

Tax-Qualified Retirement Plans: Year-End Action Items and the HEART Act

September 18, 2009

As fall approaches, it is important for plan sponsors to review whether any qualified plan action items must be addressed prior to year-end. The following checklist describes potential year-end amendments and notices that may be necessary for tax-qualified retirement and savings plans. The list is not exhaustive, but is intended to provide a reminder of the general issues that may need to be reviewed and considered.

Also included is information regarding the Heroes Earnings Assistance and Relief Tax Act of 2008 (the HEART Act) and its impact on qualified retirement plans. Although the HEART Act does not require plan amendments by the end of the year, its required changes should be considered now.

Additionally, this LawFlash includes a reminder that 403(b) plans must update plan documents to comply with the final 403(b) regulations by December 31, 2009.

Annual Notice Requirements

Depending upon the type of qualified plan and the plan's features, one or more annual notices may be required. Plan sponsors should carefully review the following notices to determine whether any are required to be issued for their plans.

Annual Safe-Harbor 401(k) Plan Notices

- *Traditional Safe-Harbor Plan Notice.* Safe-harbor 401(k) plans must provide an annual safe-harbor notice to all plan participants describing the safe-harbor contribution and other material plan features.
- *"Wait and See" Safe-Harbor Notice.* Sponsors of safe-harbor 401(k) plans that intend to satisfy the safe-harbor requirements through a 3% nonelective contribution may wish to follow the "wait and see" approach. Plan sponsors that follow this approach must provide a notice prior to the beginning of the plan year notifying eligible employees that the safe harbor may be adopted. Additionally, plan sponsors that previously provided a "wait and see" notice prior to the beginning of the ongoing plan year and that decide to implement a safe harbor arrangement prior to the end of the plan year (by making the 3% nonelective contribution) must provide a supplemental notice to eligible employees informing them that the safe-harbor arrangement will be adopted.

The traditional safe-harbor notice and the contingent and supplemental notices must be provided at least 30 days and no more than 90 days prior to the beginning of the plan year. Thus, calendar year plans will need to provide the applicable notice by December 1, 2009.

Note: In addition to providing the notice described above, plan sponsors that previously provided a “wait and see” safe-harbor notice and that have decided to implement the 3% nonelective safe harbor contribution for this plan year will need to amend their plans to provide for the safe-harbor contribution prior to the end of the plan year.

Also, plan sponsors are permitted to suspend safe-harbor contributions in certain situations. Safe-harbor matching contributions may be suspended at any time, subject to certain notice, plan amendment, and nondiscrimination testing requirements. Safe-harbor nonelective contributions may only be suspended if the plan sponsor incurs a “substantial business hardship.” The suspension of nonelective contributions is also subject to certain notice, plan amendment, and nondiscrimination testing requirements. (See our June 1, 2009 LawFlash, “Needed Relief for Suspension of Safe Harbor Nonelective Contributions Arrives—With a Catch,” available at http://www.morganlewis.com/pubs/EB_SafeHarborNonelectiveContributions_LF_01jun09.pdf.)

Qualified Default Investment Alternative Notices

Participant-directed 401(k) plans that invest participant contributions for which no affirmative investment election has been made into a qualified default investment alternative (QDIA) must provide an annual notice. The notice must be distributed to all participants that have been or may be defaulted into a QDIA. The notice must be provided at least 30 days before the beginning of each plan year. For calendar year plans, notice must be provided by December 1, 2009.

A QDIA is an investment alternative (for example, a balanced fund or target-date fund) in a participant-directed 401(k) or profit-sharing plan into which participant contributions are “defaulted” if the participant has not made an affirmative investment election. If a plan fiduciary properly selects a QDIA and follows the specific QDIA requirements, which includes providing an initial and an annual notice, the plan fiduciary will generally receive fiduciary protection for those defaulted investments under Section 404(c) of the Employee Retirement Income Security Act of 1974, as amended (ERISA) because participants will be “deemed” to have elected to invest their contributions into the QDIA.

Note: One of the many QDIA notice requirements is that the notice be “separate” from any other notices that are provided. However, the QDIA notice is permitted (but not required) to be combined with the safe-harbor notice described above and the automatic enrollment notices described below.

