

Executive Compensation, Benefits and Employment Law Focus

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New Law Extends Time to Make Pay Discrimination Claim

Dear Clients and Colleagues:

On January 29, 2009, President Barack Obama signed into law the “Lilly Ledbetter Fair Pay Act of 2009” (the “Act”), which extends the time in which a person may assert a claim of pay discrimination under Title VII of the Civil Rights Act of 1964 (“Title VII”), the Age Discrimination in Employment Act of 1967, the Americans with Disabilities Act of 1990 and the Rehabilitation Act of 1973. The Act provides that an “unlawful employment practice” occurs (i) when discriminatory compensation decisions or other practices are adopted by an employer; (ii) when an individual is subject to a discriminatory compensation decision or other practice and (iii) when an individual is affected by the application of a discriminatory compensation decision or other practice, e.g., “each time wages, benefits or other compensation [are] paid.”¹

The Act overturns the decision of the United States Supreme Court in *Ledbetter v. Goodyear Tire & Rubber Co., Inc.*, (2007) which held (among other things) that allegedly discriminatory compensation decisions are

“discrete acts” that must be challenged within 180 days (or 300 days if in a deferral state) of when the original compensation decision is made. In *Ledbetter*, the Court expressly rejected the so-called “paycheck accrual rule” which provided that each paycheck that carries forward the effects of a prior allegedly discriminatory compensation decision is a new discriminatory act. Under the paycheck accrual rule a person therefore may file a claim of pay discrimination within 180 (or 300) days of receiving each paycheck issued under an allegedly discriminatory compensation decision. In rejecting this rule, the Court required employees to file such claims within 180 (or 300) days of the original discriminatory compensation decision even if the employee’s pay continued to be affected by that decision years later.

Congress determined that the Ledbetter decision “significantly impairs statutory protections against discrimination in compensation that Congress established... by unduly restricting the time period in which victims of discrimination can challenge and recover from discriminatory



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The contents of this employment update should not be construed or relied upon as legal advice or a legal opinion.

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¹ Congress noted that “nothing in the Act is intended to change current law treatment of when pension distributions are considered paid.”

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compensation decisions..." The Act remedies this by now permitting pay discrimination claims to be brought up to 180 (or 300) days after an "unlawful employment practice," which includes each time that the employee receives a paycheck.

The Act retroactively applies to "take effect as if enacted on May 28, 2007," which is the day before the Supreme Court issued the Ledbetter decision. For claims brought under Title VII, employees may seek "back pay for up to two (2) years" before the date they file their claims.

FTC "Red Flag Rules" May Cover 401(k) Plan Loans

The Federal Trade Commission (FTC) announced on October 22, 2008 that it would delay enforcement of its Identity Theft Red Flag Rules (the "Red Flag Rules") until May 1, 2009, given the extent to which the Red Flag Rules apply to entities not traditionally regulated by the FTC. The Red Flag Rules were issued as part of the Fair and Accurate Credit Transactions (FACT) Act of 2003. Generally, the Red Flag Rules require creditors to create and implement written identity theft prevention programs, which were to have been in place by November 1, 2008, and which must provide for the identification, detection and response to patterns, practices, or specific activities, or "Red Flags," that could be a sign of identity theft.

The reason for the expansive reach of the Red Flag Rules is due to its broad definition of the term "creditor." Under the Red Flag Rules, a "creditor" includes any entity that regularly extends, renews or continues credit; any entity that regularly arranges for the extension, renewal, or continuation of credit; or any assignee of an original creditor who is involved in the decision to extend, renew, or continue credit. The term "regularly" is not defined by the Red Flag Rules, but for purposes of the Federal Reserve Board's regulations under the Truth in Lending Act, a person "'regularly' extends consumer credit only if it extended credit [other than credit transactions secured by the consumer's principal dwelling] more than 25 times (or more than five times for transactions secured by a dwelling) in the preceding calendar year. If a person did not meet these numerical standards in the preceding calendar year, the numerical standards shall be applied to the current calendar

year." If a similar interpretation of "regularly" were applied to the Red Flag Rules, any entity that extends consumer credit more than 25 times in the preceding calendar year (or the current calendar year) would be considered a "creditor," and hence be subject to the Red Flag Rules. (Note that, unlike the FTC, the Federal Reserve Board will expressly exempt retirement plan loans from the Truth in Lending Act, beginning on July 1, 2010. See page 8 for more information.)

