

# EMPLOYEE BENEFITS & EXECUTIVE COMPENSATION

LEGAL PERSPECTIVES

Summer 2003

## Court Finds IBM Cash Balance Plan Violates ERISA'S Age Discrimination Prohibitions

On July 31, 2003, in *Cooper, et al. v The IBM Personal Pension Plan, et al.*, Civil No. 99-829-GPM (S.D. Ill. July 31, 2003), a U.S. district court ruled that IBM's pension credit and cash balance formulas used by

The IBM Personal Pension Plan (the "Pension Plan") violated the age discrimination prohibitions of the Employee Retirement Income Security Act of 1974, as amended ("ERISA"). The court stated that IBM's conversion of its defined benefit plan first to a "pension equity" plan in 1995 and second to a "cash balance" plan in 1999 were discriminatory because participants' rate of benefit accruals decreased because of the attainment of a certain age.

The plaintiffs, a class of approximately 140,000 employees and former employees of IBM, had brought suit against IBM and the Pension Plan because of the two conversions. The plaintiffs claimed that the formulas for calculating benefits and accruals under the pension equity plan and the cash balance plan violated Sections 204(b)(1)(G) and (H) of ERISA. The pension equity plan used a complicated formula which credited certain points to / continued page 2

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## IBM Violations

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participants and accrued benefits based upon this point system. The cash balance plan created a hypothetical account for each participant to which certain “pay credits” and “interest credits” were credited. The accrued benefit is equal to the value of this hypothetical account. Both types of plans were defined benefit plans.

Section 204(b)(1) of ERISA imposes certain benefit accrual requirements on defined benefit plans. Section 204(b)(1)(G) of ERISA states that a defined benefit plan will be discriminatory “if a participant’s accrued benefit is reduced on account of an increase in his or her age or service.” Section 204(b)(1)(H) of ERISA states that a defined benefit plan will be discriminatory if “the rate of an employee’s benefit accrual is reduced, because of the attainment of any age.” In order to determine whether the benefit accrual requirements are satisfied, all defined benefit plans are required under Section 3(23)(A) of ERISA to calculate an individual’s “accrued benefit” under the plan as expressed in the form of an annual benefit beginning at normal retirement age (normally age 65).

The court held that the pension equity plan formula violated both 204(b)(1)(G) and (H). More significantly, the court held that the cash balance formula violated Section 204(b)(1)(H) of ERISA because interest credits that are valued as an age 65 annuity, “will always be more valuable for a younger employee as opposed to an older employee.” In

reaching this conclusion, the court held that the language found in Section 204(b)(1)(H) of ERISA “rate of an employee’s benefit accrual” referred to a participant’s accrued benefit. The court also showed, by using a specific example, that the accruals decreased as age increased, a clear violation of ERISA.

This decision clearly places a serious obstacle in the path of those entities which either sponsor a cash balance plan or are considering converting their current standard defined benefit plan to a cash balance plan. IBM has announced that it will appeal the decision to the 7th Circuit Court of Appeals. Many pension practitioners believe the IBM decision was not particularly well reasoned and hope that the decision will be overturned on appeal. Even if the ruling is not overturned, technically the decision should apply only to the states covered in the 7th Circuit - Illinois, Indiana and Wisconsin. However, other Circuits may apply the IBM decision as precedent. Ultimately, the fate of cash balance plans may need to be decided by the Supreme Court or Congress may be forced to step in and resolve the issue through statutory amendment.

As the progress of this case through the appeals courts may take years, employers are not required to react immediately to this decision. Many companies are taking a “wait-and-see” approach rather than implementing measures to comply with the district court’s decision. We will continue to monitor this lawsuit and any new developments. If you have any questions or concerns regarding this article, please contact us. ☺

## Treasury Department Has A Very Productive Summer

Rather than taking a vacation this summer, the Treasury Department, instead, issued a wave of proposed and final regulations relating to defined contribution plans which may necessitate that employers review and modify their plan documents. The following is a summary of some of the new regulations:

### Proposed 401(k) Regulations

The Treasury Department has issued revised 401(k) plan regulations which expand upon the existing regulations and incorporate all guidance issued by the Internal Revenue Service (“IRS”) over the last several years related to this area. The regulations are an attempt to consolidate all the guidance related

to 401(k) plans in one place, including changes to this section by the Small Business Job Protection Act of 1996, the Tax Reform Act of 1997 and the Economic Growth and Tax Relief Reconciliation Act of 2001 and guidance issues by the IRS since 1997.

