In the second part of this essay I will be examining the key policy motivations behind the Quistclose trust and I will assess if the Quistclose trust is being employed by the judiciary as a tool to achieve fairer decisions in the commercial realm. I will also consider whether the Quistclose trust should be subject to the registration regime.

Policy motivation

From analysing the earlier authorities preceding Quistclose Investments like Toovey v Milne,1 Moore v Barthrop,2 Edwards v Glyn,3 Giber v Gonard,4 Re Rogers5 it’s clear courts favour claims made by lenders to companies struggling financially. There is a clear public interest in encouraging lenders to make credit available to struggling companies. The courts via the vehicle of the Quistclose trust have provided an incentive for lenders to do so by ensuring that until the money is applied for the purpose the money will be beneficially vested in them, so that if the company does go insolvent in the meantime the money is securely held for them. Though the judiciary have actively sought to upheld this policy view it’s unclear whether the legislators endorse this extra level of protection for lenders in corporate rescue situations.

The Insolvency Service published a consultative paper6 exploring the possibility of giving lenders who give funds to a company in a company voluntary arrangement a statutory super priority (SSP) ‘One option for guaranteeing funding during a moratorium is to introduce the concept of statutory super priority so that providers of funding during this period can have priority over all existing creditors. This is a concept found in the USA Chapter 11’7 However this suggestion was quickly dashed on the premise that ‘competition between lenders to provide SSP funds (with repayment having priority over all existing debts, including secured debts) might mitigate against the proper consideration of the viability of the business by a lender’.8 This seems to betray an unwillingness to give lenders who are providing finance in a moratorium an extra dimension of protection. Companies who are in a CVA are in a more desperate position than company’s who are struggling before a winding up petition is served so if there is no desire to aid lenders in CVAs its unlikely legislators will want to provide extra protection to lenders providing money before a CVA.

The Quistclose trust is built upon the backdrop of corporate rescue scenarios, the judiciary in these cases have shown a willingness to allow lenders to be treated as a beneficiary, however these reports from the Insolvency Service doesn’t replicate this attitude or policy motivation. It could be that the Insolvency Service believes that the Quistclose trust provides enough security for lenders in corporate rescue situations and they do not wish to build on this.

If this is the case any attempts to constrain Quistclose trusts via imposing registration requirements on them or downgrading the current ultimate priority they have would be severely damaging and will inhibit investors from providing funds to struggling companies. Furthermore under the SSP the lender would become a creditor so would still be placed in an insolvency queue and would be affected by deductions of liquidation fees etc.9 Whereas the Quistclose trust gives the lender ultimate protection as the property is cocooned from all creditors as the property is trust property it was never part of the company’s general funds. So if the Quistclose trust retains the priority it currently enjoys it offers lenders an infinitely superior protection than

Notes

1 Toovey v Milne (1819) 2 B. & Ald. 683.
2 (1822) 1 B. & C. 5.
3 (1859) 2 E. & E. 29.
4 (1884) 54 LJ (Ch.) 439.
5 (1891) 8 Morr. 243.
7 Ibid., para. 2.29.
the scheme rejected by the Insolvency Service and will therefore continue to encourage lenders to lend to struggling companies.

Additional policy motivations behind the Quistclose trusts

Over the years the Quistclose trust has been applied outside of the corporate rescue context as controversially marked in Re Kayford Ltd., the courts have deviated from their preoccupation with creditors who make money available to financially frail companies and are now focussing on the plight of non trade creditors.

Re Kayford Ltd

A company which carried out a mail order business was in financial difficulties so it sought advice about how best to go about protecting its customers. Its customers were sending money to the company in anticipation of receiving the goods they had ordered. The company were advised to open a new account branded as the ‘Customer Trust Deposit Account’ and to ensure all the money sent by the customers were placed in that account. This would ensure that if the company went into liquidation these funds could be refunded to the customers seamlessly. The company followed this advice but instead of opening a new account they utilised a dormant company account. The company went into liquidation and Megarry J held that a trust had been successfully created for the customers as it ensured the moneys beneficial ownership remained with those that transferred the money initially.