401(k) plans that allow in-service loans may find themselves among the entities affected by this expansive definition of "creditor," as a plan loan to a participant is an extension of credit to that participant. If a 401(k) plan makes loans to more than 25 participants from the 401(k) plan in a given plan year, that plan may be subject to the Red Flag Rules.

If a 401(k) plan determines that it is subject to the Red Flag Rules, it must develop a written program which identifies and detects the relevant warning signs ("Red Flags") of identity theft. This program must include reasonable policies and procedures to:

- Identify relevant Red Flags for the 401(k) plan accounts, and incorporate those Red Flags into the program;
- Detect Red Flags which have been so incorporated;
- Respond appropriately to any Red Flags which are detected to prevent and mitigate identity theft; and
- Ensure the program (including the incorporated Red Flags) are updated periodically to reflect new issues regarding identity theft.

Examples of “Red Flags” suggested by the FTC generally fall into five categories, which include alerts, notifications, or other warnings received from consumer reporting agencies or service providers, such as fraud detection services; the presentation of suspicious documents; the presentation of suspicious personal identifying information (such as a suspicious address change); the unusual use of, or other suspicious activity related to, a covered account and notice from customers, victims of identity theft, law enforcement activities, or other persons regarding possible identity theft in connection with

covered accounts held by the financial institution or creditor.

The FTC has indicated that the nature of the written program should depend on the complexity, size and nature of the creditor’s business. As a result, a 401(k)’s written program might well be relatively straightforward.

Once the Red Flag Rules become effective on May 1, 2009, creditors (including 401(k) plans) which have not developed the written program required by the Red Flag Rules may be subject to penalties of up to US\$3,500 for each independent violation.

Military Benefits Warm the “HEART”

The Heroes Earnings Assistance and Relief Tax Act of 2008 (the “HEART Act”) (also known as the “HEROES Act”) is an eclectic piece of legislation enacted on June 19, 2008, containing provisions impacting tax-qualified plans, health and welfare plans, as well as having a host of tax incentives that benefit military personnel and their families. The HEART Act provides for retirement plan survivor and disability benefits, qualified reservist distributions from tax-qualified plans, death gratuities and life insurance payments to military spouses and provides a broad range of tax provisions with respect to military and certain first responders and US Peace Corp. volunteers. Some of the provisions provided under the HEART Act are mandatory and, therefore, plans must be amended to comply, while other provisions are voluntary. Those provisions that are mandatory must be adopted *by the last day of the first plan year beginning on or after January 1, 2010*. However, a plan will be treated as operating under the terms of the HEART Act as long as the plan is amended retroactively and operated in accordance with the amendment from its effective date. Optional

provisions must be adopted *by the last day of the plan year in which the plan sponsor elects to provide for such provision(s)*.

This article is not meant to be exhaustive of all issues under the HEART Act, but will concentrate on the major provisions of the HEART Act that affect retirement plans and health and welfare plans (specifically health care flexible spending accounts (FSAs)).¹

Qualified Plans:

The Uniformed Services Employment and Reemployment Rights Act (“USERRA”)² required qualified plans to provide employees who returned to work after a period of “qualified military service,” as defined in USERRA, and who met certain requirements, to receive credit for benefit accruals under a defined benefit plan, or employer contributions under a defined contribution plan, which they would have received had they been

¹ For example, the HEART Act imposes certain withholding requirements on deferred compensation of United States expatriates, extends the Mental Health Parity Act (“MHPA”) through December 31, 2008 (the Tax Extenders and Alternative Minimum Tax Relief Act of 2008 makes the MHPA permanent), grants a 20 percent income tax credit to certain small businesses that provide differential wage payments, imposes FICA withholding requirements on certain foreign affiliates of US corporations and contains numerous other provisions.