However, in consolidating 401(k) plan guidance, the IRS has

## Employee Plans — New Law Action Checklist

### ✓ 401(K) PLANS — NEW PROPOSED AND FINAL RULES

The new proposed and final regulations relating to 401(k) plans including proposed 401(k) and proposed 401(m) regulations, final catch-up contribution regulations and proposed optional form of benefit regulations necessitate that employers review their current documents to ensure that the plans accurately reflect employer intent and actual operation, particularly in regard to catch-up contributions. If changes relating to catch-up contributions language are required, the changes must be completed prior to January 1, 2004, the effective date of the final regulations.

### ✓ HEALTH PLANS — COBRA RULES

Though the new COBRA regulations are still in proposed form, they may be effective as early as plan years beginning in or after January 2004. Therefore, employers should review their current COBRA administrative practices to ensure that they satisfy the new regulations (see the article on page 5). The regulations created new model notices which may need to be provided to participants. Finally, the new regulations impose new requirements on summary plan descriptions (“SPDs”) for health plans and summaries of material modifications (“SMMs”) of such health plans. Therefore, current SPDs and SMMs need to be reviewed and modified by the end of the year so that these documents are compliant with the new COBRA regulations.

proposed modifications of some of the requirements, including, but not limited to, the following:

- ⊙ *Employee Stock Ownership (“ESOP”) 401(k) Plan.* Under Treasury Regulation Section 1.401(b)-7(c)(2), an ESOP combination plan such as an ESOP with 401(k) plan features is required to separate out the ESOP and non-ESOP portions of the plan. Each separate portion then must separately satisfy the Actual Deferral Percentage (“ADP”) test (which compares elective deferrals of non-highly compensated employees (“NHCEs”) to highly compensated employees (“HCEs”)) and the Actual Contribution Percentage (“ACP”) test (which generally compares employer matching contributions for NHCEs to employer matching contributions for HCEs). Often, because HCEs are more likely to invest in employer securities, either the ESOP or non-ESOP portion of the plan would fail to satisfy the ADP or ACP test which caused the entire plan to fail. The new regulations allow aggregation of the ESOP and non-ESOP portions of the combination plan. Thus, for purposes of ADP and ACP testing, disaggregation of ESOP and non-ESOP portions of an ESOP combination plan is not required. However, mandatory disaggregation would still be required for coverage testing.
- ⊙ *Reduction of Use of “Bottom-Up QNECS”.* Currently, the Internal Revenue Service permits employers to correct ADP and ACP violations by contributing enough money to certain NHCEs to cause the ADP and/or ACP test to be satisfied. These contributions are called qualified non-elective contributions (“QNECs”) (and

sometimes qualified matching contributions (“QMACs”)). QNECs can be made using different formulas. Most formulas provide a QNEC of some amount to all NHCEs. However, there is one type of QNEC which only provides a QNEC to the lowest-compensated NHCE. This type of QNEC is called a “bottom-up” QNEC. An example of a “bottom-up” QNEC would occur in a situation where a 401(k) plan allowed immediate participation, there was an individual who had worked part-time for the employer and earned \$7,000 but who had made no deferrals for the year, and a \$4,000 contribution to this individual’s account would cause the ADP test to be satisfied. The “bottom-up” QNEC is preferred by many employers because it may be the lowest-cost corrective QNEC. Of course, this leads to a strange situation where a very low-paid person essentially receives a windfall and was not actively participating in the 401(k) plan. While the IRS had permitted this method, the new regulations limit its use. The new regulations impose two requirements. First, at least 50% of the NHCEs must receive a QNEC, if one is necessary (“50% Test”). Second, the ratio of QNEC/compensation (expressed as a percentage) for any one NHCE cannot exceed 200% of the ratio of QNEC/compensation another NHCE receives (“200% Test”). However, any QNECs which result in a 5% or less (QNEC/compensation) ratio are still permitted and not required to satisfy either the 50% or 200% Tests.