Megarry J went on to state a trust could be created by the transferor using appropriate words to showcase the desire to retain the beneficial ownership or the recipient could take suitable steps before or when the money is received. However concern lingers over this judgement as it flirts dangerously close to being perceived as a fraudulent preference. It is clear from the case that the customers had no desire to create a trust or ensure that their payments were safeguarded in any way as far as they were concerned they were sending in money in exchange for goods there was no contemplation of the company going into insolvency. Therefore they sent the money in without any note or any letter stating that the money should be held separately or that the money should remain theirs in equity until they receive the goods. There is no need to use trust language or even know what a trust is but there must be some evocation of intent to achieve something similar to a trust – which there isn’t.

This leads us to the conclusion that the customers intended the money to be owned absolutely by the company. And if the company received the money on these terms it means the money was owned beneficially and legally by the company on receipt and on receiving the money the company declared themselves trustee over the funds and put it in a segregated account. This is heavily indicative of a fraudulent preference as if the company takes steps over property it wholly owns which has the effect of altering the statutory order of priorities it is a fraudulent preference. A fraudulent preference is defined as putting a creditor ‘into a position which, in the event of the company going into insolvent liquidation, will be better than the position he would have been in if that thing had not been done’ and this preference must be made within 6 months of the commencement of winding up if the creditor is a non connected person and 2 years if he is connected (i.e. family/friend/employee of the company). As the company had no obligation or any external pressure exerted on it to establish the trust it is easy to find a desire to prefer the consumers over other creditors.

‘The customers never knew of Kayford’s intention to create a trust ... If Kayford, on receiving a customer’s cheque, had decided to pay it into its ordinary account rather than the trust account, could the customer (assuming that he subsequently discovered all the relevant facts) have compelled Kayford to pay the money back into the trust account? The answer, it is suggested must be “no”’ this further elucidates that the money was not subject to a trust on receipt so it must be the company’s property.

Yet Megarry J rebuked such a suggestion stating ‘one is concerned here with the question not of preferring creditors but of preventing those who pay money from becoming creditors by making them beneficiaries under a trust’. This seems to skip the assessment of whether or not this fits into the criteria of a fraudulent preference and instead is restating that the company has ensured the customers are not creditors and instead are beneficiaries by employing a trust structure, this is not disputed, what is queried is did the company

Notes

10 [1975] 1 WLR 758 at p. 281.
12 Insolvency Act 1986 s. 239(4).
14 Re Kayford Ltd[1975] 1 WLR 758 at p. 281.
by making the customers beneficiaries commit a fraudulent preference.

The decision in Re Kayford Ltd also conflicts with British Eagle International Air Lines Ltd. v Compagnie Nationale v Air France. In the case both parties were members of IATA whose rules regulated inter-airline transactions and at the end of each month whichever airlines were in net credit on all its transactions could get credit from IATA and those who were in net debit were required to pay the amount of debit to IATA so there was no scope for direct settlement between the airlines. British Eagle was in net debit to IATA but there was a credit balance on its transaction with Air France. The liquidator sought to recover the credit balance from Air France and IATA refused stating its arrangements allowed the IATA not to be treated as ordinary unsecured creditors instead its regulations elevated them to the status of secured creditor. The House of Lords firmly rejected this, stating that the agreement was contrary to public policy if it was allowed to dictate on insolvency as it would infringe the pari passu principle.

So it follows 'if the company had unilaterally created a trust over its own property for the purpose of ensuring that one group among the persons who had dealings with it should escape unscathed from the contemplated crash, that trust would also be contrary to the policy' yet Megarry J chose to ignore this and decided in favour of the customers.

