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Pensions Legal Update

Legal Update Contents

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Issue 148 August 2010

Key legal issue this month

Change to pension inflation measure

The inflation measure that is used to calculate minimum increases on pension benefits is set to change from the RPI to the CPI- a measure that traditionally shows a lower inflation rate. This is likely to mean lower increases on benefits for members, and thus lower liabilities for employers.

Schemes should consider how the change will affect them.

Monitoring employer support: consultation

Summary. The Pensions Regulator (the Regulator) is consulting on guidance on monitoring employer support (the guidance).

Facts. The guidance follows requests from the pensions industry to accumulate guidance on assessing the employer covenant on an ongoing basis. The guidance is divided into three main sections: covenant, security and monitoring. The key points are that:

- Mechanisms should be put in place to monitor both market conditions and the employer covenant, including assessing an employer's legal obligations to a scheme and its financial position, so that trustees can consider the likelihood of those obligations being met. Some examples of what the trustees should do include:
  - understanding the legal structure of the employer's group and whether there are any interdependent relationships which may affect the covenant;
  - considering the employer's competitive position, size, management ability, track record, credit rating, profitability and long-term future;
  - understanding the position of the scheme in comparison to other creditors and the implications flowing from this; and
  - seeking professional advice as appropriate.
- The employer covenant and scheme security may be strengthened in a variety of ways, such as by granting the trustees priority over other creditors, seeking commitments from the employer to increase funding, and seeking contingent assets (for example, company guarantees). Trustees are likely to require legal and professional advice in such matters and should understand the issues involved in setting up any security.
- Trustees need to be confident that they can rely on employer support at all times. To help them achieve this:
  - covenants should be reviewed regularly as they can vary over short periods of time. A full review should be conducted before each valuation and it should also be a standing item on the trustee meeting agenda;

- monitoring plans should be agreed, with specific triggers enabling trustees to take action early before the covenant weakens too far;
- one-off significant events may request immediate action being taken, such as bringing forward the valuation, adjusting valuation assumptions or realigning the investment portfolio; and
- the Regulator should be involved at an early stage, if the trustees have serious concerns.

The guidance is intended to replace the contingent assets guidance published in May 2006.

Comment. This is a detailed consultation which certainly helps trustees to establish their duties in monitoring employer support; it will be interesting to see what changes (if any) come out of the consultation process.

Source: Guidance on monitoring employer support: covenant, contingent assets and other security, 15 June 2010, www.thepensionsregulator.gov.uk/docs/employer-support-consultation-document.pdf. Comments are requested by 7 September 2010.

Change to pension inflation measure

Summary. The government has announced its intention to change the measure of inflation used for working out statutory minimum increases to defined benefit (DB) occupational pension schemes.

Background. The government sets the annual statutory increases that DB occupational pension schemes are required to apply to early leavers' benefits on retirement, pensions in payment and guaranteed minimum pensions (the statutory increases). These are currently based on increases in the Retail Prices Index (RPI).

Facts. In the future, the government will base the statutory increases on the Consumer Prices Index (CPI) rather than the RPI. The mathematical formulae used to calculate the two indices are different, which in practice means that the CPI has tended to show a lower inflation rate than the RPI.

Whether a scheme's increases will move to CPI increases will depend on its rules:

- Some schemes' rules simply link increases to the statutory requirements (for example, statutory revaluation and pension increase orders), in which case members would be directly affected if the statutory measure changes. When implemented, the change would affect rights already built up (that is, pensions already in payment and the whole of a member's deferred pension).
- Other schemes' rules "hard code" a link to the RPI measure of inflation. Here, members may not be directly affected. If the CPI is ever higher than the RPI, it (the CPI) may apply as an underpin.

