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COMMODITIES LITIGATION

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corporatedisputes@financierworldwide.com

HOT TOPIC

COMMODITIES LITIGATION

PANEL EXPERTS

Robert Bright
Barrister
7kBW
T: +44 (0)207 910 8300
E: rbright@7kbw.co.uk

Robert Bright QC practices primarily as an advocate and case-leader with experience in a broad range of commercial litigation. Recent and ongoing arbitrations include a very large number of LMAA arbitrations as well as several LCIA and ICC arbitrations. Mr Bright also regularly sits as an arbitrator both in London and overseas. His work as an advocate has included involvement in several international arbitrations taking place in Europe, Singapore, Hong Kong and Malaysia.

Evan Koster
Partner
Hogan Lovells
T: +1 (212) 918 8260
E: evan.koster@hoganlovells.com

Evan Koster is a partner at Hogan Lovells whose experience is both broad — including all asset classes, such as commodities, fixed income, foreign exchange and equities — and narrow, including energy derivatives and energy trading. In addition to his transactional work, he counsels clients regarding Dodd-Frank derivatives regulatory and compliance issues, and has been active in advocacy related to the Dodd-Frank rulemaking process.

Brian T. Daly
Partner
Schulte Roth & Zabel
T: +1 (212) 756 2758
E: brian.daly@srz.com

Brian T. Daly advises hedge, private equity and real estate fund managers on regulatory, compliance and operational matters. He has extensive experience designing and improving compliance processes and organisational systems and helps clients navigate their initial and ongoing regulatory compliance obligations under the rules and regulations of the Securities and Exchange Commission, the Commodity Futures Trading Commission and the National Futures Association.

David M. Edwards
Partner
Skadden, Arps, Slate, Meagher & Flom (UK) LLP
T: +44 (0)20 7519 7287
E: david.edwards@skadden.com

David M. Edwards is a partner at Skadden, Arps, Slate, Meagher & Flom, based in London. Recognised as a rising star in the field of international arbitration, Mr Edwards' experience with major international disputes spans the energy, telecom, pharmaceutical, banking and finance, commodities and offshore construction industries, in which he has acted as counsel to many of the world's largest corporations and high-net-worth ultimate beneficial owners.

Tom Rodd
Senior Associate
Stephenson Harwood LLP
T: +44 (0)20 7809 2553
E: tom.rodd@shlegal.com

Tom Rodd is a commodities and shipping lawyer specialising in transactional and contentious matters involving sale contracts, letters of credit, bills of lading and charterparties. With particular expertise in crude oil, petroleum products, agricultural products, iron ore and coal, his commercial approach in advising clients was developed from a period in-house for an investment bank in Singapore.

CD: Could you provide a brief overview of the key issues currently facing commodities markets? To what extent are these issues causing disputes resulting in litigation?

Rodd: The commodities supercycle ended with a fundamental shift in supply and demand, which led to a downward trajectory in prices. The sector has been grappling with this slump in prices since 2011 and a quick recovery has proved elusive. Furthermore, global growth has slowed. This has been marked in the emerging market of China, the world's largest consumer of raw materials, and also in Brazil and Russia. Indeed, few thought the price of oil would drop below $30 per barrel or copper would trade below $4000 per ton. There has also been geopolitical instability. While there are opportunities with new markets like Iran, the sector is adapting to these shifts. The macro market issues have created a tougher market in which to operate. As a result, we have seen a greater willingness on the part of suppliers to litigate against their customers, and customers to litigate against their suppliers, especially where traditionally they would not have done so, in order to preserve a commercial relationship.

Daly: There are two sources of litigation exposure in the commodities markets – CFTC-level violations and exchange-level violations. At the CFTC level, we are seeing more traditional allegations of fraud, such as Ponzi schemes and garden-variety fraudulent misrepresentations, and actions focusing on improper, manipulative or deceptive trading.

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The trading bucket encompasses enforcement triggers such as insider trading, where the CFTC is now actively exercising its enforcement muscles under the relatively new Rule 180.1, 'spoofing' and other manipulative trading. We have also seen a surge in enforcement activity at the commodities exchange and – even more recently – at the swap exchange facility level. These actions are generally quite technical in nature and do not involve any manipulative intent or effect, but can result in a public order that hedge fund managers are required to disclose to investors. These are the most frustrating cases to defend because all sides will readily agree that the violation did not cause any harm and that there was no scienter on the part of the manager, but the exchanges feel that the CFTC is demanding that they fine and punish even inadvertent offences.

