



Treasury Issues New Employee Compensation and Corporate Governance Standards for TARP Recipients

June 23, 2009

OVERVIEW

On June 10, 2009, the U.S. Department of the Treasury ("Treasury") issued an Interim Final Rule (the "Interim Final Rule") as required under the American Recovery and Reinvestment Act of 2009 (the "ARRA")¹ on the Troubled Assets Relief Program ("TARP") standards for employee compensation and corporate governance (the "TARP Standards"). The TARP Standards apply to any public or private institution that receives assistance under TARP, and to the subsidiaries or parents of such institutions (based on an at least 50% ownership interest determined in accordance with rules set forth in the Internal Revenue Code of 1986, as amended (the "Code")).² The ARRA, as implemented and expanded by the Interim Final Rule, significantly increases the restrictions on employee compensation and severance arrangements for TARP recipients. The TARP Standards became effective on June 15, 2009 and superseded all prior rules and guidance issued by Treasury regarding the executive compensation and corporate governance standards required of TARP recipients.³ However, Treasury has invited public comment on the Interim Final Rule, which comments are due by August 14, 2009.

Described briefly, the TARP Standards provide for the following:

- **Restrictions on Compensation Applicable to all TARP Recipients.** A TARP recipient will be required to adjust many compensation arrangements for its "senior executive officers" and potentially other "most highly compensated employees" so as to, in general: (1) cap bonus accruals and bonus payments to one-third of the applicable employee's total amount of "annual compensation" (with all bonuses payable solely in "long-term restricted stock"); (2) eliminate "golden parachute payments" (e.g., any

¹ The ARRA was enacted on February 17, 2009.

² The Interim Final Rule clarifies that entities that are not party to a direct financial transaction with Treasury, such as entities that receive loans under the Federal Reserve's Term Asset-Backed Securities Loan Facility, are not considered to be in receipt of "financial assistance." Therefore, they are not subject to the TARP Standards.

³ The \$500,000 cap on deductibility under Code Section 162(m)(5) continues to apply to TARP recipients, as do any contractual provisions previously agreed to with Treasury by a TARP recipient, to the extent such provisions are not inconsistent with the Interim Final Rule.

severance and/or change-in-control related payments, regardless of the amount of such payments) and most tax “gross-up” arrangements; and (3) impose clawback provisions on bonus, retention and incentive compensation.

- **Corporate Governance and Risk Assessment Rules Applicable to all TARP Recipients.** A TARP recipient will be required to establish an independent compensation committee, which will be required to: (1) meet on a regular basis to review and evaluate compensation arrangements and risks related to compensation structures; (2) prepare a narrative report regarding its review; and (3) together with the TARP recipient’s principal executive officer and principal financial officer, certify compliance with the TARP Standards. In addition, the TARP recipient’s board of directors is required to adopt a corporate policy on luxury and excessive expenditures.
- **Additional Disclosure Requirements Regarding Perquisites and Use of Compensation Consultants Applicable to all TARP Recipients.** A TARP recipient will be required to provide to Treasury and its primary regulator additional disclosure regarding any annual perquisites valued in excess of \$25,000 that are provided to senior executive officers and other most highly compensated employees, as well as any services received from its compensation consultant.
- **Say-on-Pay Shareholder Vote Applicable to all TARP Recipients.** A TARP recipient will be required to submit its compensation arrangements with its senior executive officers to a non-binding shareholder vote at each annual meeting, in accordance with rules to be adopted by the Securities Exchange Commission (the “SEC”).
- **Compensation Payable by TARP Recipients that have Received Exceptional Assistance is Subject to Approval by a Special Master and Compensation Paid by All TARP Recipients is Subject to Review and Negotiation for Reimbursement by a Special Master.** Each TARP recipient that has received “exceptional assistance” (e.g., Citigroup, Bank of America, General Motors) must obtain the approval of the newly established Office of the Special Master for TARP Executive Compensation (the “Special Master”) for payments and compensation arrangements of its senior executive officers and other most highly compensated employees. Additionally, the Special Master is required to review compensation paid prior to February 17, 2009 to senior executive officers and other most highly compensated employees of all TARP recipients to determine if such payments were inconsistent with the ARRA, and if so, is also required to negotiate with such employees for reimbursement of such payments.