- Some schemes have restrictions that will make it impossible to use the scheme's amendment power to change to CPI increases for rights already built up. Changing to the CPI for future increases might involve a worsening of past service rights, which trustees may not think is appropriate. The usual position is that adverse amendments cannot be made to benefits earned through past service without member consent (*section 67, Pensions Act 1995*). It is not clear whether the government will introduce overriding legislation to allow schemes a new power to move to the CPI for benefits earned through all service. If the government does this then trustees would need to consider carefully whether to use this new power.
- Some rules already give the trustees power to change the index they use. Changing to an index that is expected to be less generous may be a difficult decision, especially as it affects past service.
- In some cases, the scheme defines the RPI in a way that provides for a different index to apply if the RPI is replaced. RPI is not being abolished so, in our view, it has not been "replaced". In such cases, RPI increases would continue unless the rules were amended.

The government's intention is that compensation payments made by the Pension Protection Fund and the Financial Assistance Scheme will also be linked to the CPI.

Comment. The government has said that the change is being proposed because the CPI is a better measure of pensioners' cost of living than the RPI. But it seems likely that another purpose is to reduce pension liabilities in both the public and private sectors. For employers, this is a rare piece of good news. Members may take a different view.

The government needs to give more thought to schemes which have RPI increases hard coded into their rules. Trustees need to assess the extent to which their scheme is affected by this change. Employers and trustees will also want to estimate the impact of this change on the funding position. Whether by accident or design, the timing of the announcement should minimise disruption to funding discussions, given that the 15-month deadline after most 2009 valuations has just expired.

Source: Written ministerial statement, Occupational pensions, 8 July 2010, www.publications.parliament.uk/pa/cm201011/cmhansrd/cm100708/wmstext/100708m0001.htm.

Scheme funding and employer debts

Summary. The High Court has made a number of important rulings relating to scheme funding and employer debt legislation and their interaction with scheme rules.

Background. Trustees and employers must satisfy statutory funding requirements for defined benefit pension schemes (scheme funding requirements) (*Part 3, Pensions Act 2004*). It is not clear in all cases how this legislation interacts with a scheme's employer contribution rules (contribution rules).

Employers must pay a statutory debt in certain circumstances, including where there is an employment cessation event (ECE) (*section 75, Pensions Act 1995 Act*) (section 75). The test for an ECE that applied before 6 April 2008 was the subject in *Cemex UK Marine Limited v MNOPF Trustees Limited [2009] EWCH 3258*.

Facts. P is an industry-wide scheme for marine pilots (the scheme). P has a substantial buy-out deficit and the scheme's trustee (T) wanted to know who might be required to make the deficit good. The main participants of the scheme are the competent harbour authorities (CHAs), which are divided into the "ECHAs", which employ pilots, and the "SCHAs", which authorise pilots who are self-employed. The scheme rules originally limited the legal contributions from the CHAs, but T amended the contribution rule to demand higher contributions.

T sought guidance in the High Court on a number of issues, including: its ability to amend the scheme rules to broaden its powers to demand additional contributions from the CHAs; whether SCHAs are "employers" for purposes of the scheme funding requirements and section 75; when an ECE was triggered in the past (and whether *Cemex* was wrongly decided); and whether the contribution rule allowed T to demand higher contributions than the scheme funding requirement.

Decision. The High Court held that:

- T could amend the contribution rule to require CHAs to make higher contributions.
- The SCHAs were not employers for the purposes of the scheme funding requirement and section 75.
- *Cemex* was overruled in part. An ECE was triggered before 6 April 2008 where an employer continued to employ deferred and pensioner members who were no longer eligible for benefits under the scheme.
- The contribution rule could (in some cases) allow T to require higher contributions than permitted under the scheme funding requirements.

Comment. This decision covers a number of important issues on the scheme funding requirement and section 75.

Case: PNPF Trust Company Ltd v Taylor [2010] EWHC 1573 (Ch).

Winding up: guidance

Summary. The Pensions Regulator (the Regulator) has issued guidance (the guidance) on winding up occupational pension schemes (the schemes).

Background. The winding up provisions of a scheme are set out in the [scheme's] governing documentation. It is common for schemes to wind up on the main sponsoring employer's insolvency or, in some cases, the main sponsoring employer may have a power to terminate the scheme and wish to use it.