Koster: Before the US election, the main challenges facing the commodities markets were, namely, large amounts of supply, as well as decline in demand from India and China, due to slow demand and growth in emerging markets; declining commodity prices; and the fact that commodity related investment was largely debt-financed, through the use of increased leverage to expand production, where buyers and producers providers used leverage, assuming that revenue streams would continue to be robust, but such streams were commodity-price dependent. When prices declined, these firms' negative exposure increased. These issues have led to increasing litigation, particularly contract disputes and bankruptcy related litigation. After the election results, however, arguably the greatest challenge may be where president-elect Trump's policies on trade will go and their possible effect on commodity supply and demand. There are a number of potential scenarios. However, if an aggressive protectionist policy is adopted in the US, this could have a depressing effect on commodity flows, although a positive effect on price.

Edwards: Price volatility is, as ever, a key factor in the generation of litigation. While clients are accepting of the vagaries of the commodities markets, which is really a necessary prerequisite to any involvement in the commodities trade, the impetus to pursue disputes is heavily influenced by the realities affecting the base assets. This is nothing new, but it is the single biggest factor in movement in the litigation 'market' aspect of this business. Perhaps unsurprisingly, as the market price for the relevant commodity in raw form starts to soften, counterparties to long-term contracts start to pay closer attention to the terms of supply contracts in the hope that an exit path may be found, to their advantage. Similarly, preventative analysis is often carried out by parties of opposing persuasion, to 'keep an eye' on tricks that a counterparty may seek to employ in such a situation.

CD: How would you characterise the impact that plunging commodity prices have had on disputes in this space?

Bright: All market volatility generates disputes. But very dramatic downturns, such as those some trades have experienced at various times in recent years, have resulted in some players going bust – which makes recovery uncertain. Reduced margins

also mean that there is simply less to fight over. In a lot of sectors there has been noticeable market contraction and consolidation, leading to fewer players remaining active in the market.

Koster: Litigation in states which are energy dependent has increased. For example, litigation in the Texas energy sector has increased substantially as a result of the drop in oil prices; cases related to unconventional oil & gas litigation in Texas have risen approximately 180 percent since 2014. Producers have expanded their operations due to increased liquidity, but this has proved unsustainable with the lower-price environment.

Rodd: A key feature of most commodities markets is that the commodities are bought and sold in chains. In this way, the exposure of the various participants to different parts of the chain is different and price movements can affect parties differently. This leads to litigation with regard to the particular transaction. More generally, of course, plunging prices put pressure on suppliers to chase debts and enforce legal rights more readily. End users may appear immune to plunging prices, but they would also be affected by problems in the contractual chain that ends with them, and this creates uncertainty. Further, there is also an impact on the traders that sit between those parties, as they may be stuck with unprofitable long-term supply contracts. This has been reported in the media with traders shutting down unprofitable business units and restructuring. Further, a downturn in activity generally creates issues on the shipping side and potentially causes disputes, which can manifest as ship arrests or insolvencies in the charter chain. The recent examples of OW Bunkers or Hanjin illustrate the problems, as if vessels are arrested or parties in the charter chain go under, this may have repercussions for the sale contract string, as the carriage of cargo is affected. Finally, pricing is a factor giving rise to disputes. The classic example is a party looking to exit an unprofitable contract without legal grounds, which has been referred to as 'price majeure'.

CD: What are some of the common types of commodities-related litigation that you have seen over the last year or so?

Bright: There is no normal, apart from the truism that most disputes begin with a contract that is, or becomes, adverse to one or other party. Recent cases include disputes about quality, quantity, title, delay, shipping terms and payment obligations – but price is always a factor. Less common but sometimes more intellectually challenging issues include illegality and force majeure. In geographical terms, Asia remains the biggest generator of disputes, whether in terms of buyers, mostly in China but also India, or suppliers, especially Indonesia, which in my experience manifests an unusually high rate of contractual disputes.