401(k) Plan Annual Automatic Enrollment Notices

Sponsors of 401(k) plans that automatically enroll participants must provide an annual notice to all eligible employees describing the circumstances under which contributions may be automatically contributed to the plan. This notice may be combined with the QDIA notice described above. This notice must be distributed at least 30 days prior to the beginning of each plan year. For calendar year plans, the notice must be provided by December 1, 2009.

Note: There are a number of different automatic enrollment arrangements (for example, one arrangement simply provides for the automatic enrollment of participants and another arrangement is linked to satisfying 401(k) plan discrimination tests), but all such arrangements require a notice.

Defined Benefit Plan Annual Funding Notice

Plan sponsors of single- and multiemployer defined benefit pension plans must provide an annual funding notice to participants, beneficiaries, and labor organizations representing participants. The notice must contain certain information about the plan, including, among other items, the plan's funding status for the previous two years and a statement of the plan's assets and liabilities.

The notice must generally be provided within 120 days following the end of the plan year. Small plans (covering fewer than 100 participants) must provide the notice by the filing due date of the plan's IRS Form 5500. Additional notice requirements apply if the plan is subject to benefit restrictions due to failure to meet certain funding targets.

For calendar year plans, the notice is due by April 30, 2010.

Notice of Consequences of the Failure to Defer Benefits

Under Section 411(a) of the Internal Revenue Code (the Code), a plan is required to obtain participant consent in order to distribute defined contribution or defined benefit plan benefits that have a present value exceeding \$5,000. The Code Section 411(a) regulations indicate that the consent is only valid if the participant is properly informed of the right to defer receipt of distribution. The Pension Protection Act of 2006 (PPA) added the requirement that participants must also be informed of the consequences of failing to defer their distributions until normal retirement age. While the notice requirement is in effect for plan years beginning after December 31, 2006, the PPA included a "reasonable attempt to comply" standard until 90 days after the issuance of final regulations.

IRS Notice 2007-7 contained a safe harbor describing what would be considered a "reasonable attempt" to comply with the notice requirement. In October 2008, the IRS issued proposed regulations. Until the issuance of final regulations, plan sponsors should continue to take good faith reasonable steps to comply with the notice requirements. A LawFlash will be issued when the final regulations are released.

Participant Benefit Statements

Depending upon the type of qualified plan, specific participant benefit statement requirements apply, as described below.

- *Defined Benefit Pension Plans.* Plan sponsors of defined benefit pension plans must either provide participant benefit statements every three years to vested participants who are active employees or provide an annual notice to participants describing how a benefit statement may be obtained. If a plan sponsor decides to provide an annual notice instead of providing a benefit statement every three years, the notice must be provided by December 31, 2009.
- *Participant-Directed Defined Contribution Plans.* Participant-directed defined contribution plans are required to provide participant statements on a quarterly basis. Plan sponsors are deemed to

timely provide statements if they are provided within 45 days following the end of the calendar quarter.

- *Nonparticipant-Directed Defined Contribution Plans.* Plans that do not permit participants to individually direct their account balances are required to provide statements at least once each calendar year. Plan sponsors are deemed to timely provide statements if they are provided on or before the date on which the Form 5500 annual report is filed by the plan (including extensions).

New Safe Harbor Tax Notice—Changes Required by January 1, 2010

The IRS recently issued Notice 2009-68, which provides two revised safe harbor explanations that may be given to qualified plan participants who receive a distribution of an eligible rollover distribution. One of the safe harbor explanations relates to distributions that do not contain a Roth account and the other relates to distributions that contain a Roth account. The Notice indicates that use of the prior safe harbor explanation from Notice 2002-3, updated for subsequent tax law changes, will continue to be considered a safe harbor through December 31, 2009. Thus, plan administrators should start to use the revised notice by January 1, 2010.

Plan Amendments

Amendments to comply with the various provisions of the PPA, including certain technical corrections in the Worker, Retiree, and Employer Recovery Act of 2008 (WRERA), are generally required to be adopted by the last day of the first plan year beginning on or after January 1, 2009. Thus, plans with calendar-year plan years must adopt these amendments by December 31, 2009. Collectively bargained and governmental plans may have later effective dates and/or amendment deadlines. Also, certain rules may differ for multiemployer plans. Plan sponsors of plans that are not collectively bargained, governmental, or multiemployer plans should review the list below to determine if any amendments are required for their plans by the end of the 2009 plan year.

