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CLIENT MEMORANDUM

TREASURY PROPOSES DEFERRED COMPENSATION REGULATIONS: BRAVE NEW WORLD FOR EXECUTIVES

Executive Summary

New Internal Revenue Code Section 409A ("Section 409A") became effective on January 1, 2005. It radically changed the procedures that all employers must establish and follow when their employees defer compensation to a later year, and when they receive payments of previously deferred compensation that was not fully vested by December 31, 2004.

The penalties for violating Section 409A are severe. Amounts deferred under defective plans or arrangements will generally be taxable immediately to service providers (hereinafter referred to as "participants" or "employees"), and subject to an additional 20% penalty tax, plus interest at the underpayment rate plus 1%. For the affected employee, these penalties apply to all amounts deferred under the defective plan, as well as all amounts deferred under all *other* plans and arrangements of the *same type* in which the employee participates, for the taxable year of noncompliance and *all prior* taxable years, whether or not they are also defective. The first wave of IRS audits is expected to examine 2005 compliance beginning in 2007.

Interim guidance was provided last December in Treasury Notice 2005-1 ("Notice 2005-1").[1] On September 29, 2005, the IRS and the Treasury issued proposed regulations under Section 409A. The proposed regulations afford substantial relief by confirming that a number of common pay practices will not involve a payment of deferred compensation. However, the rules are still overly complicated, and leave much room for inadvertent noncompliance. Many traps remain and employers will need to exercise great care to avoid them.

This memorandum identifies issues that require immediate attention, either because of year-end 2005 deadlines, or because of issues that may need to be faced throughout 2006. It also highlights key provisions of the proposed regulations that clarify or change the initial guidance under Notice 2005-1.

Overview of Regulations

Section 409A and guidance issued to date require two things: (i) until December 31, 2006, with respect to all deferred compensation arrangements that are not grandfathered, a good faith effort to comply in operation with the requirements of Section 409A and (ii) by no later than December 31, 2006, completion of required amendments to all deferred compensation arrangements. Full compliance with all rules will be required starting in 2007.

[1] For a discussion of the initial guidance set forth in Notice 2005-1, see our client memorandum, "Initial Guidance on New Deferred Compensation Rules," dated December 28, 2004.

Employers have two choices in deciding what constitutes good faith compliance. Although the proposed regulations are not scheduled to become effective until January 1, 2007, they may be relied on now. Alternatively, taxpayers may continue to rely on Notice 2005-1 or, to the extent an issue is not addressed in Notice 2005-1, on a good faith interpretation of Section 409A, until the regulations become final. Interim compliance with either the proposed regulations or Notice 2005-1 will be deemed good faith compliance with Section 409A.

To provide a context for the rules discussed in this memorandum, in order for a deferral of compensation to be valid, Section 409A generally requires that:

- an irrevocable election to defer be made prior to the beginning of the year when the compensation will be earned;
- both the time and form of payment be specified irrevocably when the deferral election is made;
- a specified payment date or dates be objectively determinable when the deferral election is made without the exercise of employer or employee discretion; and
- no acceleration of deferred compensation can be permitted, except in very limited circumstances.

Most importantly, Section 409A guidance requires that an employer understand all of the circumstances under which a deferral of compensation will be treated as having occurred, before necessary changes can be identified and implemented.

What Employers Should Do Now

<u>Make Sure the Compliance Team Is in Place</u>. Section 409A applies to all nonqualified deferred compensation plans. This term is broadly defined to include many compensation arrangements or practices that were not previously considered to involve deferral of compensation. Since the rules are currently effective, each employer should be certain that an appropriate individual or team has been designated to be responsible for compliance. This person or team must develop a working familiarity with the Treasury guidance issued to date so that all covered nonqualified deferred compensation plans and practices can be promptly identified and necessary changes can be addressed.

<u>Review All Executive Compensation Plans and Other Pay Practices</u>. A partial list of plans and agreements that may be treated as covered nonqualified deferred compensation plans includes:

- voluntary deferral plans and arrangements, and mandatory plans that do not require any deferral elections but that result in the deferral of compensation;
- equity compensation plans (*e.g.*, plans that provide for grants of stock options, stock appreciation rights ("SARs"), phantom stock units, restricted stock units and/or deferred shares, and all related forms of grant agreements), and amendments to any of the foregoing that might involve modifications or extensions of a participant's rights;

- employment and consulting agreements;
- severance pay plans, change in control plans and separation agreements;
- long-term and short-term incentive plans; and
- 401(k) wrap plans and supplemental executive retirement plans.