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Koster: The most common types of commodities related ligation we have seen in the last year have been contracts disputes; regulatory investigations chiefly involving anti-fraud and anti- manipulation, bankruptcy litigation, workouts, royalty disputes, Fair Labour Standards Act class actions and other employment disputes, lawsuits related to pure economic distress, such as simple contracts breach claims, and nuisance cases for energy companies in Texas, Pennsylvania and other areas with significant or developing oil & gas production, such as pricing review disputes. Notably, we have seen increased litigation in the liquefied natural gas space.

Edwards: Disputes arising from failures to accept cargoes – attributable ultimately to market movement driving a desire to avoid an existing obligation – are as common as ever. There has been heightened activity around issues with obtaining suitable trade credit and payment instruments, especially letters of credit from acceptable institutions, which is in part connected to a decreasing pool of participating first rate banks in this market. Disputes frequently arise from attempts to leverage those types of payment issues – again, in the context of a party seeking to achieve a price correction in existing orders or obligations under longer term supply contacts. These kinds of issues are not new in the commodities market – most sophisticated operators will have seen disputes of this nature many times over. One area which has emerged more recently as being ripe for the creation of disputes is so-called 'escalation clauses' in commodities supply contracts. These require a number of preliminary steps to be fulfilled prior to litigation or arbitration being commenced. Such clauses are intended to resolve emerging disputes informally, and cost-effectively. But without careful consideration they actually end up producing a dispute – where parties disagree as to whether a particular preliminary resolution stage has been fulfilled, often with allegations and cross-allegations of bad faith arising in that context. Such disputes are often fact-heavy, and dependent on witness evidence. None of that bodes well for cost-effective or fast resolution of what otherwise may have been a relatively simple dispute.

Rodd: Commodities litigation is rarely a case of one contract, as the problem under one contract causes knock-on effects under other contracts, either within the same chain or in related contracts, such as the shipping contracts. Generally, on the physical side, the key contracts are the sale contract, the letter of credit, the bill of lading contract or contract of carriage, and the charterparty, depending on the delivering Incoterm. For example, a CIF seller may sell goods that are wrongfully rejected by the buyer at the disport, leaving the CIF seller, who is also a charterer, with problems under the sale contract and charterparty, as well as, potentially, the bill of lading. It is also important to note that many disputes do not develop into litigation. In fact, the majority may not. Instead, the focus is on real time problem solving and settlement, with the threat of future litigation if the dispute is not resolved.

Daly: Some of the most interesting matters that we have seen are related to EFRP violations. An exchange for a related position occurs when a futures broker facilitates the migration of a bilateral, OTC exposure to a look-alike futures contract that is traded on a futures exchange. We have seen actions where this exchange of an OTC swap position for a listed, 'physical' position was deemed to be non-bona fide because it involved multiple, simultaneous steps, or because slight differences in relative exposure resulted where multiple accounts were traded in tandem. The frustration in these matters is that the exchange finds – and publicly sanctions – an accidental, technical non-compliance with the exchange rules that did not result in any price or volume distortion. We also see many examinations of managers by the National Futures Association (NFA). The NFA exam is often relatively straightforward, but there are situations where managers are alleged to have violated CFTC regulations and a CFTC enforcement referral is implicated. Obviously, in these kinds of situations a manager should be working closely with outside counsel from the start of the regulatory interaction.

CD: Could you highlight any recent, notable cases which illustrate the extent to which litigation is now a major consideration for commodity-trading companies? How do these cases break down in terms of class actions and individual lawsuits?

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Rodd: Litigation has always been a major consideration for the more sophisticated trading houses. Their legal teams are viewed as an extension of their commercial teams. The close interaction and more sophisticated use of litigation tools is used to obtain advantages over counterparties. The sophisticated use of internal and external lawyers is a major consideration, certainly for traders, but perhaps less so for some producers and end-users. Legal steps will be taken with 'without prejudice' exchanges following, so that a combination of pressure and negotiation can produce the desired outcome, including the required financial outcome. Therefore, in our experience, while litigation is a consideration, this must be placed in the context of how you achieve objectives with legal support and legal tools, only one of which is formal litigation.