Required Amendments

Below is a list of amendments relating to changes in the law that need to be adopted by the end of the 2009 plan year, if applicable:

Defined Contribution Plan Amendments

Amendment	Explanation
Accelerated Vesting of Employer Nonelective Contributions	All employer nonelective contributions to qualified defined contribution plans (including ESOPs) are required to vest, at a minimum, under a three-year cliff or a six-year graded schedule. This change is effective for contributions allocated in plan years beginning after December 31, 2006.
Gap Period Earnings Not Permitted on Corrective Distributions (ADP/ACP Testing)	Distributions of income or losses allocable to corrective distributions for ADP/ACP testing failures for the “gap period” between the end of the taxable year and the date of distribution are no longer permitted. This change is effective for plan years beginning after December 31, 2007.

Amendment	Explanation
Diversification Requirements	<p>Effective for plan years beginning after December 31, 2006, participants, alternate payees, and beneficiaries must be permitted to diversify, no less frequently than quarterly, the investment of amounts attributable to elective deferrals and after-tax contributions that are invested in publicly traded employer securities. Additionally, participants with at least three years of service, alternate payees, and beneficiaries must be permitted to diversify, no less frequently than quarterly, the investment of amounts attributable to employer contributions that are invested in publicly traded employer securities. For this purpose, the plan must offer at least three investment options, other than employer securities, that have materially different risk and return characteristics. This rule does not apply to an ESOP if (1) the ESOP does not hold any elective deferrals, employee after-tax contributions, or employer matching contributions; and (2) the plan is a separate plan from any other plan maintained by the employer.</p>
Gap Period Earnings Not Permitted on Corrective Distributions (Excess Deferrals)	<p>Final Treasury regulations under Code Section 402(g) require distributions of income or loss allocable to corrective distributions for Code Section 402(g) excess deferrals between the end of the taxable year and the date of distribution (i.e., the “gap period”) beginning with the 2007 plan year. Pursuant to Notice 2008-30, plans are required to be amended to reflect the final regulations by the end of the 2009 plan year. The WRERA eliminated this requirement effective for plan years beginning after December 31, 2007. Thus, the plan amendment should reflect that gap period income will be distributed with excess deferrals for the 2007 plan year only.</p>
Expansion of Hardship Rules	<p>Code Section 401(k) plans may permit participants to obtain a hardship distribution for expenses such as medical costs or college tuition for the participant’s beneficiary that would qualify as a hardship, even if the beneficiary is not the spouse or a dependent of the participant. This is an optional provision that was available for distributions made on or after August 17, 2006.</p> <p>Plan sponsors that implemented this change during the 2009 plan year or earlier are required to amend their plans by the end of the 2009 plan year. Plan sponsors that adopt this change in the future will need to amend their plans by the end of the plan year in which the change is effective.</p>
Qualified Reservist Distributions	<p>Code Section 401(k) plans may permit reservists ordered or called to active duty after September 11, 2001 and on or before December 31, 2007 for more than 179 days (or indefinitely) to take early distributions of elective deferrals, effective for distributions made on or after the date of the order to call to duty. (As noted below, the HEART Act extends the availability of this provision to individuals ordered or called to active duty after December 31, 2007.)</p> <p>Plan sponsors that implemented this change during the 2009 plan year or earlier are required to amend their plans by the end of the 2009 plan year. Plan sponsors that adopt this change in the future will need to</p>