WHO IS COVERED?

Senior Executive Officers.

The TARP Standards rely on federal securities rules for compensation disclosure (“Proxy Rules”) to, among other things, determine which employees of a TARP recipient are subject to

the TARP Standards. Specifically, the TARP Standards apply to compensation arrangements with – at a minimum – a TARP recipient’s “senior executive officers” (or “SEOs”), which are the TARP recipient’s “named executive officers” as defined under the Proxy Rules. Under the Interim Final Rule, these officers will include at least: the principal executive officer, the principal financial officer and the other three most highly compensated executive officers of a public entity whose compensation is required to be disclosed in the TARP recipient’s annual proxy statement or other applicable annual compensation disclosure. Note that smaller reporting companies will have five SEOs, even if they are otherwise only required under the Proxy Rules to disclose the compensation of three executives. Non-reporting companies are required to apply the public company rules by analogy.

Other Highly Compensated Employees.

In addition to covering SEOs, many of the restrictions under the ARRA also cover between five and twenty additional “most highly compensated employees” (or “HCEs”), depending upon the level of financial assistance provided to the TARP recipient and the applicable rule (and, if the TARP recipient has received exceptional assistance, then, as discussed further below, the compensation structures of its executive officers and its 100 HCEs that are not subject to the TARP Standards will be subject to approval by the Special Master). The definition of HCE is not limited to executive officers or policymakers – any highly compensated employee (e.g., investment bankers and traders) could be subject to the TARP Standards. Whether an employee is an HCE is determined by reference to that employee’s total “annual compensation” for the prior fiscal year, calculated using the same Proxy Rules used to determine a public company’s SEOs. As a result, there may be significant changes in the HCEs from year to year, as the application of the restrictions on bonus payments (described below) in one year may cause an employee whose bonus is restricted to cease being an HCE in the following year. SEOs and the applicable number of HCEs are collectively referred to in this memorandum as “covered employees.”

Note, however, that partners or members in a TARP recipient that is a partnership or a limited liability company generally are excluded from the definition of “employee” of such TARP recipient and are therefore not covered employees, unless the entity in question was created to avoid the compensation restrictions imposed by the TARP Standards.

PERIOD DURING WHICH THE TARP STANDARDS APPLY

Under the ARRA, a TARP recipient must satisfy certain “standards for executive compensation and corporate governance” for so long as the TARP recipient has an obligation to repay financial assistance received from the U.S. Government under TARP (excluding any period during which Treasury only holds warrants to purchase common stock of the TARP recipient) (the “TARP Period”). However, even after the TARP Period, the TARP Standards regarding limitations on bonus payments and golden parachute payments paid to a former covered employee will still apply to payments that are determined by the Special Master to be payable or accrued in respect of services performed by the covered employee during the TARP Period.

TARP STANDARDS FOR COMPENSATION AND CORPORATE GOVERNANCE

Restrictions on Compensation Applicable to all TARP Recipients.

- ***No Payment or Accrual of Bonuses (Including the Grant of Equity-Based Awards) for Covered Employees, Except Long-Term Restricted Stock Grants with a Value Not to Exceed One-Third of Total Annual Compensation.*** TARP recipients cannot pay or accrue any bonus, retention or incentive compensation to covered employees (including by granting a stock option or other equity-based award or contributing to a nonqualified deferred compensation plan), unless either (1) the compensation is payable solely in “long-term restricted stock” that has a value no greater than one-third of the covered employee's total amount of annual compensation or (2) the covered employee had a legally binding right to the compensation under an agreement as of February 11, 2009.

Covered Employees. The employees who are subject to this limitation on bonus payments will vary depending on the amount of financial assistance the TARP recipient has received, as follows:

- Only the most highly compensated employee of any TARP recipient that has received less than \$25 million in financial assistance;
- At least the five HCEs of any TARP recipient that has received at least \$25 million but less than \$250 million in financial assistance;
- All CEOs and at least the ten HCEs of any TARP recipient that has received at least \$250 million but less than \$500 million in financial assistance;
- All CEOs and at least the twenty HCEs of any TARP recipient that has received \$500 million or more in financial assistance.