- ⊙ *Inconsistencies Between Prior Year and Current Year Testing.* Current regulations and guidance require that an employer either / continued page 4

## Treasury Department

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choose “current year” ADP/ACP testing (that is, comparing current year HCE data to current year NHCE data) or “prior year” ADP/ACP Testing (that is, comparing current year HCE data to prior year NHCE data). The new regulations allow an employer to switch from year to year without penalty. This is permitted as long as there is no movement of elective contributions or QMACS between the ADP and ACP tests.

- ⊙ *Imposition of Excise Tax of Failure to Return Excess Contributions and Excess Aggregate Contributions.* The new regulations delay the imposition of the excise tax on failure to return excess contributions (under the ADP Test) and excess aggregate contributions (under the ACP Test). Current law imposes an excise tax on the employer of 10% on excess contributions and excess aggregate contributions which are not returned within two and one-half months of the end of the plan year to which they relate. The new regulations delay the imposition of the tax until 22 months after the end of plan year to which they relate. This will allow the employer to self-correct errors without imposition of tax.
- ⊙ *Employer Deduction for Prefunded Matching Contributions is Eliminated.* Under the existing regulations, the determination of whether an employer contribution is on account of an elective deferral or a matching contribution is determined under all relevant facts and circumstances. The proposed regulations would provide that contributions cannot be treated as matching contributions if they are contributed before the employee’s performance of services. Thus, these new regulations would eliminate an employer’s accelerated income tax deduction by prefunding its matching contributions.

These proposed regulations will be effective no later than 12 months after publication of the final regulations.

### Final “Catch-up” Regulations

The Treasury Department has finalized regulations relating to “catch-up” contributions under 401(k) plans. Catch-up contributions are deferral contributions in excess of the annual dollar limits that may be made by participants age 50 and over if the plan has been amended to permit catch-up contributions. The final regulations adopted most of the rules in the proposed regulations that were issued in October 2001, except as noted below:

- ⊙ *Plan Year Different From Calendar Year.* The final regulations

clarify that if the plan year is not a calendar year that an individual may be “catch-up” eligible for only that portion of the calendar year in which he or she will attain age 50 during such year. This means, for example, if the plan year is July 1, 2002 through June 30, 2003, and an individual turns age 50 in October of 2003, the individual is eligible to make catch-up contributions beginning on January 1, 2003.

- ⊙ *Universal Availability Not Required for Collectively-Bargained Employees.* Current law requires that if one 401(k) plan sponsored by an employer within a controlled group permits catch-up contributions, then all 401(k) plans within the controlled group must also permit catch-up contributions, including collectively-bargained plans. The final regulations provide that collectively-bargained employees are disregarded for purposes of determining whether the universal availability rule is satisfied. This new rule helps eliminate the difficult coordination task that certain employers with collectively-bargained employees faced, particularly those employers with more than one collective bargaining unit and those employers who participated in multiemployer plans.
- ⊙ *Universal Availability in Mergers and Acquisitions.* As mentioned above, current law requires that if one 401(k) plan within a controlled group provides for catch-up contributions then all plans within the controlled group must provide for the provisions. This may cause difficulties when a new 401(k) plan is acquired by a purchaser in a merger or acquisition where the regulations required a new plan without the catch-up provisions to include the catch-up provisions as soon as practicable, but no later than the end of the plan year following the plan year in which the merger or acquisition occurred. The new regulations eliminate the “as soon as practicable” requirement and allow adoption of catch-up provisions in the newly-acquired plan to be delayed until the end of the plan year following the plan year in which the merger or acquisition occurred.
- ⊙ *Nondiscrimination Testing for Matching Contributions to Catch-Up Contributions.* Employers may elect whether to match catch-up contributions. If the employer elects to match the catch-up contributions, as in the proposed regulations, the matching contributions must be included in the ACP Test. This raises the question of whether by providing a matching contribution for catch-up contributions, the matching contribution for catch-up contributions qualifies as a separate benefit, right or feature which must satisfy nondiscrimination requirements.