Decide Whether Action Is Needed in 2005

- 2006 Deferral Elections. Participants who wish to defer compensation that will be earned in 2006 *must* make their deferral elections no later than December 31, 2005.

- March 15, 2005 Deferral Election Rights Must Be Reflected in Plan Documents by December 31, 2005. Employers who permitted employees to defer 2005 compensation by making their deferral election as late as March 15, 2005 *must* amend their plan documents by December 31, 2005 to reflect the deferred election date.

- One-Time Opt-Out Election. Until December 31, 2005, employers may terminate any nonqualified deferred compensation plan or arrangement (including a grandfathered plan) and distribute the amounts deferred, provided any vested deferred compensation that is distributed is included in 2005 income. Employers may also amend any plan (including a grandfathered plan) to allow employees to terminate their participation in the plan, or to cancel one or more outstanding deferral elections, provided that any related vested deferred compensation is included in 2005 income. Either of these actions would require appropriate participant communications.

- 2005 Changes to Form and Timing of Payments. The time by which participants may change a previous deferred compensation election to modify the form of payment, or to accelerate or delay the timing of payment, without violating the subsequent deferral or anti-acceleration rules, has been extended from December 31, 2005 until December 31, 2006, provided that the relevant plan or arrangement is amended by December 31, 2006. However, participants who wish to accelerate a payment of deferred compensation into 2006, or further defer a payment that would otherwise be paid in 2006, may only do so if an election is filed in 2005 and there is no constructive receipt under pre-409A principles.

- Exercise or Cash-Out of Discounted Stock Options and SARs. Discounted stock options and discounted SARs involve a deferral of compensation subject to Section 409A. They can be terminated without penalty by exercising them and cashing them out in 2005. Alternatively, they can be replaced by an option or SAR (options and SARs, together with other stock-based awards such as restricted stock units, are collectively referred to herein as "stock rights") with an exercise price that would not have been discounted (*i.e.*, priced at fair market value) on the original date of grant, and a fully vested additional cash payment can be made to make up for the lost discount, provided that the replacement and cash payment is made by December 31, 2005.

- Corrections of Inadvertent Modifications. If action has already been taken to amend a plan or arrangement but participants have not yet made elections in reliance upon the amendment, it can be rescinded prior to December 31, 2005 if the effect of the amendment is undesirable, *e.g.*, because it would cause the plan to lose its grandfathered status.

- 2005 Forms W-2 and 1099. Employers need to decide what compensation has to be reported as deferred in 2005. Information reporting of 2005 deferrals to employees on Form W-2 and nonemployees on Form 1099-MISC will generally be required by January 31, 2006, if the amount deferred exceeds $600. Guidance for calculating the amount deferred was promised but not provided. Guidance under Notice 2005-1 provides that employers need only report compensation actually deferred *during or after* 2005. The Notice makes clear that the deferral takes place during the taxable year when the employee first acquires a legally binding right to payment in a later year, regardless of whether the payment is subject to a substantial risk of forfeiture because of the operation of the objective terms of the plan or arrangement.

  As a practical matter, this means that information reporting for most deferrals made prior to 2005 will not be necessary, since a legally binding right will normally be present unless the employer has discretion to unilaterally reduce or eliminate compensation after the services have been performed. The proposed regulations further clarify that no deferral takes place if the payment will not be treated as deferred compensation when paid because of one of the exclusions, *e.g.*, the short-term deferral exception.

Decide Whether Action Is Needed in 2006

- Plan Document Compliance. Employers have until December 31, 2006 to amend plan documents to comply with the Section 409A provisions that require the inclusion of specific plan language. (As noted, good faith operational compliance has been required since January 1, 2005.)

- Replacement of Discounted Stock Rights. Until December 31, 2006, discounted stock rights that were not terminated in 2005 can be replaced with new stock rights that have an exercise price equal to the fair market value of the stock on the *original* date of grant. However, any make-up payment made in 2006 for the lost discount must be subject to vesting in a future year.

