Is Finally Over' (2008) 20 *Singapore Academy of Law Journal* 275; R. Parry and H. Zhang, 'China's New Corporate Rescue Laws: Perspectives and Principles' (2008) 8 *Journal of Corporate Law Studies* 113; L. Qi, 'The Corporate Reorganization Regime under China's New Enterprise Bankruptcy Law' (2008) 17 *International Insolvency Review* 13; M. Falke, 'China's New Law on Enterprise Bankruptcy: A Store with a Happy End' (2007) 16 *International Insolvency Review* 63; X. Wang, 'Study of Bankruptcy Revocable Rights' (2007) *China Legal Science*, Issue 5, 147 (in Chinese).

value, this is likely to fall outside the scope of its ordinary course of business. In order to identify whether a particular transaction is being carried out in the ordinary course of business, a number of criteria need to be considered, such as the intention and relationship of the contractual parties, the method, price and regularity of payment.⁷

In addition, insolvency laws should specify a period which is usually referred to as the 'suspect period' which operates retrospectively from a particular date, from the date an application for insolvency was presented to the court or from the date of the commencement of insolvency proceedings. The transactions subject to avoidance provisions can be set aside if such transactions occurred within the relevant 'suspect period'. Different suspect periods should be stipulated in relation to different types of voidable transactions.⁸

Transaction avoidance provisions under the old regime and revocable rights outside insolvency law

There were only two provisions in the EBL 1986 which regulated voidable transactions. The first provision related to preference transactions and provided that any payment, which was made to a particular creditor or creditors after a bankruptcy application had been accepted by the court, was void unless such payment was necessary for the normal production and operation of the debtor.⁹ The second provision specified five types of transactions which may be voidable in the event that such transactions occurred within the 'suspect period' commencing on the date six months prior to the court's acceptance of the bankruptcy application and ending on the date when the court declared the bankruptcy. These transactions included the following:

- (1) hiding property, secret distribution, or transfer of property free of charge;
- (2) sale of property at an unreasonably low price;
- (3) providing security for a debt which was previously unsecured;
- (4) making a payment in respect of a debt which is not due and payable; and
- (5) abandonment of credits.¹⁰

It should be noted that Article 12 of the EBL 1986 only regulated the preferential conduct after the bankruptcy application was accepted by the court. It, however, failed to stipulate preferential conduct which occurred within a prescribed period prior to the commencement of insolvency proceedings.

Article 35 of the EBL adopted objective criteria when considering whether a transaction may be voidable and specified a suspect period applicable to such voidable transactions. If a transaction did not occur within the suspect period, such transaction would not be set aside even though it was carried out with dishonest intent.¹¹ This was considered to be the biggest weakness within the old legislation because it provided an opportunity for a debtor to escape debt repayment obligations by disposing of or transferring property outside the suspect period.

It is important to note that the Chinese Contract Law 1999 provides a supplement to the old insolvency laws by setting out provisions enabling a creditor to challenge several types of transactions by the debtor.

Under the Chinese Contract Law 1999, a creditor can apply to court for setting aside certain transactions if a creditor's claim is damaged on account of the debtor's abandonment of credits or transfer of property without compensation.¹² A creditor can also apply to court for the setting aside of certain transactions if such creditor's claim is damaged on account of a transfer by the debtor of property at an unreasonable low price to a purchaser who is aware of the seller's intentions.¹³

It should be noted that a creditor can seek to have the debtor's voidable transaction(s) set aside through civil litigation outside formal insolvency proceedings, but the revocable transactions should be within the abovementioned scope.¹⁴

A notable feature of China's new bankruptcy law: the establishment of a transaction avoidance system

The old bankruptcy law was not used in courts as a means of disposing of assets of the debt-laden state-owned enterprises ('SOEs') and making distribution to creditors, but rather as an approach to avoid debt repayments. It was neither adequate nor effective to restrict the problematic SOEs from carrying out

Notes

7 UNCITRAL, n. 1 above, at 140.

8 The World Bank, n. 2 above, at 36.

9 Art. 12, EBL 1986.

10 Art. 35, EBL 1986.

11 For more details about the objective and subjective criteria, see UNCITRAL, n. 1 above, at 137-138.

12 Art. 74, first sentence, Contract Law 1999.

13 Art. 74, second sentence, Contract Law 1999.

14 X. Wang, *Bankruptcy Law* (2nd edn, China Renmin University, Beijing, 2007), p. 164 (in Chinese).

fraudulent transactions with the purpose of transferring valuable assets at an unreasonably low price or without compensation. After such transactions were completed, there was nearly nothing left for creditors.