The final regulations clarify that if matching contributions are made based on a single matching formula as it relates to the amount of elective deferrals, the matching contributions related to catch-up contributions are not treated as a separate benefit, right or feature. As long as the employer satisfies the ACP Test, no additional nondiscrimination testing need be completed. The final regulations also clarify that if employers do not wish to make matching contributions to the catch-up contributions, the plan should specify which contributions will be matched and that any matching contributions to catch-up contributions will be forfeited.

- ◎ *Cash Availability Rule.* Employers were concerned that if they imposed restrictions on the maximum amount that may be withdrawn on a pre-tax basis from any paycheck, that they would violate the universal availability rule. The final regulations permit such a restriction without violating the universal availability rule.

The regulations become effective for all contributions in taxable years beginning after January 1, 2004.

## Proposed Regulations on Advance Notice Before Eliminating Optional Forms of Benefits from Defined Contribution Plans

The Treasury Department has issued proposed regulations on providing advance notice before eliminating optional forms of benefits from a defined contribution plan. Internal Revenue Code (Code) Section 411(d)(6) generally prohibits plan amendments which eliminate optional forms of benefit payments, unless certain requirements or exceptions are met. Under one exception, a plan may be amended to eliminate an optional form of payment if, after the amendment becomes effective, the plan provides a lump sum option which is "otherwise identical" to the eliminated or restricted payment option. A lump sum option is "otherwise identical" if it is identical in all respects or provides greater benefits, except for the timing that benefits begin. For this exception to apply, the law had required that the participant receive at least a 90-day advance notice of the amendment. The proposed regulations would eliminate all advance notice requirements under the previous regulations. These proposed regulations are expected to become finalized and effective by the last calendar quarter of 2003. ◎

## New DOL Proposed COBRA Regulations Require Immediate Action From Employers

The Department of Labor "DOL" has issued proposed regulations relating to requirements under the Employee Retirement Income Security Act of 1974 ("ERISA") Sections 601-608 which codify requirements imposed under the Consolidated Omnibus Budget Reconciliation Act of 1985 ("COBRA"). These new regulations include many new additional requirements with which employers must comply. The DOL is proposing that these regulations will be finalized and effective for the first plan year that occurs on or after January 1, 2004.

The following is a brief description of additional changes imposed by these new regulations:

- ◎ *Timing of Initial Notice.* Current regulations require that employers provide notice to participants of their COBRA rights when such participants first become covered by a health plan. The current regulations do not specify exactly when this notice requirement must be satisfied. The new regulations specifically require that the initial notice of

COBRA rights be provided no later than 90 days after coverage begins. The notice may be provided as a single notice for both the participant and his or her spouse, if they live together, at the current address and if coverage for both begins at the same time. If coverage begins at different times, the notice should be provided separately to each individual. The proposed regulations include a new model initial notice which may be used in place of the current model notice. Use of the

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## COBRA Regulations

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old model notice which was provided in ERISA Technical Notice 86-2 is no longer deemed to be good faith compliance of the COBRA provisions. As an alternative, the employer may elect to include the required information of the additional notice in the summary plan description ("SPD"), rather than as a separate notice, as long as the SPD is provided within that 90-day period. The employer must ensure that both the SPD and notice requirements are satisfied in the SPD to eliminate the requirement for any other initial notice.