Definition of Bonus Payment; Rules Regarding Accrual and Payment of Bonus Payments. The term “bonus payment” is broadly defined under the ARRA as a payment that is, or is in the nature of, a bonus, incentive compensation, or a retention or “make whole” award (including certain contributions to, or increases in benefits under, a nonqualified deferred compensation plan and forgiveness of loans or other indebtedness). The term “bonus” is any payment in addition to any amount payable to a covered employee for services at a regular periodic rate, but excludes the following types of compensation:

- payments to or on behalf of an employee as contributions to tax-qualified retirement plans,
- benefits under a broad-based benefit plan (generally, an ordinary course welfare benefit plan), bona fide overtime pay or routine expense reimbursements, and

- commission payments, but only to the extent that such payments are paid pursuant to a very narrowly tailored ordinary course of business exemption, which expressly does not include bonuses for special transactions such as an initial public offering.

Bonus payments accrued but unpaid before the TARP Period may still be paid during the TARP Period. In addition, bonus payments for multi-year service periods that begin before or end after the TARP Period can still be paid, but must be reduced to reflect the portion of the service period that the employee was a covered employee (and if the service period ends during the TARP Period, even the reduced payment cannot be made until the employee ceases to be a covered employee).

Note that a TARP recipient cannot simply defer bonuses until the end of the TARP Period or until an individual ceases to be a covered employee. If an individual who has been identified as a covered employee ceases to be a covered employee, and at or after that time is paid a bonus or provided a legally binding right to a bonus payment that is based on services performed or compensation received while a covered employee, such bonus or right will nevertheless be treated as having accrued during the TARP Period (and would therefore be subject to the limitations of the ARRA and the TARP Standards).

Exception for Long-Term Restricted Stock Grants. A TARP recipient is permitted to grant to its covered employees restricted common stock or restricted stock units (whether payable in cash or stock, and whether based on common stock or, if granted by a division of the TARP recipient, a unit analogous to common stock), so long as the grant satisfies the following requirements:

(1) One-Third of Total Compensation. The fair market value of the stock or units, as of the date of grant, does not exceed one-third of the covered employee's total annual compensation as determined for the fiscal year in which the grant is made (that is, using the compensation calculation criteria under the Proxy Rules, but not using the look-back method for the prior year, and not including the value of any equity-based compensation awards granted in years ending prior to June 15, 2009 that would otherwise be included in the annual compensation calculation under the Proxy Rules).

(2) Transfer Restrictions. The restricted stock or units may become transferable or payable in increments of 25%, at each time that the TARP recipient repays 25% of its TARP obligations, but not on any earlier schedule, except that a portion of any restricted stock reasonably required to pay taxes due upon vesting may also be sold.

(3) Vesting Schedule. The covered employee receiving the grant must be required to perform services for at least two years from the date of grant in exchange for the grant, and the grant must be forfeited if this service condition is not met, except in the event of the employee's death or disability or a "change in control event" of the

TARP recipient (as defined in the regulations promulgated under Code Section 280G or Section 409A).

Exception for Grandfathered Bonus Arrangements. TARP recipients may pay to covered employees, without limitation, bonus payments required to be paid under a “valid employment contract” if the covered employee had a legally binding right under the contract to the bonus payment as of February 11, 2009 (note the term “valid employment contract” appears to include incentive compensation grant agreements and bonuses payable under a discretionary bonus plan if the TARP recipient’s board of directors or compensation committee has determined, as of February 11, 2009, the amount of bonus to be paid and set a payment date). Any amendment to the contract to increase the bonus payment, accelerate vesting conditions or otherwise materially enhance the benefit available to the covered employee will result in the disqualification of the bonus payment from this exception.