When such an SOE was placed into formal insolvency proceedings, it was merely an empty shell. It was known as 'false bankruptcy, real escape'.¹⁵ In order to restrict a debtor's intention to initiate false bankruptcy liquidation proceedings and prevent a debtor from avoiding its repayment liabilities, the 'Regulation on Several Issues Concerning Hearing Enterprise Bankruptcy Cases' (the 'Regulation 2002') was adopted by the Supreme People's Court in July 2002. The Regulation 2002 provided that a debtor's insolvency application would be rejected by the court if such debtor was involved in hiding or transferring assets for the purpose of avoiding making payments to creditors.¹⁶

Although this provision could prevent formal insolvency proceedings being commenced against a debtor, it did not fundamentally deal with the debtor's dishonest transactions and protect the pool of assets available for distribution to the creditors. Therefore, the establishment of an effective legal framework in relation to voidable transactions became the aim of the insolvency law reforms.¹⁷ In the final draft of the new insolvency laws, there were four articles dedicated to dealing with voidable transactions.¹⁸ These articles were fully adopted by the EBL 2006. Each of these articles is analysed below.

Article 31: Revocable transactions

If a transaction involving debtor's property takes place within one year prior to the court's acceptance of a bankruptcy application, the administrator¹⁹ is entitled to apply to the court for revocation of such transaction. The following five types of transactions are caught by Article 31:²⁰

- (1) transfer of property without compensation;
- (2) transaction at an obviously unreasonable consideration;

- (3) provision of security for a debt which was previously unsecured;
- (4) making a payment for a debt which does not fall due; and
- (5) giving up credit as a creditor.

There is no need for an administrator to prove that a debtor made the above transactions with fraudulent intent. If the transactions occur within the one year suspect period and objectively lead to the reduction of assets of the debtor, the court can set aside the transactions and the assets which are depleted by such transactions can be claimed back.²¹ Under the new regime, the suspect period is extended from six months (as was the case under the old regime) to one year. This change recognises that very often there is a lengthy period between the point when a company starts facing financial difficulty and the actual commencement of formal insolvency proceedings. Accordingly, the shorter period under the old legal regime was not sufficient to cover the above transactions.²²

Transfers of property for no, or nominal consideration, may take place in the ordinary course of business. Sometimes, the value of the property which is transferred is very low. However, if such transfers occur, whether by gift or otherwise, within the one year period prior to the commencement of insolvency proceedings and cause a depletion of the debtor's assets, such transactions are also susceptible to be set aside.

It should be noted that on 12 May 2008, the Sichuan Province of China suffered a horrible earthquake and many Chinese enterprises made donations to support the local reconstruction. If such donations had been made within one year prior to a bankruptcy application against the company in question was accepted by court, such donation could be revoked according to the objective criteria specified in Article 31.

Transactions with unreasonable consideration could take place in two circumstances. The debtor may either purchase a property for an unreasonably high price, or sell a property for an unreasonably low price.²³ Both transactions would have the same effect, i.e. cause the assets of the debtor to be diminished. The key aspect of

Notes

15 A. Tang, *Insolvency in China and Hong Kong: A Practitioner's Perspective* (Sweet & Maxwell Asia, 2005), para. 3.71.

16 Art. 12(1), Regulation 2002.

17 S. Li, 'The Enactment of New Bankruptcy Law and the Chinese Credit Culture and System' (2005) *Jurists Review*, Issue 2, 17-18 (in Chinese).

18 Arts 18, 33, 34 and 35, Draft October 2004.

19 For more details regarding 'administrator' in the EBL 2006, see H. Zhang, 'A Notable Feature of China's New Bankruptcy Law: Administrator' (2009) 6 *International Corporate Rescue* 98; J. Shi, 'Twelve Years to Sharpen One Sword: The 2006 Enterprise Bankruptcy Law and China's Transition to a Market Economy' (2007) 16 *Norton Journal of Bankruptcy Law and Practice* 645; J. Ye, *Theory and Practice of Bankruptcy Administration* (China Commerce and Trade Press, Beijing, 2005) (in Chinese).

20 Art. 31, EBL 2006.

21 Y. Zhang, 'Analysis of Bankruptcy Revocable Act Regarding the Arts 31 and 32 of the Enterprise Bankruptcy Law 2006' (2007) *Law Science Magazine*, Issue 3, 71 (in Chinese).