² The Uniformed Services Employment and Reemployment Rights Act was signed into law by President Bill Clinton on October 13, 1994.

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employed during the period of “qualified military service.” The HEART Act expands on these provisions in the following ways:

Treatment of Differential Military Pay as Wages

Prior to the enactment of the HEART Act, USERRA required that payments made by an employer that made up the difference between military pay and an employee’s normal pay (“differential wage payments,”³) for those employees on active duty in the military for a period of more than 30 days, were not considered wages from the employer for the purpose of income tax, social security, FICA, FUTA and similar withholdings, and were treated as “compensation” under a tax-qualified retirement plan, only if the plan so provided. The HEART Act changed this, so that effective on and after January 1, 2009, differential wage payments, if provided for by an employer, must be included as wages (and therefore reported on Form W-2), and treated as “compensation” for purposes of benefit accruals under any plan subject to USERRA.

For example, under a 401(k) plan, an employee who is on active duty for a period of more than 30 days and receives differential wage payments from his employer may continue to make elective deferrals from the differential wage payments and receive matching contributions, if applicable. Contributions made by an employee from differential wage payments to a 401(k) plan will limit the amount of contributions the employee may be able to make in the year he or she returns to employment.

Even though, under USERRA, employers are not obligated to make differential wage payments, once they do so, the above HEART Act provision with respect to any retirement plan becomes mandatory.

Qualified Reservist Distributions

Under current law, a taxpayer who receives a distribution from a qualified retirement plan prior to age 59½, death or disability, generally is subject to a ten percent (10%) early withdrawal tax on the amount included in income, unless an exception to this tax applies. Among other exceptions, the early distribution tax does not apply to distributions made to an employee who separates from service after age 55, or to distributions that are part of a series of substantially equal periodic payments made for the life (or life expectancy) of the employee or the joint lives (or life expectancies) of the employee and his or her beneficiary (e.g., annuities).

Amounts held in a 401(k) plan generally may not be distributed before severance from employment, age 59½, death, disability or financial hardship of the employee.

The Pension Protection Act of 2006 (“PPA”) amended Section 72(t) of the Internal Revenue Code of 1986, as amended (the “Code”), to waive the ten percent early withdrawal tax on a “qualified reservist distribution.” For this purpose, PPA defines a “qualified reservist distribution” to be a distribution: (i) from an individual retirement account (“IRA”) or attributable to elective deferrals under a 401(k) plan, among other similar arrangements; (ii) is made to an individual who by reason of being a member of a reserve component of the military was ordered or called to active duty for a period of more than 180 days or for an indefinite period and (iii) that is made during the period beginning on the date of such order or call to duty and ending at the close of the active duty period. Neither PPA, nor the Technical Explanation of HR-6081 with respect to the HEART Act (the “Committee Report”), address whether a reservist can withdraw all or just a portion of his or her elective deferrals as a qualified reservist distribution. Also, unlike in the case of a hardship distribution from a qualified plan, there is

³ “Differential wage payment” is defined as any payment an employer makes to an employee who is on active duty for more than 30 days that represents all or a portion of the wages the employee would have received had he or she continued working for the employer.

Practice Pointer

As a practical matter, if a reservist were to, for example, take all of his or her elective deferrals under a 401(k) plan as a qualified reservist distribution, and not repay such amount within the two-year period, this could have an adverse effect on his or her retirement savings. In today's economy, this is a significant consideration, and employers and reservists should be mindful that qualified reservist distributions should be taken with full knowledge of the practical effects.

no requirement that the reservist first receive all available loans and other available distributions under such plan. Importantly, effective January 1, 2009, a reservist who takes a qualified reservist distribution is barred from making elective deferrals to the plan for six months from the date of the qualified reservist distribution. Qualified reservist distributions do not violate the distribution restrictions otherwise applicable to a 401(k) plan.

Under PPA, the special rules applicable to a qualified reservist distribution apply to individuals ordered or called to active duty after September 11, 2001 and before December 31, 2007. The HEART Act removed the December 31, 2007 "sunset" date, making this provision permanent.