- Payment Elections Controlled by a Linked Qualified Plan. Until December 31, 2006, elections as to timing and form of payment under a nonqualified 401(k) wrap plan or SERP will not violate Section 409A if such payments are controlled by payment elections under a linked qualified plan.

Key Provisions

Stock Options, SARs and Other Equity-Based Compensation

- Relief for SARs. The proposed regulations provide that SARs (including cash-settled SARs and SARs issued by a private corporation), like stock options, will not be treated as deferred compensation subject to Section 409A so long as they (i) have an exercise price that cannot be less than the fair market value of the underlying stock on the date of grant and (ii) do not provide for the deferral of compensation beyond the date when the SARs are exercised.

- Modifications of Stock Rights that Should Be Avoided. Any modification of a stock right (other than a timely modification to bring it into compliance with Section 409A) will cause it to become subject to and potentially defective under Section 409A. The term "modification" means any (i) reduction in exercise price, (ii) addition of a deferral feature or (iii) extension or renewal of the stock right (regardless of whether the holder in fact benefits from the modification). The proposed regulations treat any modification (other than an extension or a renewal) as the grant of a new stock right on the date of modification, which will constitute a deferral of compensation if the price of the stock has risen since the original grant date. A stock right that is extended or renewed is treated as having had a deferral feature (and thus becomes subject to Section 409A) from the original date of grant.

- Permitted Modifications of Stock Rights. Exceptions are provided for any stock right that is extended to a date that is no later than the *later* of (i) the 15th day of the third month following, or (ii) December 31 of, the calendar year in which the right would otherwise have expired if it had not been extended. Employers can use this exception to provide for a limited extension of an employee's post-termination exercise period. The proposed regulations also confirm that the acceleration of vesting, the addition of the right to use previously acquired stock to pay the exercise price and the addition of a stock withholding feature to satisfy applicable tax withholding will not constitute modifications.

- Prompt Action May Cure Inadvertent Modifications. An inadvertent or other inappropriate modification of a stock right can be rescinded prior to the earlier of (i) the date the stock right is exercised or (ii) the last day of the calendar year during which the change occurred.

- Establishing the Strike Price. Permissible valuation methodologies are provided for public and private companies. The fair market value of public company stock may be determined using (i) the last sale price before or first sale price after the grant date, (ii) the closing price on the grant date or the trading day prior to the grant date or (iii) any other reasonable basis consistently applied (including the average of the sales prices during a period within 30 days before or after the grant date, provided the period is set before the date of grant).

  The fair market value of private company stock must be determined by applying a reasonable valuation method based on the facts and circumstances on the valuation date. In order to be reasonable, the method must consider all available information material to the valuation.

Three safe harbor valuation methods are provided that will be presumed to result in a reasonable valuation, which include (i) use of an independent appraisal within 12 months of the valuation date, (ii) use of a valuation formula consistent with the rules under Section 83 of the Code for valuation of shares subject to a nonlapse restriction and (iii) a reasonable good faith valuation of an illiquid start-up company evidenced by a written report, if performed by a person with significant knowledge of and experience with such valuations.

- Only Employer Common Stock Can Be Used. To be exempt from Section 409A, stock rights must relate to common stock of the employer that is readily tradable on an established securities market or, if not so tradable, the class of employer common stock with the highest aggregate value of any class of employer common stock on the grant date, or other employer common stock having substantially similar rights (disregarding differences in voting rights). Most stock rights granted before 2005 (whether vested or not) are not subject to the above limitations. However, any stock rights on preferred stock, or rights on common stock that are subject to a mandatory repurchase obligation or put or call rights (that are not lapse restrictions) based on a measure other than fair market value, will *not* be exempt, even if granted before 2005.

- Stock Rights Granted to Employees of Subsidiaries. Flexibility is provided to make grants of stock rights to employees of subsidiaries by treating parent companies that own at least 50% of the subsidiary as issuers of employer stock. Where there is a legitimate business purpose (*e.g.*, a joint venture), a 20% ownership interest will be sufficient.

- Substitutions and Assumptions in Corporate Transactions. The substitution or assumption of a stock right in a corporate transaction will not be treated as the grant of a new stock right or change in the form of payment if the ratio of the exercise price to the fair market value of the stock following the transaction is not greater than the ratio prior to the transaction. Similarly, proportional adjustments for stock splits or stock dividends are not modifications.