Koster: A few cases stand out as having particular consequences for commodity trading companies. With respect to energy related litigation, in *Aspire Commodities LP et al. v. GDF Suez Energy North America Inc. et al*., the US Court of Appeals for the Fifth Circuit refused to reconsider its decision that an exemption created by a CFTC order barred two commodities traders from suing GDF Suez Energy North America Inc. claiming market manipulation on Texas' largest electrical grid. This ruling was hailed as a victory for energy trading companies in the Texas wholesale power market as it prevented private rights of action. In a case that has implications for the metals and foreign exchange markets, in August 2016 in *In re Aluminum Warehousing Antitrust Litig*., the Court of Appeals for the Second Circuit held that certain commercial and consumer end users of copper, down the distribution chain, did not have standing and could not bring actions against a number of banks alleging anti-competitive pricing behaviour under US antitrust laws. Finally, in *United States v. Coscia 100*, prosecutors obtained a conviction of a futures trader under the 'spoofing' provisions of the Dodd-Frank Act, even though the trader claimed that his trades were based on algorithmic trading and hence there was intent to execute the trades, a theory which was rejected by prosecutors.

Bright: The OW Bunkers litigation, particularly the *Res Cogitans* decision in the English Supreme Court, should be of major interest to anyone selling, or buying, on credit terms against the security of ROT clauses. Among other things, it is a reminder to take another look at standard terms to make sure they are appropriate and comprehensive. Above all, it emphasises that ROT clauses provide only very fragile and temporary security to the seller; and to the buyer they may result in the tortious liability to the real owner, higher up the contractual chain. This could be a complete stranger, in an unfamiliar and uncongenial jurisdiction. A completely separate feature of the OW Bunkers litigation that ought to interest traders in commodities is the fact that, because it involves bulk sales selling to trade purchasers around the world on terms including arbitration clauses, every dispute with each purchaser involves separate arbitration proceedings – so there are no class actions and there is only limited scope for global case-management. This imposes great case-handling challenges on the seller's legal team, but the upside is the ability to divide and conquer – and, to a degree, the opportunity to pick and choose which cases to prioritise or delay.

CD: In what ways is the current regulatory environment impacting the commodities markets? Are you seeing, for example, greater monitoring and enforcement actions?

Edwards: In recent years we have seen a global increase in regulatory intervention, or threatened intervention, regarding alleged corruption in the acquisition of commodities assets. This is particularly the case where politics converge with commercial interests. In such situations, it is not uncommon for commodities related business to find themselves under the microscope, potentially with valuable concession rights being placed under threat, pending the completion of an investigation into the wider situation. In that type of situation, the relevant entity is often left with no choice but to commence litigation – perhaps under a relevant investment protection treaty to protect its asset from aggressive state acts – or instigate a detailed and invasive internal investigation as to the circumstances. The potential for regulatory regimes to be manipulated

for commercial advantage – in jurisdictions with less well developed systems of law and control – is a real threat and one that can place a business under huge strain, both in terms of resources and reputation.

Daly: The exchanges and swap exchange facilities have all developed very sophisticated monitoring systems, and have fairly deep benches of market surveillance personnel. We find that the CME, in particular, is quite quick to spot anomalies and to reach out to traders.

Koster: A distinction should be made in the regulatory environment before and after the election of president-elect Trump. Prior to the election results, the regulatory environment, in terms of monitoring and enforcement, was very active, in particular spoofing cases and index manipulation. In a post-election world, while the agencies will still be vigilant, perhaps we may see only clear cases where spoofing or manipulative behaviour existed, which, in addition to circumstantial trading evidence, have direct evidence of fraudulent and manipulative intent, rather than situations which can be inferred from conduct.

Bright: Two areas of particular interest just now are sanctions and anti-corruption. The US election throws up the possibility of great changes in the 'hot' territories for sanctions, as well as the possibility of differing legislative attitudes among the major trading nations. Anti-bribery laws are a real headache for deals in many jurisdictions and, in some cases, a major disincentive to doing business. Both issues have the potential to give rise to arguments about illegality, which in different contexts can be raised either by the innocent party or by the guilty. Illegality remains as complex and unpredictable as ever, and therefore is very difficult to advise on – in spite of, or because of, the 'clarification' provided by the English Supreme Court in *Patel v. Mirza*. One other difficult area is contractual penalty clauses. These can be affected by state intervention in many jurisdictions. For example, differing national attitudes to provision for interest on late payments – there are huge variations on what is regarded as acceptable, most obviously in Islamic countries. They also raise inherent legal

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>
> *Brian T. Daly, Schulte Roth & Zabel*

problems – once again not necessarily clarified by the English Supreme Court, this time in *Cavendish Square v. Makdessi*.