If a defined benefit (DB) scheme winds up in deficit, the remaining employer or employers are responsible for making a payment into the scheme to reflect their share of the deficit. This is known as the employer debt. Section 73 of the Pensions Act 1995 sets out the order of priority in which benefits should be paid if a DB scheme winds up in deficit. This is known as the statutory winding up priority order.

Facts. The guidance provides practical tips for trustees on how to wind up schemes within the Regulator's two-year target time frame. The guidance's key points are that:

- Trustees should try to identify and address any issues as soon as possible. The Regulator encourages parties to have a project plan which sets out in advance the tasks that need to be completed to meet the two-year time frame and allocates responsibility for those tasks. It should be clear to the trustees who is project managing the winding up process and driving it forward.
- Key activities should be completed as soon as possible and within two years. The Regulator should be informed of any delays. The key activities for DB schemes are:
  - demanding any employer debt;
  - securing pensioner and non-pensioner benefits (for [DB] schemes in deficit, this should be done in accordance with the statutory winding up priority order); and carrying out a final actuarial valuation.

The key activities for defined contribution schemes are:

  - recovering member/employer contributions due from the employer;
  - establishing that all pensioner members have annuity policies in their own name; and
  - establishing that all non-pensioner members' fund values have been determined and secured.

- Trustees should ensure that they know what sorts of annuities are required and seek competitive quotes to get the best deal.
- Trustees have a duty to ensure that members receive the correct benefits. A data cleansing exercise will usually be carried out to highlight any deficiencies and the trustees should discuss the appropriate level of data cleansing with their advisers.
- Trustees need to consider the extent to which member tracing should be performed during wind-up. Trustees can protect themselves to a certain degree by showing that they have tried to trace missing members by placing an advert in appropriate local and national newspapers to say that the scheme is winding up and asking for any potential beneficiaries to make themselves known.
- Trustees need to reconcile any contracted-out liabilities as soon as possible. This is a time-consuming task, and one of the main issues that causes delays in completing the winding-up process. Trustees are advised to contact the National Insurance Services to Pensions Industry to help them with this process.

- Members should be told about the winding up process and also be informed about any options on how they can take their pension benefits.
- The Regulator encourages trustees to take a pragmatic and proportionate approach in completing the wind-up, while having regard to their trustee duties.

Comment. The guidance has practical tips for trustees, administrators and professional advisers to complete the winding up process. Trustees will need to balance their desire to protect themselves from legal claims and carry out their duties properly with their goal of completing the wind-up in a efficient and cost-effective way.

Source: Regulatory Guidance on Winding Up, June 2010, www.pensionsregulator.gov.uk/guidance/guidance-winding-up.aspx.

Independent trustees: assessment criteria

Summary. The Pensions Regulator (the Regulator) has published the final assessment criteria to be used for its register of independent trustees.

Background. The Regulator has power to appoint independent trustees to pension schemes where the employer has become insolvent. Only trustees who are named on a register maintained by the Regulator may be appointed (*section 23, Pensions Act 1995*). A trustee must meet a number of conditions in order to be included on the register, including fact-based conditions (for example, the trustee conducts business from premises in the UK) and also the following judgment-based conditions:

- The applicant has sufficient relevant experience of occupational pension schemes.
- The applicant is a fit and proper person to act as a trustee of a scheme.
- The applicant operates sound administrative and accounting procedures.
- The applicant has adequate indemnity insurance cover.

Facts. The final assessment criteria for the judgment-based conditions are, among other things, that:

- Both individual trustees and persons with overall management responsibility for the pension trustee work of a corporate trustee (key persons) should have at least five years of regular or continuous experience as a trustee of a scheme. Corporate trustees must have at least three years of regular or continuous experience as a trustee of a scheme.
- All individual trustees, all key persons and officers of corporate trustees must demonstrate a minimum level of understanding of the nature of trusteeship (for example, by completing the Regulator's online training toolkit).
- Trustees must answer questions on an application form as an interim measure while the Regulator's proposed framework (developed by the Audit and Assurance Faculty of the Institute of Chartered Accountants in England and Wales) requiring trustees to obtain a certificate from a reporting accountant that controls have been met, is developed. The Regulator may use an independent expert to assess responses and to visit a trustee's premises.