In addition, an individual who receives a qualified reservist distribution may, at any time during the two-year period beginning on the day after the end of the active duty period, re-contribute the distributed amount to an IRA, *but not into a tax-qualified plan*. However, as a concession, the dollar limitations otherwise applicable to contributions to an IRA (i.e., US\$5,000, or, if older than age 50, US\$6,000) do not apply to contributions made pursuant to the repayment of a qualified reservist distribution. Therefore, a reservist may repay the entire amount that he or she had taken as a qualified reservist distribution, provided the two-year period requirement is met.

Survivor Benefits

The HEART Act provides a new tax qualification requirement for a tax-qualified retirement plan under Section 401(a) of the Code. Under the new requirement, in order for a plan to remain qualified, it must provide that, in the case of a participant who dies while performing qualified military service, the survivors of the participant must be entitled to any additional benefits (other than benefit accruals relating to the period of qualified military service) that would be provided under the plan, had the participant resumed employment with the employer the day before death and then terminated employment on account of death. Therefore, for example, if a plan provides for accelerated vesting, ancillary life insurance benefits or other survivor benefits that are contingent upon a participant's termination of employment on account of death, the plan must provide such benefits to the beneficiary of a participant who dies during qualified military service.

Benefit Accruals Upon Death or Disability

USERRA governs certain benefits for employees returning from military duty, and provides that returning employee's military service is considered to be employment for benefit accrual purposes. The HEART Act permits, but does not require, a plan to

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treat an employee who dies or becomes disabled while on a qualified military leave and, therefore cannot be reemployed, as if he or she had resumed employment on the day before his or her death or disability. Moreover, for benefit accrual purposes, the HEART Act permits, but does not require, an employer to treat an employee who dies or becomes disabled in military service as though he or she had worked until his or her date of death or disability. If a plan provides for this feature, the Committee Report states that all employees who die or become disabled while on a military leave be credited with service and benefits on a reasonably equivalent basis (i.e., the provision is subject to the Code's nondiscrimination requirements).

The HEART Act provides that, for an employee who dies or becomes disabled in active military service, the amount of contributions and elective deferrals for this purpose is determined based on the individual's average actual contributions or elective deferrals for the 12-month period of service with the employer immediately before the qualified military service, or, if less, the actual length of continuous service.

Under PPA and the Committee Report, it is unclear whether an employer may provide for such benefit accruals on a selective year basis (for example, provide for such accruals in one year and discontinue them in the following year). Therefore, employers should carefully take into account the cost and other relevant considerations when deciding whether to add this feature to their plans.

The above provisions apply with respect to deaths and disabilities occurring on or after January 1, 2007.

Health Flexible Spending Arrangements

Health flexible spending accounts ("Health FSAs") are health plans or arrangements typically associated with cafeteria plans under Section 125 of the Code

("Cafeteria Plans"). Generally stated, a Health FSA is a plan or program which is designed to reimburse employees for certain health and medical expenses that are not covered under other benefit plans or insurance. Employees who participate in a Health FSA make pre-tax contributions from their compensation to a FSA account. Upon incurring medical expenses that are not otherwise covered from other sources, an employee requests reimbursement from the FSA account. One consideration with respect to contributing to a Health FSA account is the "use-it-or-lose it" rule, which requires the forfeiture of any unused amounts in a FSA account at the end of the plan year (or, if a plan provides for a grace period of up to two and one half months following the end of the plan year, then until the end of such grace period).

The HEART Act added Section 125(h) to the Code, which provides a special rule allowing (but not requiring) qualified reservists distributions of unused amounts in a Health FSA account. Notably, for this purpose, a "qualified reservist distribution" is defined in the HEART Act, and explained in Internal Revenue Service ("IRS") Notice 2008-82 (the "Notice"), as a distribution to an employee of all or a portion of the balance in the employee's Health FSA account if: (i) the employee is a member of a reserve component ordered or called to active duty for a period of more than 180 days or for an indefinite period and (ii) the request for distribution is made during the period beginning with the order or call to active duty and ending on the last day of the plan year (or grace period, if applicable) including the date of the order or call to active duty. These qualified reservist distributions are an exception to the general rule stating that a Health FSA may not make distributions other than reimbursement of substantiated medical expenses.