Rodd: Along with price volatility, market complexity is a problem. It is abundantly apparent that regulators are introducing changes to the way commodities markets are controlled. It affects financing and has seen greater efforts by governments to exercise control over raw materials. Regulations have tightened with the Bribery Act, which allow for greater reach. While we see these impacts on our clients' business, the issues we see on a day-to-day basis tend to predominantly arise from operational risk and performance risk. That said, one pertinent example is sanctions advice, which is relevant with respect to countries like Iran.

CD: What general advice can you offer to companies facing commodities-related litigation? What initial steps, such as case evaluation, settlement analysis and expert witnesses engagement, should parties take?

Daly: What is shocking, but is not uncommon, is managers waiting far too long to engage outside counsel. When managers hear from the SEC, they generally reach out to outside counsel specialising in securities law and generally do so immediately. For some reason, incoming calls and letters from the futures exchanges and the NFA do not generate the same response. I think that is because the NFA and the exchanges play several roles, in addition to their enforcement function, and managers become habituated to responding to them. However, if there was one piece of advice we would give, it would be to reach out to outside counsel immediately following any contact from a futures regulator on a trading or examination matter, even if it seems to be 'routine'.

Koster: First and foremost, try to avoid litigation. It is time consuming, expensive and can consume valuable resources. Arbitration would be one key step, and companies should engage an expert early who has the ability to distil and communicate complex concepts and valuation into simple explanations. There are many experts with excellent and prestigious qualifications that cannot communicate in this type of effective manner.

Bright: Always engage lawyers early. The first few days and weeks of evidence-gathering are crucial, even if the case is one that is likely to settle. The sooner you start, the evidence will be not only easier to obtain and more reliable, but also cheaper. This also tends to promote early settlement. Have engaged lawyers work out what the issues are, in particular the issues that may involve expert witnesses. Experts who are truly expert in the relevant field but who are also experienced at giving evidence and amenable are rare. Of course, there are cases where there is no need for expert involvement or the expert issues are not especially unusual; but if your case is one where having a good expert witness may make all the difference, it can be crucial to engage the right expert while you can.

Rodd: Commercial teams, and in-house teams or external lawyers, should work together closely from an early stage. This may avoid the dispute or manage the dispute. This is because often a dispute starts with a real-time problem. That initial real-time problem may arise under one contract, such as the sale contract, but have knock-on effects under related contracts, such as the charterparty, the contract of carriage, the insurance policy or the letter of credit. This needs to be understood in its totality and rights should not be waived. Problem solving and solutions should be made in the appropriate manner. The control of communications at early stage may reap dividends.

Edwards: It is essential to engage with legal counsel – whether internal or external – as soon as a potential dispute starts to emerge in the trading relationship. The management of that relationship as the dispute starts to mature is crucial to aligning yourself for successful litigation or arbitration. Early evidential advantages may be achieved by having counsel involved in the background. Those who will end up running any dispute can start to engage with potential expert witnesses to both inform the commercial discussions around whether and how to resolve the dispute at an early stage, and to start to build that aspect of the case. This is useful should it become necessary to proceed with a dispute, and in any event to better arm the commercial players with leverage in any discussion between the parties. Market-specific disputes often turn on the experience and credibility of the expert witness, so it can be a case of 'first to the expert' wins. In terms of settlement analysis, it is always important to accurately assess the amount of management time and internal resource that will be consumed by a full-scale arbitration or litigation, as well as enforcement risk and practicalities, and, of course, a comprehensive review of the legal and commercial merit of the dispute. Armed with that, the commercial team will be well placed to make an informed decision.

CD: To what extent is arbitration now being used as an alternative means of resolving a commodities-related dispute?

Rodd: In our experience, arbitration is extremely common. Different forums are used and it is difficult to point to a favourite. This is also the case where different governing laws and seats of that arbitration are used, such as English law and Singapore arbitration. If we look at sale contracts, in our experience, it depends on the commodity.