- Trustees will have to provide evidence of professional indemnity cover of (in respect of all its occupational pension trustee work):
  - at least £2 million for a single claim with at least two reinstatements (that is, three claims as a minimum); and
  - at least £6 million in aggregate annually.

The policy must be solely in the trustee's name or the trustee must be named in a group policy. Cover must be provided by an independent third party insurer. The trustee must also have sufficient assets to cover its policy excess.

Trustees who are currently on the register will need to reapply by 31 July 2010.

Comment. The Regulator's new criteria will need to be satisfied by existing independent trustees who wish to remain on the register. The requirement for corporate trustees to have three years' relevant experience will prevent new businesses from joining the register for three years, regardless of the experience of their personnel.

Source: The Regulator: Changes to our Trustee Register, May 2010, www.thepensions-regulator.gov.uk/docs/trustee-register-consultation-response.pdf.

Record-keeping: guidance

Summary. The Pensions Regulator (the Regulator) has published new guidance on record-keeping (the guidance).

Background. There are number of legal requirements relating to good record-keeping, falling within the statutory requirement to operate adequate internal controls under section 249A of the Pensions Act 2004 and the Occupational Pension Schemes (Internal Controls) Regulations 2005 (SI number 2005/3379.) Disclosure and data protection legislation are also relevant.

The Regulator consulted with the Financial Services Authority over the new guidance, which follows two consultation papers: "Record-keeping: a consultation document" (July 2008) and "Record-keeping: measure member data" (February 2010).

Facts. The Regulator considers that poor record-keeping leads to significant additional costs in areas such as administration, member claims, buy-outs and wind-ups, and it may potentially necessitate more conservative actuarial assumptions being adopted.

The Regulator recommends that the presence of some of the most important items of member data be measured and that the results of such tests be reported to the trustees. It considers this should form part of the risk assessment process and internal controls framework.

The guidance distinguishes between the different types of member date and tests that need to be recorded and carried out:

- Common data is necessary to identify a member, and is applicable to all schemes. The Regulator lists ten data items (such as a member's name and date of birth) that it recommends should be maintained by schemes. The targets for the standard of common data that the Regulator recommends are reached by December 2012 are:
  - 100% accuracy for new data created after June 2010; and
  - 95% accuracy for data created before June 2010 (legacy data).
- Conditional data is additional data that is required for the administration of different pension schemes. The Regulator has produced illustrative tables for contract and trust-based schemes, and specific requirements for career average schemes, HM Revenue & Customs data and contracted-out schemes. Targets for the standards of conditional data should be set by the trustees in conjunction with the administrators.
- Numerical data is information regarding membership records and membership statistics that will help put the results of other measures into context. Where the tests indicate that there may be inconsistencies or errors, [the guidance] recommends that action plans be drawn up for further investigation and correction where appropriate include all reasonable endeavours to reach the targets set out above by December 2012. However, this deadline is not the end: schemes should adopt a continuous improvement approach, with reports of progress made on a regular basis and testing taking place annually, or on the occurrence of specific events. This could form part of the scheme's audit process.

Enforcement action may be taken where breaches of pensions legislation are identified in this area. However, the Regulator has said that enforcement action is unlikely where trustees and providers are actively remedying the situation through the implementation of a realistic action plan.

Data audits will be carried out in respect of selected schemes during 2010. The results will be published so that trustees and providers can see how well their results fare against other schemes. Progress within the pensions industry as a whole is going to be reviewed throughout 2010, with an update from the Regulator expected in 2011.

Comment. This is an issue that the Regulator is concerned by and schemes should be assessing how they should respond.

Source: The Regulator: Record-keeping, June 2010, www.thepensionsregulator.gov.uk/guidance/guidance-record-keeping.aspx.