- Dividend Equivalents. A dividend equivalent paid to the holder of a stock option or SAR will be treated as a discount to the exercise price and cause it to be subject to Section 409A from the outset, unless the right to the dividend equivalent is set forth in an arrangement separate from the option or SAR grant and independently complies with Section 409A.

Short-Term Deferrals

- No Plan Document Required. Notice 2005-1 provided that where a payment is made within two and a half months of the end of the first taxable year in which the payment is no longer subject to a "substantial risk of forfeiture," the arrangement would not constitute a deferral of compensation under Section 409A, provided that the arrangement *required* that payment be made no later than two and a half months following the end of the year. The proposed regulations clarify that a plan document or other arrangement need not specifically require payment by this date, and in fact no plan document is required for Section 409A purposes, so long as the payment is actually made by such date. However, if the short-term deferral date is not specified in the plan, and if payment is not in fact made within the short-term deferral period, the payment will not be timely and the arrangement will be treated as a deferral of compensation subject to Section 409A. By contrast, if the plan document requires that a payment be made by the short-term deferral date, relief will generally be available provided that the payment is made in the same calendar year as the fixed payment date (See *"Time and Form of Payment – Making the Payment"* below). For this reason, plans seeking to comply with the short-term deferral rule generally should specify a payment date within the permissible short-term deferral period.

Separation Pay Arrangements

- <u>Involuntary Terminations</u>. Severance pay, whether pursuant to a severance pay plan, a change in control agreement, or an individually negotiated employment agreement or separation agreement, may constitute deferred compensation subject to Section 409A. However, an exemption is provided for severance arrangements where the severance is paid upon an employee's involuntary separation from service or pursuant to a window program, provided that the severance amount (i) does not exceed the *lesser* of (A) two times the employee's aggregate annual compensation for the year immediately prior to the year of termination or (B) two times the compensation limit under Section 401(a)(17) of the Code for the year prior to termination (*i.e.*, $205,000 for 2005 terminations, and $210,000 for 2006) and (ii) is paid no later than December 31 of the second calendar year following the year of termination.

  Because severance payments are generally subject to a "substantial risk of forfeiture," involuntary separation pay arrangements that do not qualify for the prior exemption may still be exempt from Section 409A under the "short-term deferral" exception, if paid within two and a half months following the end of the year in which the involuntary termination occurs.

- <u>Key Employees</u>. The proposed regulations do not categorically treat the right to a payment upon a resignation for "good reason" as a nonvested right subject to a "substantial risk of forfeiture," and therefore neither of the exemptions described above may be available for payments made to key employees of public companies who resign for good reason. Until further guidance is provided on this point, arrangements for key employees that provide payment of severance upon resignation for good reason should be analyzed on a case-by-case basis, and in some circumstances it may be advisable to amend such arrangements to delay severance payments until six months following any termination of employment.

- <u>Post-Termination Reimbursement of Expenses</u>. The proposed regulations also provide an exemption for the reimbursement of business expenses, reasonable outplacement and moving expenses, medical expenses and certain other expenses (including in-kind office space, secretarial services and certain *de minimus* expenses less than $5,000) provided in connection with a termination of employment, provided that all payments are made no later than December 31 of the second calendar year following the year of termination.

- Separate Plan Category for Separation Pay Arrangements. The proposed regulations create a new category of deferred compensation plans for separation pay arrangements and window programs for purposes of the plan aggregation rules. Thus, all amounts that a participant defers under a separation pay arrangement or window program will be aggregated as a single plan, but will not be combined with amounts the participant defers under account balance plans, nonaccount balance plans or other plans or arrangements.

Time and Form of Payment

- Time for Electing Deferral of Performance-Based Compensation. Where the compensation is "performance-based," Section 409A provides an exception to the general requirement that deferral elections must be made no later than the end of the year preceding the year in which the services are to be performed. Under this exception, deferral elections may be made as late as six months prior to the end of the service period in which the performance-based compensation is to be earned.

  In order to qualify as performance-based compensation, the proposed regulations provide that the compensation must be contingent on the satisfaction of organizational or individual performance criteria established in writing not later than 90 days after the commencement of the performance period and the performance period must last at least 12 consecutive months. The performance criteria may be subjective, provided that (i) the criteria relate to the performance of the employee, or a group or business unit that includes the employee, and (ii) the employee has no control or influence, directly or indirectly, over the determination of whether the subjective performance criteria are satisfied.