22 W. Wang, *Interpretation and Substance of Bankruptcy Law* (Law Press-China, Beijing, 2007), p. 89 (in Chinese).

23 *Ibid.*

this sub-provision is the understanding of the term ‘obviously unreasonable’ and its subsequent application in practice. Fundamentally, three elements should be assessed: (a) the market price; (b) competition mechanisms; and (c) the legitimacy of the debtor’s conduct.

First, an administrator should ascertain the normal market price of the same type or a similar type of asset to the property which has been disposed of. Secondly, an administrator needs to identify the current market in terms of demand and supply for this type of asset. The price of a certain asset may significantly vary depending on the season.²⁴ Where there is a lot of competition, some assets are unable to be sold for a good price. Thirdly, an administrator should consider whether the debtor’s purchase or sale at an unreasonable price is legitimate. When a debtor is encountering financial trouble, it tends to sell certain assets to deal with cash flow problems. If the assets cannot be realised at a good price at that moment, the debtor has to accept lower bids because cash flow liquidity is urgent, otherwise the debtor will fall into further financial trouble.

Providing security subject to collateral is a standard transaction which could result in the increase of assets. Secured creditors will take priority in a liquidation process.²⁵ A company is able to use its assets to secure a new debt as long as it considers this necessary. It does not matter whether this happens within the one year period. The aim of the law is to restrict granting security in respect of a debt which was previously unsecured. The granting of such security may improve the position of an existing unsecured creditor over other unsecured creditors in the same rank, and as a result undermine the *pari passu* principle.

The repayment of a debt which is not yet due and payable also goes against the principle of a fair distribution. Such a transaction depletes the debtor’s property and deteriorates the potential recovery for other creditors.

Finally, giving up a claim as a creditor is another voidable transaction pursuant to which the sum due to the debtor will not be available for distribution to its creditors. By abandoning a credit, a debtor ignores the interests of certain creditors subjectively. Such transactions may be set aside provided that they occur within the one year period prior to the commencement of insolvency proceedings.²⁶

Article 16: Preference (after the acceptance of a bankruptcy application by the court)

Chinese insolvency laws provide a collective approach to the recovery of creditors’ claims and prohibit the enforcement of debts of individual creditors. Preferential repayment to a particular creditor or creditors violates this basic principle, whether this repayment occurs prior to or after the commencement of insolvency proceedings. The EBL 2006 sets out two provisions in relation to the pre- and post-insolvency disposals which are considered below.

Article 16 which regulates the post-insolvency preference follows the previous Article 12 of the EBL 1986. Article 16 provides that any payment to a creditor made after the bankruptcy application is accepted by the court is voidable. Two things should be noted. First, the new law adopts a strict approach – there is no exception for any form of repayment. Secondly, in addition to the administrator, any creditor can apply to the court for an order that the post-insolvency disposal be set aside.²⁷

Article 32: Preference (within six months prior to the acceptance of a bankruptcy application by the court)

An administrator is entitled to apply to the court for the setting aside of a preferential payment, if such payment was made to a particular creditor or creditors within six months prior to the commencement of insolvency proceedings, and the debtor was insolvent at the time.²⁸ The insolvency conditions include the following:

- (1) a company is unable to pay its debts when due and its assets are insufficient to satisfy its liabilities; or
- (2) a company is unable to pay its debts when due and the company obviously lacks the ability to repay all the debts.²⁹

There are three aspects that need to be noted here. First, in contrast to the voidable transactions set out in Article 31, the suspect period for a preference is six months rather than one year prior to the commencement of formal insolvency proceedings. Secondly, compared with the post-insolvency disposal provisions, there is an exception to the pre-insolvency preference. If the making of a preferential payment can increase the debtor’s assets, such payment will be not subject to challenge. Thirdly, only the administrator is allowed to apply to the court for the setting aside of any such transaction.³⁰

Notes

24 Y. Zhang, *Studies on Legal Regulations of Fraud in Bankruptcy* (Peking University Press, Beijing, 2008), p. 94.

25 Art. 109, EBL 2006.

26 X. Wang, *Bankruptcy Law* (2nd edn, China Renmin University, Beijing, 2007), p. 168 (in Chinese).

27 W. Wang, n. 22 above, at 46.

28 Art. 32, first sentence, EBL 2006.

29 Art. 2, EBL 2006.

Article 33: Void transactions

This article specifies two types of transactions which are voidable regardless of the time of occurrence. They are:

- (1) hiding or transferring the property for the purpose of avoiding creditors' claims; and
- (2) fabricating debts or admitting inexistent debts.