Restricted tax relief: consultation

Summary. The government is consulting on restricting tax relief on pension contributions by reducing the annual allowance (AA) (the consultation).

Background. The Finance Act 2004 introduced:

- The AA, which is an annual limit on contributions that can be made to a registered pension schemes on a tax-relieved basis.
- The lifetime allowance (LA), which is, broadly, a limit on benefits that can be paid from a registered pension scheme without incurring charges.

The Finance Act 2010 (2010 Act) introduced measures to restrict tax relieved contributions for high earners from April 2011.

In the June 2010 Emergency Budget, the government indicated that the measures in the 2010 Act were too complicated and indicated that a consultation in this area would follow.

Facts. Key points raised in the consultation include:

- Setting the AA in the range of £30,000 to £45,000, and using flat rate, rather than age-related, factors for valuing the accrual of defined benefits. The suggested factors would be in the range of 15 to 20.
- Taking account of past service benefits in the method of calculation.
- Aligning the period over which accrual is calculated to the tax year rather than scheme year.
- Exclusions on death and terminally ill-health, but not for early retirement on the grounds of ill-health or redundancy. The government is considering excluding deferred members.
- Requiring schemes to provide, or make available, within a reasonable timeframe details of the pension input amounts to members who request it, to enable members to complete their self-assessment.
- Revisiting the level of the LA. This could see a reduction from £1.9 million to £1.5 million.

Any change in the tax measures will still need to generate £3.5 billion in tax savings which has been earmarked by the government.

A further announcement from the government will follow at the end of September 2010. It is likely that further legislation will be brought during the autumn to take effect on 6 April 2011.

Comment. The proposed changes are likely to have a significant effect on high earners.

Source: Restriction of pensions tax relief: a discussion document on the alternative approach, 27 July 2010, www.hm-treasury.gov.uk/consult_pensionsrelief.htm.

An incorrect representation is sufficient to ensure an unmarried partner is entitled to a surviving spouse's pension

Summary. An incorrect representation to a member's partner that the partner would be eligible for a surviving spouse's pension from the scheme even though they were not married was sufficient to ensure that the partner was entitled to such a pension.

Background. Mr C lived with his long-term partner, a member of the Alitalia pension scheme (the Scheme), for 24 years before her death in 2007. In 2004 the member wrote to the secretary of the Trustees to enquire about the definition of "spouse" in the Scheme Rules. She asked whether she and her partner "*needed to be legally married*" to receive the spouse's benefits detailed in the booklet.

The response received stated that the definition of spouse includes "*a person…who is living with the member as his spouse*". After the member's death it turned out that this advice was wrong - the definition was for a limited purpose which did not include a spouse's pension. Under the Scheme's rules a spouse's pension can only be paid to a person who was legally married to a member. The Trustees also had discretion to award a dependant's pension to a person who was dependent on a member for maintenance and support.

Mr C applied to the Trustees for a spouse's pension. He received a letter from the Scheme administrators which stated that he was not eligible for a spouse's pension under the Scheme, but that he could apply for a discretionary dependant's pension. Mr C then applied for a discretionary dependant's pension which was rejected by the Trustees. He then made an application to the Pensions Ombudsman in relation to the spouse's pension and the dependant's pension.

The Ombudsman accepted that the incorrect information had given the couple an unwarranted degree of comfort and that it was possible that they would have got married had they known the true position. However, he found that the incorrect advice caused no loss as he was not satisfied, on the balance of probabilities, that they would have married if they had been correctly advised as to the Scheme's rules.

Facts. Mr. Catchpole appealed the Ombudsman's decision to the High Court. The remedy he sought was a declaration that he was entitled to a spouse's pension. Such a declaration could be made only if he could establish that the Trustees were "estopped" from denying his entitlement.

The principles on which an estoppel by representation claim is based are:

- a clear representation or promise made by the defendant to the claimant upon which it is reasonably foreseeable that the claimant will act;
- an act on the part of the claimant which was reasonably taken in reliance upon the representation or promise; and
- the claimant being able to demonstrate, after the act has been taken, that he will suffer detriment if the defendant is not held to the representation or promise.