The Notice clarifies that a Cafeteria Plan is not required to provide for qualified reservist distributions. In addition, the Notice indicates that a qualified reservist distribution may not be made before a

Cafeteria Plan is amended to provide for qualified reservist distributions from a Health FSA. A Cafeteria Plan may be amended at any time on a prospective basis and must apply uniformly to all participants in the Cafeteria Plan. However, under a transition rule, the Notice provides a transition that allows a Cafeteria Plan to be amended retroactively to permit for qualified reservist distributions requested on or before December 31, 2009, provided that the amendment is made by December 31, 2009 and is effective retroactively to the date of the first qualified reservist distribution paid under the Cafeteria Plan (but not prior to June 18, 2008). Regardless of when the Cafeteria Plan is amended, the transition rule does not allow an employee to request a qualified reservist distribution with respect to a plan year after the last day of the plan year (or grace period, if applicable) during which the order or call to active duty occurred.

The Notice also provides details as to: (i) when a qualified reservist distribution may be made; (ii) various methods for determining the balance in a Health FSA available as a qualified reservist distribution; (iii) cafeteria plan procedures to be followed with respect to requesting of a qualified reservist distribution; (iv) the effect on the cafeteria plan nondiscrimination rules and (v) the taxation of a qualified reservist distribution. Employers who are considering adding these qualified reservist distributions to their Health FSAs should seek legal advice on, and carefully take into consideration, the details of these provisions.

What Employers Need To Do Now

Employers sponsoring tax-qualified plans, and health and welfare plans containing Health FSAs, should

carefully review their obligations with respect to the mandatory HEART Act provisions that are already effective (for plan years beginning on or after January 1, 2009). As previously stated, plans need to be amended *by the last day of the first plan year beginning on or after January 1, 2010*, to reflect the operation of these mandatory provisions.

Employers also should take time now to consider whether to add any of the optional provisions available under the HEART Act. Some of these provisions, for example, allowing for qualified reservist distributions and/or military survivor benefits, are beneficial to reservists and, therefore, to employers who employ them; however, the cost factor should be taken into account. As a reminder, plans need to be amended to comply with optional provisions *by the last day of the plan year in which the plan sponsor elects to provide for such provision(s)*.

Last, but not least, as always, employers need to communicate any and all plan changes to participants in a timely manner. Adequate and prompt communication goes a long way towards eliminating confusion and possible future disputes.

Conclusion

Qualified reservist distributions and the other pertinent mandatory and optional provisions of the HEART Act require tax-qualified plan and health and welfare plan sponsors to act, and make certain decisions, in the near future. As always, White & Case is available to help you decipher the HEART Act and the Notice, and provide helpful guidance with respect to this matter.

Truth in Lending Act's "Regulation Z" Amended to Exempt Plan Loans

On December 18, 2008, the Board of Governors of the Federal Reserve System approved final rules which amend the regulations implementing the Truth in Lending Act of 1968 ("TILA"), widely known as "Regulation Z." Among other things, the revised rules now exempt loans taken from employer-sponsored retirement plans, which were previously subject to Regulation Z.

TILA and Regulation Z generally require creditors to disclose key terms of lending arrangements to consumers, as well as the costs related to that extension of credit. While TILA covers both open-end and closed-end credit, the amendments made on December 18 largely affect only open-end, or revolving, credit arrangements. Previously, 401(k), 403(b) and 457(b) plans that allowed loans to be taken against participant accounts were subject to Regulation Z. As a result, plan administrators of such plans were required to follow Regulation Z's rules with regard to the determination of finance charges and the APR applicable to such loans, and the requirement of disclosures and periodic statements to the participant taking such loan.