- **No Severance Payments or Change in Control Payments to “Top 10”.** TARP recipients are prohibited from making any severance or other payment to its CEOs and the next five HCEs, either for the departure of any such covered employee for any reason, or due to a “change in control event” (as defined in the regulations promulgated under Code Section 280G or Section 409A) of the TARP recipient (or any of its affiliates). Accordingly, a TARP recipient (and its affiliates) are prohibited from paying a transaction bonus or any other “single trigger” payment upon a change in control (such as accelerated vesting of equity-based awards) in addition to the prohibition on payments upon termination of employment imposed by the ARRA. The only exceptions to this rule are “payments for services performed or benefits accrued” and certain specified excluded payments described below:

(1) Payments for Services Performed or Benefits Accrued. Whether a payment is for services performed or benefits accrued is a facts and circumstances test, but this test will generally be satisfied so long as:

(x) the payment would be made regardless of whether the covered employee departs or the change in control event occurs, or if the payment is due upon the departure of the covered employee regardless of whether the departure is voluntary or involuntary (excluding any required forfeiture of a payment upon an involuntary departure for cause); and

(y) if the payment is to be made from a benefit plan or deferred compensation plan, (I) the plan must have been in effect, without amendment that would increase the benefits payable under the plan, at least one year prior to the departure and provide only for the periodic accrual of benefits for current or prior service, (II) the covered employee has a vested right at the time of the departure or change in control event (but not due to such departure or event) and no payments being made are based on any discretionary acceleration of vesting or accrual of benefits

occurring later than one year prior to the departure or change in control event, and (III) for payments under a deferred compensation plan, the TARP recipient has previously recognized compensation expense and accrued a liability for the benefit payments according to GAAP or set aside assets in a nonbankruptcy-remote trust that may only be used to pay plan benefits and payments are not in excess of such accrued liability.

(2) Specified Exclusions. The following payments are permissible: (x) payments under a U.S. tax-qualified retirement plan or a pension or other retirement plan governed by the laws of any non-U.S. country; (y) payments made upon a departure of the covered employee due to death or disability; and (z) any severance or similar payment due under any state statute or foreign law applicable to all employers within the applicable jurisdiction (without regard to whether a contract exists providing for such payment).

- ***Prohibition on Tax Gross-Up Payments to "Top 25"***. TARP recipients are not permitted to provide to any SEO or the next 20 HCEs payment of, or a right to a payment of, any reimbursement of taxes owed by the covered employee with respect to any compensation, excluding payments under a tax equalization agreement intended to compensate the covered employee for taxes imposed by a foreign jurisdiction in excess of those imposed if the covered employee's compensation was subject only to U.S. federal, state and local income taxes.
- ***Clawback on Bonuses Paid to "Top 25" based on Materially Inaccurate Financial Statements or Performance Metric Criteria***. TARP recipients will be required to have the right to recover any bonus, retention or incentive compensation that has been paid based on "statements of earnings, revenues, gains or other criteria that are later found to be materially inaccurate." Generally, whether a financial statement or performance metric criteria is materially inaccurate (including, for purposes of a performance criteria, the inaccurate measurement of performance or application of the criteria to actual performance) is based on the facts and circumstances. However, with respect to any covered employee who knowingly engaged in providing (or not timely correcting) inaccurate information relating to any financial statement or performance metric, such statement or criteria will be treated as materially inaccurate whether or not such inaccuracy is in fact material (and consequently such covered employee's bonus shall be subject to this "clawback" provision).

This "clawback" provision applies to SEOs and the next 20 HCEs of the TARP recipients, and must be enforced unless the TARP recipient demonstrates it is unreasonable to do so (e.g., if the expense to clawback the amount paid would exceed the amount to be recovered). An amount is deemed paid for these purposes at the time the covered employee obtains a legally binding right to payment of such amount. There are no exceptions to this clawback requirement.

Corporate Governance and Risk Assessment Rules Applicable to all TARP Recipients.

- *Prohibitions on Plans that Encourage Manipulation of Reported Earnings or Provide Incentives to Senior Executive Officers to take Unnecessary and Excessive Risks.* The TARP Standards require a TARP recipient to take the following actions (and certify annually that it has taken such actions) in order to be in compliance with these prohibitions:

(1) Establish Independent Compensation Committee. To the extent not already in existence, a TARP recipient must establish (and maintain through the duration of its TARP Period) an independent compensation committee, whose independence is determined by reference to the TARP recipient's applicable stock exchange requirements (or, for unlisted issuers, to the stock exchange requirements of the TARP recipient's choice), by September 14, 2009 (or, if later, 90 days after the date it becomes a TARP recipient). If a TARP recipient is not publicly traded and has received \$25 million or less in financial assistance, its board of directors may perform the duties required of the compensation committee.