- ⊙ *Employee Notice of Certain Qualified Events to Employer.* A covered employee or beneficiary must notify the employer within 60 days if the employee divorces, or becomes legally separated or if a dependent child ceases to be covered under the plan because of the attainment of a certain age, etc. In addition, if a second qualifying event occurs during the 18-month period after a termination of employment or if the employee is determined to be disabled at the time COBRA begins (or within 60 days), the covered employee or beneficiary must also notify the employer. If the covered employee or beneficiary fails to provide the employer notification of such events, the covered employee or beneficiary forfeits his or her rights under COBRA. The regulations clarify that employers must establish "reasonable procedures" for the employee to provide such notices. Generally, along with certain other requirements, the plan's procedures are deemed reasonable if:
    - ⊙ the procedures are described in the SPD for the plan;
    - ⊙ the SPD must specify the individual or entity which must notified of the qualifying event (or disability determination) and the means by which the notice should be given; and
    - ⊙ the SPD must describe the information about the qualifying event (or disability determination) that the plan administrator requires so that the plan administrator can provide the appropriate notices.
  - ⊙ *New Notice Provisions for Employer When Employee Notifies Employer of Event Which is Not Qualifying Event.* In the event an individual notifies the employer of an event which is not a qualifying event and does not allow a participant to continue under COBRA, the employer must notify the individual within 14 days of the individual's notification to the employer
- that COBRA coverage will not be offered. This will allow individuals to obtain other coverage on a timelier basis.
- ⊙ *Timing of Employer COBRA Notice When Employer is Plan Administrator.* An employer has 14 days after a qualifying event to notify the plan administrator that a qualifying event has occurred. The plan administrator then has 30 days to provide the required COBRA notice to qualified individuals. There has been a controversy in situations where the employer and the plan administrator are the same entity as to whether the employer has 44 days to provide the notice to qualified beneficiaries in such circumstances. The regulations resolve this controversy by indicating that employers who are plan administrators have 44 days to provide the notice even though they are the same entity.
  - ⊙ *Information to be Included in Employer COBRA Notice to Qualified Beneficiary.* The employer notice to qualified beneficiaries which allows such qualified beneficiaries to elect continued health coverage must now provide additional information. The new information is included within a new model notice. Use of the model notice provided in ERISA Technical Release 86-2 (the previous model notice) is no longer deemed good faith compliance with COBRA. All health plans covered by COBRA should modify their current model notices to match the information provided in the new regulations. The proposed regulations require that the COBRA notice to qualified beneficiaries contain all of the following information (which is included in the new model notice):
    - ⊙ an explanation of the consequences of failing to elect COBRA coverage including possible effects on the Health Insurance Portability and Accountability Act of 1996 ("HIPAA") (which provides for certain portability and special enrollment rights and prevents or shortens limitations under new plans for pre-existing conditions);
    - ⊙ description of the COBRA coverage available under the plan;
    - ⊙ description of how long COBRA coverage will last, including events which will discontinue coverage; and
    - ⊙ description of the cost of coverage for each individual and the method of paying the premiums.
  - ⊙ *New Notice Provisions For Employer If COBRA Coverage Is Prematurely Terminated.* If the employer prematurely terminates a qualified beneficiary's cov-

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erage (because of failure of timely payment of premiums by the qualified beneficiary), the employer must provide a notice of such termination to the qualified beneficiary as soon as practicable after the termination of coverage. The notice should include information about the reason for the termination and any other rights the qualified beneficiary may have, including conversion rights.

- *New SPD Requirements.* In addition, the new regulations impose a new requirement in SPDs for health plans relating to the Trade Act of 2002 which quietly added new election provisions to the COBRA requirements for workers who are eligible for a trade readjustment allowance credit under Code Section 35(c) (“TAA-Eligible Individual”). TAA-Eligible Individuals who fail to timely elect COBRA coverage (within the 60-day period beginning on the date the qualified beneficiary receives the COBRA notice from the employer) have an additional time to elect COBRA coverage. An individual who becomes a TAA-Eligible Individual has 60 days from the date he becomes a TAA-Eligible Individual to elect COBRA coverage, as long as the election occurs within 6 months after the loss coverage. Essentially, then, if an individual who becomes a TAA-Eligible Individual within 6 months after the qualifying event and who elects COBRA coverage within

that 6-month period is entitled to have his coverage reinstated under COBRA. However, unlike the typical COBRA provisions which require retroactive reinstatement back to the date of the qualifying event, the TAA-Eligible Individual only receives COBRA coverage beginning on the first day of the 60-day election period. Thus, if the individual becomes a TIAA-Eligible Individual 3 months after losing health coverage and elects COBRA coverage within 60 days of becoming a TIAA-Eligible Individual, the health coverage would need to be reinstated as of the first day of the 60-day period. The time elapsed between the loss of coverage and the reinstatement under the TIAA exception is not counted towards the 63-day period under HIPAA for a break in coverage (and thus possible issues relating to pre-existing condition exclusion limitations are avoided). The regulations now require that information about the extended election period be included in the SPD. Employers should issue a summary of material modification (“SMM”) or modify their SPDs to reflect this new requirement.