  Notice 2005-1 provided that performance-based compensation could not be based solely on the value of, or increase in the value of, the employer or the stock of the employer. The proposed regulations reverse this position and allow for performance-based compensation based solely upon an increase in the value of an employer or employer stock after the date of award. However, if an amount of compensation that an employee will receive pursuant to such equity/performance-based award is not based *solely* on an increase in the value of the employer or employer stock after the date of award (*e.g.*, in the case of restricted stock units or a stock right granted with an exercise price that is less than the fair market value of the stock as of the date of award), and the portion of the award that is not based solely on such increase would not otherwise qualify as performance-based compensation, none of the compensation attributable to the award will be performance-based compensation.

- Setting the Payment Date. The proposed regulations afford substantial flexibility, both for specifying the distribution events and for making distributions. Under Section 409A, payments of deferred compensation must be made at a predetermined time (or pursuant to a fixed schedule) specified under the plan or upon separation from service, disability, death, change in control or unforeseeable emergency. The proposed regulations effectively expand these options by allowing payments to be made either on a specified date or in a calendar year, or pursuant to a fixed schedule beginning on a specified date or in a calendar year, that is objectively determinable by reference to a permissible payment event (*e.g.*, three substantially equal payments during the three calendar years following the year of death).

A payment may also be made on a date or in a calendar year (or pursuant to a fixed schedule beginning on a specified date or in a calendar year) that is objectively determinable based upon the date of the lapse of a substantial risk of forfeiture. For example, where a bonus payment is subject to the condition that the employer complete a successful initial public offering within a 12-month period, a participant could elect to receive payment in three annual installments on the first three anniversaries following the initial public offering. Moreover, a plan may specify the earlier or later of two or more specified permissible payment events as well as alternative dates or schedules (*e.g.*, three equal annual installments commencing on the first day of the month following separation from service, or in a lump sum 30 days following death).

- <u>Making the Payment</u>. Payments do not have to be paid on the actual scheduled payment date to be timely. A payment will be treated as made upon a designated date if the payment is made by the end of the calendar year containing the designated date (or the 15th day of the third calendar month following the specified date, if later). For example, a payment scheduled to be made on July 7, 2007 will be treated as paid on such date if it is paid by December 31, 2007 and a payment scheduled to be made on December 7, 2007 may be paid at any time until March 15, 2008.

- <u>Delayed Payments Allowed</u>. The proposed regulations also allow for further delays (i) if calculation of the payment amount is not administratively practicable (so long as the delay is not caused by the action or inaction of the participant), (ii) where employer funds are insufficient, (iii) where payments would violate securities or other laws or loan covenants of the employer or other contractual terms to which the employer is bound, and where making such payments would result in material harm to the employer and (iv) where payment on the specified date would result in the loss of a deduction under Section 162(m) of the Code. However, delays for violations of law or contractual terms and on account of Section 162(m) must be provided for in the plan document or other arrangement.

- <u>Earn-Outs in Connection with a Change in Control</u>. The proposed regulations provide a special rule to allow employers to delay earn-outs paid to participants following a change of control. Under this special rule, payments can be delayed for up to five years from the change in control event, so long as they are paid on the same schedule and under the same terms and conditions as (i) payments made to shareholders in connection with a change in the ownership of the corporation or (ii) payments made to the employer pursuant to a change in the effective control of the corporation. Any amounts paid pursuant to such schedules and terms and conditions will be treated as being paid at a specified time or pursuant to a fixed schedule, in conformity with the requirements of Section 409A, and will not be treated as violating the initial or subsequent deferral election rules.

Mandatory Six-Month Delay for Distributions to "Key Employees" of Public Companies on "Separation from Service"

- Identification. Section 409A requires that payments of deferred compensation scheduled to be made by publicly traded companies to "key employees" upon a "separation from service" must be delayed for at least six months following separation. Key employees are defined by reference to the top-heavy rules under tax-qualified retirement plans (generally the 50 highest paid officers in the employer's controlled group). The proposed regulations provide that key employees may be identified by reference to a 12-month period ending on December 31 or such other identification date chosen by the employer. Any individual who is a key employee during this 12-month identification period will be a key employee for the 12-month period beginning on the first day of the fourth month following the identification period. Once determined by the employer, any change in the identification date cannot take effect for 12 months. The proposed regulations also provide guidance for determining key employees following mergers and spin-offs. As part of the transition relief, the proposed regulations provide that any designation of an identification date chosen by an employer prior to December 31, 2006 may be applied to any separation from service that occurs after January 1, 2005.