(2) Review and Correct Employee Compensation Plans. At least every six months during the TARP Period after it is established, the compensation committee must "discuss, evaluate and review" the TARP recipient's "employee compensation plans" (as defined under the Proxy Rules) to ensure that these plans do not encourage the manipulation of reported earnings of the TARP recipient to enhance the compensation of any of the TARP recipient's employees, and to ensure that the employee compensation plans provided to its CEOs ("CEO compensation plans") do not encourage the CEOs to take unnecessary and excessive risks that threaten the value of the TARP recipient. Moreover, the compensation committee must limit the features in the applicable plans that could lead to the taking of the prohibited risks or that otherwise pose risks to the TARP recipient, and eliminate those features that could encourage manipulation of reported earnings to enhance the compensation of any employee.

(3) Provide Narrative Description of Corrective Actions. The compensation committee must also, at least once each fiscal year, provide a narrative description of: (1) how the CEO compensation plans do not encourage the CEOs to take unnecessary and excessive risks that threaten the value of the TARP recipient; (2) the risks posed to the TARP recipient by all employee compensation plans and how these risks were limited; and (3) how the TARP recipient has ensured that employee compensation plans do not encourage the manipulation of the reported earnings of the TARP recipient to enhance the compensation of any of its employees. If the TARP recipient is a public company, this narrative must be provided in the compensation committee report set forth in the TARP recipient's annual proxy statement and to Treasury. If the TARP recipient is not a

public company, the narrative must be provided to its primary federal regulator and Treasury.

- ***Certification of Compliance.*** The principal executive officer and principal financial officer (or equivalents thereof) of the TARP recipient must provide written certification of compliance with all of the above standards. This certification is to be provided on an annual basis to both (1) Treasury, and (2) if the TARP recipient is a public company, to the SEC as an exhibit to the TARP recipient's Form 10-K filing or, if the TARP recipient is not a public company, to its primary regulator. The TARP Standards provide model forms of such certifications, which must be provided within 90 days of each fiscal year (or portion thereof) of the TARP recipient that ends during the TARP Period.
- ***Implementation of Policy Regarding Luxury Expenses.*** By September 14, 2009 (or, if later, 90 days after the date an entity becomes a TARP recipient), each TARP recipient's board of directors must adopt a company-wide policy regarding "excessive or luxury expenditures" and provide this policy to Treasury and its primary federal regulator, as well as post this policy on its Internet website (if one exists). This policy must be maintained at all times during the remainder of the TARP Period. The TARP Standards clarify that this policy must address four categories of expenses identified in the ARRA: (1) entertainment and events; (2) office and facility renovations; (3) aviation or other transportation services; and (4) other similar items, activities or events. The policy must identify the types of expenses that are prohibited, as well as expenses for which prior approval is required (including reasonable approval procedures), and if such prior approval is by any senior executive officer, other executive officer of a substantially similar level of responsibility, or the TARP recipient's board of directors (or a committee thereof), the principal executive officer and the principal financial officer must certify that such approval was properly obtained. The policy must also require prompt internal reporting of violations and mandate accountability for adherence to the policy.

Additional Disclosure Requirements Regarding Perquisites and Use of Compensation Consultants.

The TARP Standards require the following additional disclosure to Treasury and the TARP recipient's primary regulator within 120 days after the completion of the TARP recipient's fiscal year if any part of such fiscal year includes the TARP Period:

- **Perquisites.** TARP recipients must annually disclose any perquisite whose total value for the TARP recipient's fiscal year exceeds \$25,000 for each SEO and HCE subject to the restrictions on bonus payments (described above). This disclosure must include a narrative description of the amount, nature and recipient of these perquisites, as well as a justification of the offering of the perquisite.

- **Compensation Consultants.** TARP recipients must annually provide a narrative description of all types of services any compensation consultant has provided during the prior three years to the TARP recipient, its board of directors or its compensation committee (including information on “benchmarking” or other comparisons that the consultant has used to identify percentile levels of compensation).

Say-on-Pay (Nonbinding Shareholder Vote on Executive Pay).