In crude and petroleum products, you do see High Court jurisdiction, as this is provided for in some of the applicable GTCs. In other cases and with bulk concentrates in particular, the contracts tend to refer disputes to arbitration, under LCIA or ICC rules. With Asian counterparties, we have seen Singapore arbitration (SIAC). In terms of sale contract demurrage claims, you sometimes see London Maritime Arbitration Association arbitration (LMAA) arbitration. In terms of the shipping contracts, for example charterparties, the majority of disputes are referred to arbitration and usually under the LMAA. It is very rare to see ad-hoc arbitration.

Edwards: Arbitration is an increasingly common choice for parties to commodities contracts, especially where parties are buying and selling across jurisdictional borders. By their very location, parties to such contracts end up building into their relationship some degree of payment and enforcement risk. If care is not taken, the adoption of court litigation over arbitration as the contractual dispute resolution mechanism can leave one, or both, parties with little practical prospect of ever seeing payment or delivery. That said, even with arbitration, complex issues around recognition of decisions in different jurisdictions can still arise – some courts are more 'maverick' than others when faced with what should sensibly be done on receipt of an arbitral award, validly issued in accordance with a contract.

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Evan Koster, Hogan Lovells

Koster: While there is not agreement on the actual volume of matters that use alternative dispute resolution methods, there are certain trends, with respect to the use of arbitration, that can be noted. Firstly, arbitration tends to be used when the amount in dispute is relatively small, less than $10m for example, and secondly, particularly in the energy and natural resources area, where contract disputes are involved in large valuation disputes, arbitration is more likely to be used.

Bright: By far the majority of the commodities contracts I have seen over the last few years have included arbitration clauses, and very few of the litigious matters I have been involved in have not been arbitrated. This pattern has expanded far beyond trades such as grain, sugar and metals – which developed their own arbitration models long ago – to the point where nearly all experienced sellers have standard-form contracts providing for institutional arbitration in one of the major arbitration centres – often LCIA or ICC, sometimes SIAC. Arbitration remains quicker than court proceedings in certain jurisdictions, but speed is no longer the advantage that it was, and certainly not in England. Furthermore, its so-called confidentiality is greatly exaggerated –arbitrators' awards are rapidly become common knowledge in the 'global village' that most trading environments really inhabit. However, the ability to restrict who is actively involved in the proceedings remains a distinction. Beyond that, arbitration in one of the recognised centres continues to be seen as a 'safe space' by parties anxious to ensure that their disputes will be heard in a neutral setting.

CD: How do you expect commodities litigation issues to develop over the next 12 months or so? What are likely to be the major challenges that define this market?

Koster: Litigation issues are, of course, dependent on the economic and regulatory environment in the US. As far as the regulatory environment is concerned, many commentators have predicted the demise of the Dodd-Frank Act which would limit the regulatory enforcement tools of regulators. I am not sure that is going to happen. We could see more selective enforcement, however. With respect to the economic environment, if the US economy enters an active growth phase, and there is an uptick in commodity prices, we could see less contractual and bankruptcy related disputes.

Bright: If I could predict the commodities markets, I would not be a lawyer. There will likely be interesting times ahead for traders and lawyers alike. At the time of writing, some markets are showing tentative signs of classic cyclical up-turn, notably coal and iron ore. Others, notably oil, are hugely affected by politics. What will OPEC do, and with what effect? Will the incoming US administration prevent Iran from re-entering the free market? In the short term, I expect more market consolidation. In the longer term there will always be fresh players entering the market. In the meantime, we all have to keep hold of our existing clients and hope they are the ones that stay the course.

Rodd: If the downward trends continue and there is increased pressure on prices, there may be a continuation of parties choosing to litigate against valued counterparties. In particular, producers can no longer tolerate defaults by valued customers. Further, litigation will continue to be generated from operational risk and contract performance risk or counterparty risk. Indeed, in our experience, operational risk and contract performance risk are the most common areas that give rise to disputes, and these challenges cannot be entirely eliminated. There will also, of course, be insolvency risk, which will continue to generate litigation. We do not expect significant changes in the next 12 months, as the principal risks remain, although you may see an increase in parties that do not resort to litigation, now choosing to litigate.

Daly: We expect to see more and more actions in this area as hedge funds continue to trade in the futures and swaps market, and as trading becomes ever more sophisticated. CD