The term 'hiding' means that the property in question is moved to a secret place of which the creditors are not aware, and this information cannot be ascertained from the debtor's balance sheet. Normally, the debtor 'hides' its property with the intention to avoid paying certain debts. The transfer of property is normally a transaction undertaken in the ordinary course of business, but carrying out such a transaction with a dishonest intention to avoid paying debts causes this transaction to be voidable. However, the biggest practical difficulty for the applicant will be to find evidence to assist in tracing the 'hidden' property.

Fabricating debts occurs when a debtor intends to create debts by fabricating a contract or invoice, and as a result, the debtor's assets are reduced by realising these false debts. Admitting inexistent debts can be explained by the fact that the debtor and a third party have fraudulent intention to defraud creditors. The third party requests the debtor to make payment in respect of an inexistent debt, while the debtor recognizes the debt and makes payment which will diminish the debtor's asset pool.³¹

It should be noted that an administrator is not the only person who can apply to the court to challenge such transactions. Any creditor can initiate legal proceedings in respect of the voidable transactions. In addition, there is no suspect period. Article 33 adopts subjective criteria and no exception is available for a debtor. If a debtor conducts a false bankruptcy by hiding assets or making payments in respect of fabricated debts, causing a serious loss to creditors, the directors and the relevant management staff of the debtor may face criminal penalties. The penalties are severe and may lead to up to 5 years imprisonment and/or a fine in an amount ranging from RMB 20,000 to 200,000 Yuan (equally GBP 1,857 to 18, 570).³²

Potential problems

There are two major problems associated with the Chinese transaction avoidance proceedings. The first one is the availability of funding. Insufficient funds for the litigation in relation to voidable transactions impose a restriction on the efficacy of anti-avoidance proceedings.

In China's new bankruptcy law, the expenses of conducting avoidance proceedings do not fall within the scope of liquidation expenses (liquidation expenses rank first in the order of distribution). Liquidation expenses only encompass the following:

- (1) litigation costs of a bankruptcy case;
- (2) costs associated with management, appraisal, disposal and distribution of the debtor's estate;
- (3) expenses arising out of an administrator performing his functions, including the administrator's remuneration and the expenses for the staff hired by the administrator.³³

In addition, costs associated with the commencement of avoidance proceedings cannot be treated as debts of common interest which includes the following:

- (1) debts incurred by the administrator or the debtor to request the parties to a contract to complete the performance of that contract;
- (2) debts incurred from voluntary service to the debtor's property;
- (3) debts incurred from unjust enrichment to the debtor's property;
- (4) wages and social insurance to the workers for the continued operation of the debtor and other debts incurred as a result thereof;
- (5) debts from a tort claim incurred by the administrator or other relevant personnel;
- (6) debts from a tort claim incurred by the debtor's property.³⁴

Since the law excludes the expenses of initiating avoidance proceedings from liquidation expenses and debts of common interest, the administrator has to obtain the necessary funds from a third party who is willing to advance such funds.³⁵ The shortage of resources

Notes

30 W. Wang, n. 22 above, at 93.

31 W. Wang, n. 22 above, at 95-96.

32 Art. 6. Criminal Law Amendment Six 2006.

33 Art. 41, EBL 2006.

34 Art. 42, EBL 2006. Debts of common interest are also ranked in the first place with liquidation expenses, according to Art. 113 of the EBL 2006.

35 UNCITRAL, n. 1 above, at 150.

may to some extent restrict the commencement of transaction avoidance proceedings.

The second problem is the legislative lacuna surrounding the time limits for initiating avoidance proceedings. Insolvency laws should specify a period within which the avoidance proceedings should be commenced. This period might start from the date that either the commencement of insolvency proceedings becomes effective, or the administrator discovers the voidable transaction(s). It does not matter which approach is adopted. The time limits should be established, and the time period should not be very long. This could effectively avoid uncertainty in relation to the debtor's assets and insolvency proceedings.

Conclusion

A notable feature of China's new bankruptcy law is that a legal framework in respect of transaction avoidance has been established. It can effectively maintain the collective approach to the bankruptcy law and encourage fair treatments of creditors in the same rank. Avoidance proceedings can prevent an insolvent debtor from avoiding debt repayment and claim the property, which is disposed by way of a voidable transaction, back to the asset pool of the debtor. Even though there are still some problems within the relevant provisions, the new law has made a great step forward.

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