The ARRA requires that a TARP recipient’s annual proxy statement or other authorization for an annual or other shareholder meeting must permit a separate, nonbinding shareholder vote to approve the compensation of its CEOs. The ARRA expressly states that any such vote cannot overrule a decision by the board of directors or limit the ability of shareholders to make proposals relating to executive compensation for inclusion in the proxy statement, and that the requirement to provide such vote does not create or imply any additional fiduciary duties on the board of directors. The SEC must adopt standards to implement this provision no later than February 17, 2010 (i.e., one year after the date of enactment of the ARRA), and on February 17, 2009, the SEC issued interpretations providing that the ARRA’s “say on pay” requirement is applicable to all proxy statements filed with the SEC after February 17, 2009.

Rules Applicable to TARP Recipients that have Received Exceptional Financial Assistance; Duties of Special Master.

- *Compensation Payments and Structures of TARP Recipients that have Received Exceptional Financial Assistance are Subject to Approval by the Special Master.* TARP recipients receiving “exceptional financial assistance” (i.e., any assistance provided under the Programs for Systemically Significant Failing Institutions, the Targeted Investment Program, the Automotive Industry Financing Program, and any new program designated by Treasury as providing exceptional financial assistance) must obtain approval from the Special Master of, in general: (1) all compensation payments to, and compensation structures for, their CEOs and HCEs subject to the restrictions on bonus payments (described above) and (2) all compensation structures for other employees who are executive officers (as defined under Rule 3b-7 of the Securities and Exchange Act) or who are otherwise one of the 100 most highly compensated employees of the TARP recipient not already subject to the restrictions on bonus payments.

The TARP Standards outline the general principles by which the Special Master will review the compensation payments and structures, as applicable, which generally include determining whether the payments or structures are inconsistent with the purposes of the ARRA or otherwise contrary to public interest. For compensation structures applicable to the TARP recipient’s executive officers and the 100 most highly compensated employees not subject to the restrictions on bonus payments, the Special Master is only required to determine whether the arrangements are adequately

structured, and is not required to rule with respect to the amounts payable under the arrangements. The TARP Standards also provide that the Special Master's approval is not required with respect to any employee whose annual compensation (including certain deferred compensation and pension accruals but disregarding grants of long-term restricted stock (described above)) is limited to \$500,000 or less, and whose additional compensation for that year is provided in the form of long-term restricted stock (as described above).

- *Compensation Payments and Structures of All TARP Recipients are Subject to Review and Negotiation for Reimbursement by the Special Master; Treasury Delegation of Interpretive Authority to Special Master.* The Special Master is required to review bonuses, retention awards and other compensation paid to the CEOs and the next twenty HCEs of each TARP recipient before February 17, 2009 (i.e., the date of enactment of the ARRA) in order to determine if any such payments made were inconsistent with the purposes of the ARRA or TARP or otherwise contrary to the public interest. The TARP Standards provide that such a determination is to be made by applying principles relating to risk, competitiveness, taxpayer return, appropriate allocation between long-term and short-term compensation (and cash and equity), performance-based compensation, comparable structure and amounts for similarly situated employees and employee contribution to TARP recipient value, each of which are defined in more detail in the Interim Final Rule. If, after review, the Special Master determines that a TARP recipient has not satisfied these principles, it has the responsibility to negotiate with the TARP recipient and the individual employee for appropriate reimbursements to the U.S. Government.

In addition, Treasury has delegated the authority to interpret the ARRA, the Interim Final Rule and any other guidance relating to the TARP Standards to the Special Master, and such interpretations are not subject to appeal to Treasury.

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The intense public scrutiny of executive compensation arrangements has given rise to significant limitations on executive and key employee pay practices at financial institutions receiving government assistance. While we have in some areas attempted to provide context for these new rules, the foregoing discussion must of necessity be general in nature. Therefore, TARP recipients, and institutions that are considering becoming TARP recipients, should contact us to address any questions they may have as they proceed with their participation.

The information contained in this memorandum does not represent, and should not be regarded as, the view of Treasury or any particular client of Simpson Thacher. If you have any questions about the new TARP Standards referenced in this memorandum, please contact any of the following partners in our Executive Compensation and Employee Benefits department:

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