Furthermore there is a veiled admission from Megarry J that he would perhaps not be inclined to be so lenient and allow a valid Quistclose trust here if the creditor were usual trade creditors he states consumers ‘can ill afford to exchange their money for a claim to a dividend in the liquidation, and all of whom are anxious to avoid this’. He also compounds this point by stating that the company should be applauded for taking such action to shield its consumers and more companies should take such initiative in the future. Though the company was ‘protecting a body of creditors who by their payments are swelling the assets of the company, in ignorance of the risk they are running and without the means to bargain for security, may be commendable’ (Stevens). It doesn’t seem correct for the courts to prefer the claim of certain creditors over others and apply the law differently based on the vulnerability of the creditor.

In addition, the courts sympathetic attitude towards consumers is troubling as it doesn’t tally with the mood of the legislators as the insolvency regime does not allow certain cohorts of creditors to be elevated in insolvency via creative decision making on the courts part.

Furthermore, there is no desire to progress in this direction as recommendations from the Cork Committee can testify ‘the Cork Committee on Insolvency Law and Practice stated customers who pay money in advance for goods or services to be paid for later extends credit just as surely as the trader who supplies in advance goods or services to be paid for later. There’s no essential difference as each give credit.

However there is a strong argument in favour of a level of protection to be emplaced for consumers as purported by Samuels ‘The trader giving credit is able to use his trading skill and experience: he can make inquiries, he is aware of the risks, he expects risks, he is making a commercial judgment … The prepayment consumer, by contrast, is a layman.’ Samuels argues that a ‘consumers prepayment trust account’ should be mandatory for all companies to have in place to protect customers.

Such a requirement imposed by statute would resolve the ambiguity in this area of the law however by elevating some categories of creditors by the guise of the Quistclose trust is extremely disruptive to this area of insolvency law especially as the courts decisions are based more on its perceived vulnerability of a group of creditors. It also has the adverse effect of hampering trade creditors position, as lenders of credit to struggling companies and consumers are protected it has the unfortunate effect of further relegating the unsecured trade creditors prospects. It has long been accepted by the courts that the unsecured creditors are in the most disadvantageous position especially after the advent of the floating charge. However by elevating certain unsecured creditors via the vehicle of a Quistclose trust the fortunes of the remaining unsecured creditors are further weakened. Instead parliament should look to improve the position of the unsecured creditors collectively.

Yet the decision in Re Kayford Ltd was upheld in Re Chelsea Cloisters Ltd by the Court of Appeal. In this case a company which was the under lessee of a block of flats granted numerous tenancies and it took deposits from all tenants which reflected the sum which the tenants may owe at the end of their tenancy for any damages caused to the flat whilst they resided there.

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18 The Quistclose Trust, Critical Essays, p. 158.  
21 Ibid.  
But the company went into financial difficulty and a chartered accountant who was appointed to supervise the running of the company advised the company to set up an account to hold the tenants deposit separately from the companies general assets. The company went into liquidation and it was held that the money was held on trust for the tenants. The argument of fraudulent preference wasn’t raised in this case although Lord Denning did say that the deposits weren’t impressed with a trust from the very beginning. It’s also quite notable that no trust language was used by the chartered accountant who would have been very familiar with the construct so it seems to indicate once again the courts have exercised ‘discretionary justice’23 to safeguard the non trade creditors here (the tenants) who were ill equipped to protect themselves.

Also the company owed GBP 50m in debt and the tenants deposits equated to GBP 20,000 so instead of spreading that small sum between all the creditors it seemed much more pragmatic to give the tenants the sum in full. Though from a pragmatic perspective this seems justifiable this has the effect of bringing uncertainty into the area of insolvency as it now seems to suggest that if certain creditors are owed a small sum of money in regards to the overall sum owed collectively to the creditors the courts may be inclined to allow a trust to be found if the money is segregated. This leads to the law in this area being applied sporadically and in an unfair manner as it will allow some creditors to be repaid in full even where no trust was intended as the facts seem to suggest here, while others will be deprived.