Amendment	Explanation
	amend their plans by the end of the plan year in which the change is effective.
Required Minimum Distribution Waiver in 2009	<p>The WRERA modified the required minimum distribution (RMD) rules for 2009 by waiving any 2009 RMD for defined contribution plans. The method by which a plan should treat RMD waivers in 2009 depends upon whether a plan complies with the RMD requirements by forcing the commencement of distributions at age 70½ or by only paying the required minimum amount each year. Additionally, compliance requirements may be different for plans that permit partial in-service withdrawals prior to termination of employment.</p> <p>While amendments to comply with the required RMD waiver changes are not required to be implemented until the last day of the 2011 plan year, plans that implement optional changes in 2009 must be amended by the end of the 2009 plan year. For example, plan sponsors that wish to provide the option for participants to either take or waive the 2009 RMD must evaluate their plans to ensure that in-service withdrawals are permitted. If in-service withdrawals are not otherwise permitted, amendments may need to be adopted by the end of the 2009 plan year in order to permit the optional in-service withdrawals in 2009.</p> <p>The RMD waiver rules are complicated and each plan must be evaluated separately to confirm whether an amendment is required.</p>
Benefits Statements	Effective for plan years beginning after December 31, 2006, plan administrators must provide benefit statements at least once per quarter for participant-directed defined contribution plans and once per year for other defined contribution plans. A plan amendment may be needed if the plan provides for provision of benefit statements less frequently than required.
Qualified Default Investment Options	Effective for plan years beginning after December 31, 2006, participants in an individual account plan such as a 401(k) plan will be treated as exercising control over the assets in the account if, in the absence of an affirmative investment election by the participant, the participant's account balance is invested in qualified default investment option (QDIA). A plan amendment may be needed if the plan specifically states the default investment option.

Defined Benefit Plan Amendments

Amendment	Explanation
Code Section 415(b)(2) Amendment of Interest Rate Assumptions for Lump Sum Distributions	The interest rate assumptions used for determining the maximum amount payable in a lump sum (or any other form of payment subject to the present value requirements of Code Section 417(e)) was changed effective for distributions made in plan years beginning on and after January 1, 2006. (For the similar change for plan years 2004 and 2005 made by the Pension Funding Equity Act of 2004, the

Amendment	Explanation
	amendment deadline is also the end of the 2009 plan year.)
Minimum Lump Sum Value	The “applicable interest rate” and the “applicable mortality table” determining the minimum amount that must be distributed in a lump sum (or any other form of payment subject to the present value requirements of Code Section 417(e)) were changed for distributions with annuity starting dates occurring in plan years beginning after December 31, 2007. The new interest rate is phased in during plan years 2008–2012.
Three-Year Cliff Vesting for Cash Balance Plans	Benefits under a cash balance (or hybrid) plan in existence on June 29, 2005 must use a three-year cliff vesting schedule for all participants who have an hour of service in a plan year beginning after December 31, 2007.
Funding-Based Benefit Restrictions	Under the new pension funding rules, benefit restrictions apply to certain underfunded defined benefit pension plans. Plans that are less than 80% but at least 60% funded generally cannot pay more than 50% of the participant’s accrued benefit in a lump sum and cannot be amended to increase benefits. For plans that are less than 60% funded, no benefit accruals are allowed (mandated plan freeze) and tighter benefit restrictions apply (no lump sum payments may be made). These rules are effective for plan years beginning after December 31, 2007.
Hybrid Plan Changes	The PPA made several changes that are applicable to hybrid pension plans, including cash balance plans. While plan amendments are generally required to be adopted by December 31, 2009 for affected calendar year plans, many issues remain open. When Treasury issues final regulations (hopefully later this year), plan sponsors will need to take immediate action to amend their plans to comply with the new rules. A LawFlash will be issued to explain those changes once the final regulations are issued.
Restriction Eliminated from Average Compensation for High Three Years under Code Section 415	A participant’s annual benefit under a defined benefit plan may not exceed the lesser of (a) 100% of average compensation for the participant’s high three years of compensation, or (b) \$160,000 as adjusted for inflation. Before the PPA, a participant’s “high three years of compensation” was a period of not more than three consecutive calendar years during which the participant was both an (a) active participant in the plan and (b) had the greatest aggregate compensation from the employer. Effective for plan years beginning after December 31, 2005, the PPA eliminates the active participation requirement from the definition of “high three years.” A plan amendment may be needed if this limit is specifically stated in the plan document.