- Implementation. Where payments to a key employee are scheduled to be paid in installments commencing after separation from service, the proposed regulations permit an employer either to aggregate payments due during the first six months and make a lump sum catch-up payment at the beginning of the seventh month or to postpone each interim installment payment for six months. The plan must specify the payment method, and any change in the payment method cannot take effect for 12 months.

Definition of "Separation from Service"

The proposed regulations generally provide that a separation from service does not occur during a *bona fide* leave of absence, such as military leave or sick leave, provided that the leave does not exceed six months. Generally, unless facts and circumstances can be shown that demonstrate otherwise, an employee will not be treated as having separated from service (and distribution of deferred compensation would not be permitted on account of a separation from service) if the employee continues to perform services as an employee after the nominal separation date at an annual rate that is more than 20% of the annual services rendered, and earns more than 20% of the average annual compensation earned, over the three years preceding such separation. Even if employment is terminated, the employee will still not be treated as having separated from service if he continues to provide services as an independent contractor at an annual rate that is 50% or more of the annual services rendered, and earns 50% or more of the average annual compensation earned, over the three years preceding such separation.

Discretionary Termination of Plans

As noted above, employers have until December 31, 2005 to terminate plans without having to comply with the requirements of Section 409A. After the end of this year, an employer may terminate a deferred compensation plan and accelerate distributions to employees only in connection with certain corporate events or subject to certain restrictions.

- Voluntary Termination. The proposed regulations provide a safe harbor to allow an employer to terminate a deferred compensation plan and make distributions to participants provided that (i) the employer terminates all arrangements of the same type with respect to all participants (*e.g.*, all account balance plans), (ii) no payments are made within 12 months of the plan termination date (other than those otherwise payable under the terms of the plan absent termination), (iii) all payments are made within 24 months of the plan termination date and (iv) no new arrangement of the same type under the plan aggregation rules is adopted for a period of five years following the date of termination of the plan.

- Change in Control; Bankruptcy. The proposed regulations also allow for the discretionary termination of a deferred compensation plan (i) within 12 months following certain corporate dissolutions or with the approval of a bankruptcy court and (ii) within 30 days prior to or 12 months following a change in control.

Managers of Hedge Funds and REITs No Longer Exempt as Independent Contractors

Section 409A does not apply to amounts deferred pursuant to an arrangement between a service recipient and an unrelated independent contractor (other than a director of a corporation), if during the independent contractor's taxable year in which the amount is deferred, the independent contractor is providing significant services to each of two or more service recipients that are unrelated, both to each other and to the independent contractor. However, the proposed regulations clarify that this exclusion does not apply to situations where an independent contractor is providing *management services*, which include investment advisory services provided to investment funds, and any services involving the direction or control of the client's trade or business. For example, deferred compensation attributable to investment advisory services provided to a hedge fund, or property management services provided to a real estate investment trust, is subject to Section 409A.

Issues Not Addressed

The following issues were not addressed under the proposed regulations but are expected to be addressed under future guidance:

- Calculation and timing of income inclusion amounts. The proposed regulations do not address the calculation of the amount of deferrals, the amount of income inclusion upon the violation of the provisions of Section 409A, or the timing of income inclusion and related withholding obligations.

- Treatment of offshore trusts and other funding arrangements. The proposed regulations do not provide guidance with respect to the prohibition on the funding of deferrals in offshore trusts or transfers pursuant to a change in the financial health of the employer.

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If you have questions, or would like our assistance in identifying, reviewing or amending your nonqualified deferred compensation arrangements, please call Stephen T. Lindo at (212) 728-8242, Frank A. Daniele at (212) 728-8216, Peter J. Allman at (212) 728-8101, Peter E. Haller at (212)-728-8524, David E. Rubinsky at (212) 728-8635, J. Pasco Struhs at (212) 728-8109 or the attorney with whom you regularly work.

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November 7, 2005