**Quistclose trust:** A vehicle employed by the judiciary to reach just decisions in commercial transactions?

It has been argued by commentators like Goodhart and Jones24 that the Quistclose Trust is being utilised by the judges to help reach fair decisions in commercial transactions. A Quistclose trust is only asserted by a creditor who would otherwise be an unsecured creditor, the courts have embraced these claims, but it seems that the courts have been heavily influenced by the facts and have sympathised with the lenders position and have sought to rescue them from the perilous position of an unsecured creditor.

For example in Barclays Bank Limited v Quistclose Investments the courts sympathised with Quistclose Investments attempt to help salvage Rolls Razor and believed it would be incredibly inequitable for the unsecured creditors to obtain a windfall when this aim was not achieved. Similarly in Re Kayford Ltd there was great sympathy for the customers becoming unsecured creditors particularly as they did not have the bargaining power to negotiate with the company initially to obtain protection as the trade creditors did. It seems to suggest that the courts are utilising equitable principles to achieve fairer results in commercial transactions.

Though this is commendable courts seem to be particularly influenced by the surrounding facts of the case and the vulnerability of the providers of finance and have overlooked gaps in the evidence provided to establish a proprietary interest. For instance in Re Kayford Ltd there was a strong case for the trust to fall foul of the fraudulent preference rule but this point was largely unanswered. Exercise of such discretionary justice will introduce uncertainty into the commercial realm which is highly undesirable as parties may feel they are at the whim of the courts when deciding upon the existence of a Quistclose trust.

**Quistclose trusts — should they be subject to the registration regime?**

Due to the increasing width and scope of the Quistclose trust the question is prompted as to if it should be classified as a security interest and if it should be added to the list of security interests which need registration.

The Law Commission in its review of personal property security legislation25 in England and Wales defined security interest as a ‘transaction that secures payment or performance of an obligation’. The Commission have proposed that the present system on registration of security interests should be abolished and replaced by a new ‘first to file system’ which will determine priorities. They have also asserted that many quasi security interest’s will be deemed to be a security interest and will be subject to the new registration requirements whilst some will be acknowledged as security interests but will not be included in the regime.

The commission firstly looked at declaration of trusts and declared that they must be subject to the notice filling regime. However in coming to this conclusion the Law Commission have construed declaration of trusts to be treated like a charge if it manages to secure payment or performance, the paper stated a person ‘in principle can create an effective equitable charge over chattels by declaring that he holds them in trust for a creditor by way of security for the specified debt’.26 This

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**Notes**

26 LCCP 164, para. 7.46.
leads us on to the conclusion that ‘declarations of trust which amount to a security interest are in fact charges. It must therefore follow that they are not valid trusts. This means that if the device is a valid trust then it cannot be a charge’.27

The Law Commission have muddled the issue it is correct to suggest that trusts if have the effect of securing payment or performance they should be termed a security interest which needs to be registered, however to bring them into this category of registrable security interests by analysing them as a charge creates uncertainty. And seems to suggest the Commission are uneasy with treating trusts as security interests which require registration which is why they feel the need to reclassify declarations of trusts into charges. It also indicates that the Law Commission don’t feel that trusts naturally belong on the register.

The Law Commission dealt with Quistclose trusts separately and announced that it should not be subject to the registration requirements but Glister28 elucidates that the justifications given for this conclusion are rather convoluted which seems to be testimonial to the courts and legislators continued confusion over the device and its characteristics. The Law Commission states ‘we would regard this sort of transaction as one arising by operation of law and hence outside the scope of our proposed system’.29 The Law Commission have isolated the Quistclose trust from regular trusts perhaps as it plays a big part in corporate rescue.

Glister points out that not all Quistclose trusts arise by operation of law many are express trusts which arise solely based on the parties intentions and even resulting trusts have same basis in the party’s intentions. As they arise by way of the parties intentions this strongly undermines the assertion that beneficiaries will not know about the trust and therefore won’t be able to register it.