Defined Contribution and Defined Benefit Plan Amendments

Amendment	Explanation
Qualified Optional Survivor Annuity Options	<p>Defined benefit and defined contribution plans that are subject to qualified joint and survivor annuity (QJSA) requirements must offer a joint and 75% annuity option if the plan’s mandatory QJSA is less than 75%. If the mandatory QJSA is greater than or equal to 75%, then the plan is required to offer a joint and 50% survivor annuity option.</p> <p>These options are required to be available for distributions with annuity starting dates in plan years beginning after December 31, 2007 and retroactive annuity starting dates with payments starting in such plan years.</p>
Direct Rollovers to Roth IRAs	Distributions from qualified plans made after December 31, 2007 may be rolled over directly to a Roth IRA, provided that the Roth IRA conversion rules are satisfied.
Rollovers of After-Tax Contributions to Code Section 403(b) Plans and Defined Benefit Plans	Effective for taxable years beginning after December 31, 2006, nontaxable distributions from qualified plans also may be rolled over directly to a defined benefit plan or Code Section 403(b) plan; provided that such amounts (and earnings) are accounted for separately by the receiving plan. (Under prior law, rollovers of nontaxable amounts could only be made to a defined contribution plan or IRA.)
Rollovers by Nonspouse Beneficiaries	Nonspouse beneficiaries of deceased participants may make an eligible rollover distribution in a direct trustee-to-trustee transfer to an “inherited” IRA. This provision was optional under the PPA for distributions made after 2006. The WREERA made this provision mandatory for plan years beginning after December 31, 2009.
Change of Notice/Consent Requirements from 90 to 180 Days	<p>Plan sponsors may elect to expand the current 90-day notice and election period for direct rollovers, payments before normal retirement age, and qualified joint and survivor annuities/spousal consents to a period of up to 180 days. This change is permitted to be effective for notices provided in plan years beginning after December 31, 2006.</p> <p>Plan sponsors that implemented the above change during the 2009 plan year or earlier are required to amend their plans by the end of the 2009 plan year. Plan sponsors that adopt this change in the future will need to amend their plans by the end of the plan year in which the change is effective.</p>
Notice of Consequences of Failing to Defer Payment	Participants must be provided with a description of the consequences of failing to defer payment of benefits until normal retirement age, effective for notices of the right to defer that are provided in plan years beginning after December 31, 2006. If your plan describes the notice requirements in detail, an amendment may be needed to address this requirement.
Determination Letter Cycle	Under the IRS determination letter program, individually designed

Amendment	Explanation
Amendments	<p>plans have staggered five-year remedial amendment cycles. The current cycle is Cycle D and applies to employers with employer identification numbers that end in 4 or 9. Plan sponsors that are required to file in Cycle D must submit their plans to the IRS by January 31, 2010.</p> <p>Prior to each cycle, the IRS releases a Cumulative List of plan amendments that describes all of the required provisions that must be included in each plan that is submitted for a determination letter. Plan sponsors should review the applicable IRS Cumulative List prior to submitting a plan for a determination letter to ensure that any additional amendments that are outlined on the Cumulative List are included in the plan document.</p>

Discretionary Amendments

Plan amendments for discretionary changes (i.e., changes not required by law, such as plan design changes) must be adopted by the end of the plan year in which the amendment is effective (unless earlier adoption is necessary to avoid a benefit cutback). Thus, calendar year plans must be amended by December 31, 2009 for optional changes that took effect in 2009. The PPA created several new possible design changes, including automatic enrollment safe harbors and the expansion on the availability to make transfers to retiree medical accounts under Code Section 420. If a plan made these or other changes in 2009, plan amendments must be adopted by the end of the 2009 plan year.

The HEART Act

The Heroes Earnings Assistance and Relief Tax Act of 2008 (the HEART Act) provides enhanced benefits for qualified plan participants who enter active military service. Certain provisions are required and some are optional. While plans are not required to be amended until last day of the first plan year beginning on or after January 1, 2010 (or by December 31, 2010 for calendar year plans), many of the changes are required to be implemented in operation now.

Below is a brief summary of the provisions.

- Distribution of Elective Deferrals.** An individual performing uniformed service on active duty for more than 30 days and who is receiving differential pay must be treated as having terminated employment for purposes of eligibility to take a distribution of elective deferrals from a Code Section 401(k) plan (even if the employment relationship is otherwise considered to continue because the individual is receiving differential pay). However, a participant who takes a distribution under this provision is not permitted to make elective deferrals or after-tax employee contributions under the plan for six months after the distribution.

Note: The HEART Act, while not completely clear, suggests that a participant in military service, as described above, is required to be receiving differential pay in order to be eligible to take this distribution. Due to the lack of clarity in the statute, opinions have differed on this issue. However, absent formal IRS guidance, the conservative approach would be to permit distributions only to participants who are on active duty for more than 30 days and receiving differential pay or who are otherwise considered to have terminated employment.