We will be happy to help you modify your SPDs, issue new SMMs and modify your current model notices to reflect the new DOL provisions. Please contact Chadbourne’s employment department for further details. ●

## DOL Files Suit Against Enron For Violating ERISA’S Prudence Standards

On June 26, 2003, the U.S. Department of Labor (“DOL”) filed a lawsuit (*Chao v. Enron*) against Enron Corporation (“Enron”), Enron’s former Chief Executive Officers Kenneth Lay and Jeffrey Skilling, Enron’s former board of directors and the former administrative committee for Enron’s retirement plans in the Southern District of Texas, Houston Division.

In the lawsuit, the DOL filed multiple claims against these entities for violating the Employee Retirement Income Security Act of 1974, as amended (“ERISA”), with respect to the Enron Corporation Savings Plan (the “Savings Plan”) and the Enron Corporation Employee Stock Ownership Plan (the “ESOP”) (collectively, the “Plans”). These claims generally relate to each of the parties failures to consider the prudence of investment in Enron stock by the Plans. The DOL seeks to recover from these parties all losses caused by their mismanagement of the Plans.

The DOL also seeks to recover each of the defendant’s accounts in the Plans and to permanently enjoin each of the defendants from acting as a plan fiduciary. The DOL seeks also to impose jointly and several liability for damages due to a breach of fiduciary duty. The DOL filed this lawsuit because of its investigation into Enron financial improprieties which began November 16, 2001.

In 2001, when Enron filed for bankruptcy, the Plans’ held more than 2.1 billion

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## Enron Violations

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dollars shares of Enron stock (50% of the Saving Plan assets were invested in Enron stock, 100% of the ESOP were invested in Enron stock). Approximately 20,000 employees participated in the Savings Plan and approximately 7,600 employees participated in the ESOP. The DOL alleges that, despite obvious warning signals and the subsequent decline of Enron stock throughout 2001, the defendants did not act prudently by considering investments other than Enron stock to protect the Plans' participants from losses.

Section 404(a)(1) of ERISA requires that each fiduciary of a plan must act in the best interests of plan participants and act with "care, skill, prudence and diligence". The DOL alleges that Enron, Kenneth Lay and Jeff Skilling, as fiduciaries to the plans, breached their fiduciary duties by failing to monitor the Administrative Committee and by failing to provide accurate information regarding Enron's financial condition to the Administrative Committee. Further, Kenneth Lay and Jeff Skilling are alleged to have misled participants with statements about Enron's financial condition, including encouraging participants to invest in Enron stock. The DOL claims that Enron's board of directors failed to act prudently by not acting in compliance with the ESOP plan document and failing to name a trustee to manage the ESOP's holdings in Enron stock. The DOL also claims that Enron's Administrative Committee violated its fiduciary duty by failing to recognize the risk to plan participants of having such a large percentage of assets tied to Enron stock despite the decline in value of Enron stock throughout 2001. Finally, the DOL claims that two members of the Administrative Committee specifically ignored detrimental information regard-

ing Enron's financial condition which they had in their possession.

As a result of Enron's collapse, over 20,000 employees in Enron's retirement plans experienced substantial losses in their retirement accounts. The DOL's lawsuit against Enron's named fiduciaries has served as a "wake-up call" to many companies with retirement plans that invest in company stock. Fiduciaries of retirement plans may be held accountable for failing to consider other investments if the value of company stock continually declines. This is even true in the case of ESOPs which are designed to invest primarily in company stock. When making any decisions with respect to a retirement plan, it is imperative that the fiduciaries of the plan always act in the best interests of plan participants. It is likely that the DOL will pay particular attention to such companies and their fiduciaries in the future.

We will continue to monitor this lawsuit and any new developments. If you have any questions or concerns regarding this memo, please contact us. ☺

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### Employee Benefits & Executive Compensation: Legal Perspectives

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