Instead Glister argues the Quistclose trust should be excluded from the notice filling regime due to a number of other reasons. First of all Quistclose trusts unlike other security devices only relates to funds the lender himself has provided and doesn’t encapsulate any of the borrowers other property like a floating charge does so the consequences of a Quistclose trust is much less far reaching. And the protection it provides disappears as soon as the money is spent and the lender becomes an unsecured creditor so the protection lasts for a very small period, whereas security devices like fixed and floating charges remain intact after the money supplied by the lenders have been expended and they pertain to assets other than the funds they have transferred. Also ‘the floating chargor is free to deal with the charged fund without encumbrance in the normal course of his business, the Quistclose borrower is only free to apply the property for a specific purpose’.30 Furthermore, fixed charges will probably pertain to assets which are higher in value then the money the lender lent whereas in a Quistclose trust the protection extends only to the funds given to the borrower.

Quistclose trusts have been repeatedly compared and paralleled with Retention of Title clauses, the commission have included ROT’s in the notice filling regime which prompts the question why has the Quistclose trust been excluded despite the similarities the ROT clause and Quistclose trusts share. However there are some distinguishing features which helps to mark the ‘breadth of security the ROT affords’31 in comparison with the Quistclose trust. All monies ROT’s extend to cover past and previous debts owed to the seller whilst the Quistclose trust only covers the one debt. The ROT allows the buyer to manage the goods however he likes whereas in the Quistclose trust strict instructions govern the funds use.

From a pragmatic view the Quistclose trust should not be made subject to the registration requirements as the main point of the registration system is to inform those dealing with the companies that assets which seem to be the company’s are owned by others, so these parties aren’t induced into making credit or products available to the company on assets they believe are unencumbered. As it gives a warped view of the company’s financial position and the pool of assets available if the company goes insolvent.

However in Quistclose trusts money is usually given in a corporate rescue scenario usually at the eleventh hour so creditors won’t be induced by the sudden influx of credit in the company to give more funds or products to the company without realising the money is subject to a trust and won’t be available for distribution on insolvency. And as Glister points out the money will probably be spent very rapidly ‘to require notification of an interest which is likely to disappear in a couple of days might be seen as burdensome’.32 Bridge also states that funds ‘paid over on Quistclose terms add value to the payee company and do not upset the risk calculations of the company’s other creditors. The monies

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28 Ibid.
29 LCCP 164, para 7.53.
31 Ibid.
32 Ibid.
represent short-term assets as far as the company are concerned and do not mislead outside creditors”. 33

Furthermore, there is a legitimate policy angle to be considered, the trust gives those lending money to a flailing company an extra sense of security. If we were to impose a registration requirement which some lenders forget to observe, they would lose their equitable interest in the money, and this would deter a lot of creditors from extending finances in those situations. This would deprive struggling companies of much needed credit which could help to salvage the business and all those connected with the business (employees/trade creditors/local economy).

After construing the Law Commission’s paper it is also important to note that whilst the paper has advocated that the Quistclose trust be exempt from the registration requirement it is unclear as to whether they would retain the ultimate priority they enjoy under the current regime on insolvency. The paper has advocated for ‘Purchase Money Security Interests’ to have super priority – this allows funds advanced for the purchase of new property to attain super priority on insolvency, so cases like Twinsectra where the purpose of the Quistclose trust is to acquire new land will fall under this category and will receive super priority. However Quistclose trusts which are for the purpose of allowing the borrower to pay off his existing creditors like Barclays Bank v Quistclose Investments, Tookey v Milne and Moore v Barthrop would not fall into this category. The Commission have specifically illustrated that though they will take a pragmatic approach when assessing if a transaction fits into the class of ‘Purchase Money Security Interests’ it is highly unlikely any advance provided to a company to aid the repayment of existing debt will fall into this class as it is not adding fresh value to the company.34

By this distinction of sorting transactions into Purchase Money Security Interest’s and non Purchase Money Security Interests the commission give on the one hand by allowing Quistclose trusts to remain outside the notice filling regime, but take with the other by not allowing Quistclose trusts super priority if the money was advanced for the purpose of paying of old creditors; it unravels the good that was achieved by excluding Quistclose trusts from the notice filling regime.