- **Military Differential Pay.** If differential pay is provided to employees performing uniformed service on active duty for more than 30 days, then for purposes of applying plan qualification requirements, the employment relationship is considered to continue while the employee is receiving differential pay and the differential pay must be treated as compensation. Differential pay may be treated as compensation for purposes of determining pension benefits and/or employee or employer contributions under a qualified plan. Accruals or contributions based on differential pay generally pass qualification requirements if all controlled group employees are eligible on “reasonably equivalent terms” both (1) to receive differential pay and (2) to make contributions based on that pay. For this purpose, terms may be considered “reasonably equivalent” even if distinctions are made between union and nonunion employees.
- **Military Benefit Accruals on Death or Disability.** Qualified plans are permitted to provide additional accruals or contributions to participants who die or become disabled on or after January 1, 2007 while performing qualified military service. The accrual amount or contributions generally are based on what the participant would have earned under the Uniformed Services Employment and Reemployment Rights Act (USERRA) rules if he or she had been reemployed on the day preceding the date of death or disability and then terminated on the actual date of death or disability. However, benefit accruals or contributions provided under this rule generally must benefit all controlled group employees on “reasonably equivalent terms.”
- **Beneficiary Death Benefits.** Qualified plans are required to provide that survivors of participants who die on or after January 1, 2007 while performing qualified military service will be entitled to any additional benefits under the plan (other than benefit accruals) that the participant would have received if the participant had resumed employment and terminated due to death.
- **Qualified Reservist Distributions.** The HEART Act makes permanent an existing rule that allows a distribution of elective deferrals under a Code Section 401(k) plan to a reservist who is ordered or called to active duty after September 11, 2001 for more than 179 days (or indefinitely). Unlike distributions made pursuant to the first bullet in this list, qualified reservist distributions are optional (i.e., the plan does not have to offer them) and do not require a subsequent suspension of contributions.

Written Plan Document Deadline for Code Section 403(b) Plans

Final regulations under Code Section 403(b) were issued in 2007 and, among other things, require that Code Section 403(b) arrangements be maintained pursuant to a written plan document. Sponsors of Code Section 403(b) plans will need to update existing plan documents or adopt new plan documents by December 31, 2009 to comply with these final regulations. (See our August 8, 2007 LawFlash, “Final Regulations Under Section 403(b),” available at [http://www.morganlewis.com/pubs/EB_403\(b\)_LF_08aug07.pdf](http://www.morganlewis.com/pubs/EB_403(b)_LF_08aug07.pdf).)

If you have any questions concerning the information in this LawFlash, please contact any of the following Morgan Lewis attorneys:

Chicago

Brian D. Hector

312.324.1160

bhector@morganlewis.com

Dallas

Riva T. Johnson	214.466.4107	riva.johnson@morganlewis.com
Heath A. Miller	214.466.4118	hmill@morganlewis.com

New York

Craig A. Bitman	212.309.7190	cbitman@morganlewis.com
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Philadelphia

Robert L. Abramowitz	215.963.4811	rabramowitz@morganlewis.com
I. Lee Falk	215.963.5616	ilfalk@morganlewis.com
Vivian S. McCardell	215.963.5810	vmccardell@morganlewis.com
Steven D. Spencer	215.963.5714	sspencer@morganlewis.com

Pittsburgh

Lisa H. Barton	412.560.3375	lbarton@morganlewis.com
John G. Ferreira	412.560.3350	jferreira@morganlewis.com
Lauren Bradbury Licastro	412.560.3383	llicastro@morganlewis.com
R. Randall Tracht	412.560.3352	rtracht@morganlewis.com

Washington, D.C.

Althea R. Day	202.739.5366	aday@morganlewis.com
Benjamin I. Delancy	202.739.5608	bdelancy@morganlewis.com
David R. Fuller	202.739.5990	dfuller@morganlewis.com
Mary B. (Handy) Hevener	202.739.5982	mhevener@morganlewis.com
Dean R. Morley	202.739.5989	dmorley@morganlewis.com
Gregory L. Needles	202.739.5448	gneedles@morganlewis.com

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