However, Section 226.3(g) of Regulation Z, added by the new final rules, specifically exempts most loans taken by employees against their employer-sponsored retirement plans from TILA and Regulation Z. Under the new provision, an extension of credit to a participant in (i) an employer-sponsored retirement plan that has been qualified under Section 401(a) of the Internal Revenue Code (the "Code"),

(ii) a tax-sheltered annuity under Section 403(b) of the Code, or (iii) an eligible governmental deferred compensation plan under Section 457(b) of the Code will be exempt from TILA and Regulation Z, so long as the loan is comprised of fully-vested funds from such participant's account, and the loan is made in compliance with all relevant provisions of the Code. The Federal Reserve Board noted in its summary to the final rules that this exemption will apply to employer-sponsored retirement plans regardless of whether that plan is subject to the Employee Retirement Income Security Act of 1974 ("ERISA").

For 401(k), 403(b) or 457(b) plans that allow plan participants to borrow from their plan accounts, the addition of Section 226.3(g) is a welcome change. As the Federal Reserve Board noted in its summary, loans taken by participants from their employer-sponsored retirement plan are vastly different from other types of revolving credit, such as credit cards, in that the participant's interest and principal payments on the loan are reinvested into their plan account, instead of interest payments going to a third-party creditor. The Federal Reserve Board also observed that employer-sponsored retirement plans which are subject to ERISA must already disclose plan administration fees under regulations promulgated by the Department of Labor. Excepting employer-sponsored retirement plans from Regulation Z will come as relief to plan administrators who must maintain compliance with both the Internal Revenue Code and ERISA. The final rules amending Regulation Z become effective on July 1, 2010.

International Highlight

Germany's Government Extends Partial Unemployment Compensation

In the US, laid-off employees are eligible for state unemployment compensation. But the benefit amount is somewhat meager, and does not replace most of the final average pay. Also, US employees are eligible for unemployment compensation only when they lose their job. American employees subject to a cut in pay or hours are ineligible.

Many other countries, however, offer richer unemployment benefits. Germany, for example, has a partial unemployment compensation fund ("short-time work subsidy") that pays government money to workers who remain employed, but who are furloughed or whose work hours get cut and thus their pay reduced. This benefit helps employers, because it softens the blow when an employer needs to cut labor costs. The short-time compensation benefit paid by the state equals two-thirds of a covered employee's lost pay.

Employers in Germany actively structure their cut-backs so as to allow their workers to qualify these funds. Indeed, a cut-back in Germany that fails to qualify would not likely win necessary approvals from the workers' council (workers' representatives) under the German "co-determination" system.

As of 2009, the German government has now extended the benefit period for this partial unemployment compensation from six to 18 months, because of the downturn and concern that there will be a wave of lay-offs.

In Germany, more than 6,000 companies are currently introducing reduced hours. It is estimated that in 2009 around 250,000 employees will be affected, and the state will pay around 1.5 billion euros in these so-called "short-time work subsidies." This is five times the amount paid in 2008.

What are the eligibility requirements for these "short-time work subsidies"? Short-time work subsidy is granted by the German Federal Employment Office on request by the employer or the workers' council if:

- there is a "significant" "lack of work" with corresponding loss of pay, and the German Federal Employment Office has determined in a written notice that the requirements are fulfilled (a "significant" "lack of work" means "temporary", unavoidable economic reasons outside the employer's control in which one-third of the employees experience a loss of more than ten percent of their monthly pay; a "lack of work" is "temporary" if the employees will, within a foreseeable period, work full-time again; a "lack of work" is considered "unavoidable" if the employer and, if appropriate, the workers' council have attempted, unsuccessfully, to avoid or restrict the short-time work before notifying the lack of work to the German Federal Employment Office)
- the employee remains in an employment relationship covered by unemployment insurance
- the employment contract is not terminated or otherwise cancelled
- the employee is not excluded from short-time compensation

As to how short-time work gets implemented: Since short-time work affects a core element of the employment contract, its introduction requires a "legal basis." This "legal basis" could be a collective bargaining agreement or a "shop agreement" with the workers' council, or individual employment agreements. Introducing short-time work may trigger "co-determination rights" of the workers' council and short-time work would then require prior approval of the workers' council.

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