Traditionally the Quistclose trust was focused on the repayment of pre-existing creditors this is seen as the purest form of the trust, though it has evolved to encapsulate other purposes the original context in which the device was formulated was in the backdrop of impending corporate insolvency, when money was supplied to satisfy existing debts to salvage the company. By not allowing lenders in this scenario to achieve super priority has the effect of ripping the heart out of the device. As astutely summed up by Glister ‘it would not be surprising to find investors more hesitant to the idea of advancing funds to a troubled company’. 35

Even if the Law Commission addressed this issue and allowed for all Quistclose trusts to have super priority the priority only relates to certain other creditors, so the ultimate protection that Quistclose trusts currently get will be lost as the assets will no longer be insulated from all creditors.

Though concern has been expressed throughout this paper of the device’s width and scope being extended by the judiciary it seems that not all Quistclose trusts will get the wide ranging protection currently given, which will limit the overall impact of the trust on insolvency. Though this is comforting if the Commission was aiming to constrain the application of the doctrine they should have looked to restrict the scenarios in which a Quistclose trust can arise in. For example they could have prescribed the trust can only arise where a lender is giving money for the purpose of saving a financially unstable company. This would have the effect of overturning decisions like Re Kayford Ltd, Re Chelsea Cloisters and Twinsectra (as suggested by Smolyansky above).

They could have also enhanced the requirements needed to establish the trust in the first place by instructing courts to look for a positive intention to retain the beneficial interest in the funds and to place an emphasis on substance over form, urging courts to look at the surrounding situations. This would lead to Quistclose trusts not being found on the basis of weaker facts where for instance a vague restriction has been placed on the use of the money but no clear intent is displayed to achieve a trust. They could also restrict Quistclose trusts from arising as a resulting trust or as an operation of law where the courts find meagre evidence showing the lender didn’t intend the borrower to benefit from the funds. This would have helped restrict the number of cases arising under the device to a small number where both parties actually intend the trust to arise.

They could also propose that the evidentiary standard needed to establish a Quistclose trust could be further heightened based on the level of the company and the solicitors and advisers working for them. So if it’s a FTSE 100 company or its private equivalent or a prestigious law firm is working on the case and they try to assert a Quistclose trust has been established you

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34 LCCP 164, para. 4.159.
need to see overwhelming evidence to prove this as they are familiar with the device and its working so if they intended it to be used it should have been used clearly. The Commission could make an exception in such a scenario and stipulate that explicit trust language must be used. Smaller companies can be excused from such requirements as they do not have a fleet of reputable solicitors and advisors working for them and may not be familiar with trust structures. A lower standard could be imposed, like discovering a clear intent for the lender to retain an interest in the funds advanced.

In addition, the commission could reinstate the importance of the assets being segregated which Twinsectra devalued, and they could also state that the purpose for which the money is given must be very specific so stipulations like the money is for the ‘acquisition for property’ as in Twinsectra is not sufficient. If the commission wanted to really narrow down the cases under the Quistclose trust they could specify that the trust will only apply when the purpose is something the lender cannot achieve without the borrower and needs the borrower to act as a conduit. As in Quistclose Investments the lender could not pay the dividends to the shareholder it had to come from the company and so the lender had to transfer the money to the borrower.

However by not restricting the application of the device by heightening the requirements needed to prove a Quistclose trust, and instead allowing the trust to emerge in lots of contexts based on very little evidence and just watering down its effect on insolvency will lead to all lenders receiving a lower level of protection including those who genuinely intended to create a Quistclose trust and clearly evidenced this desire. This will further inhibit lenders from offering finance to financially frail company’s especially if the money is to pay existing creditors.

**Conclusion**

To conclude it is clear that the scope of the Quistclose trust has been widened by the courts in an attempt to allow certain creditors to escape the harsh realities of being an unsecured creditor. Though originally the finding of a Quistclose trust was based on strong evidence especially focused on the party’s intent this has recently been diminished by the courts and this must be reinforced to reach fairer and more consistent decisions in this area again.
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