The Court ruled that the letter was a sufficiently clear representation. Whilst it was not written to Mr C he knew about it and had relied upon it. Contrary to the Ombudsman's conclusion, the Court concluded it was likely that the couple would have married if they had been correctly advised on the Scheme's rules. The Court said that Mr C did not need to establish that "but for" the incorrect response the couple would have married, only that the letter was a significant factor in deciding whether to get married.

The Court acknowledged that providing a spouse's pension to Mr C might have an adverse effect on the interests of other beneficiaries. However, this is overridden by the fact that it would not be fair to deny Mr C a spouse's pension.

Accordingly, Mr C was granted a spouse's pension as though he had been married to the member at the date of her death.

Comments. This case highlights that Trustees should be vigilant about providing correct information to scheme beneficiaries, as not doing so could in theory give rise to a claim of estoppel by representation. In principle, the remedy for this could be to put the beneficiary in the position he/she would have been in if the incorrect information given was true (rather than if correct information had been given in the first place).

Source: http://www.bailii.org/ew/cases/EWHC/Ch/2010/1809.html

Transfer incentives: consultation

Summary. The Pensions Regulator (the Regulator) is consulting on guidance on transfer incentives (the guidance).

Background. A transfer incentive exercise is where an employer of a defined benefit (DB) scheme seeks to remove some or all of its DB liabilities from the scheme by offering some or all of the scheme members an incentive to transfer their benefits to another arrangement. A common form of transfer incentive is to provide the relevant member with an enhancement to their transfer value.

Facts. In January 2007, the Regulator issued initial guidance on transfer incentives and the Regulator has been actively monitoring the development of such exercises. The Regulator is concerned that members will be disadvantaged by an offer if they do not have sufficient information to make an informed choice.

The guidance sets out 5 principles and the key points are:

- The information provided should be clear, fair and not misleading. It should be tailored to suit the particular members and should not understate or overstate the position. It is also important to outline the risks involved in accepting the offer.
- The offer should be open and transparent so that all parties are aware of the reasons for the offer and the interests of the other parties. Members should be given reasonable time to make their decision and should not be pressured into accepting the offer.

- Conflicts of interest should be identified and managed appropriately.
- Trustees should be consulted and engaged at the start of the process. Trustees should question and challenge the appropriateness of an incentive offer. The Trustees should start from the presumption that transfer incentives are not in members' interests and therefore should approach any exercise with caution.
- The employer should ensure that independent financial advice is available to the relevant members. The advice should be impartial and if the employer has any concerns about a member's ability to understand the terms of the offer, it should pay for the independent financial advice. Any advice will need to be tailored to the individual member and their circumstances.

The guidance is intended to replace the guidance published in January 2007. Consultation will end on 5 October 2010.

Comment. The Regulator appears to have taken a stronger more proactive stance in addressing transfer incentives and it will be interesting to see how the roles of the employer and trustees develop in this area.

Source: http://www.thepensionsregulator.gov.uk/docs/transfer-incentives-consultation-document-july-2010.pdf

"Remember A-Day?" Tax simplification transitional period coming to an end

6 April 2006 was a pivotal date for all pensions professionals as the new tax regime came into force on "A-Day". It now seems a distant memory but it may be worth checking that there will be no impact on your scheme when the five-year transitional period comes to an end on 6 April 2011 and old Inland Revenue limits cease to apply.

The Pensions Act helpfully gave trustees a specific power to amend their schemes by resolution to continue the IR limits indefinitely. Most schemes took advantage of these powers. This allowed them to retain any pre-A Day Inland Revenue limits for as long as they want to keep them, but also let them disapply any limits that they did not want, such as the old limits on tax free cash at retirement.

If the trustees of your scheme passed such a resolution, we recommend that you check you can lay your hands on a copy, and keep a copy with the original deeds. The resolution might have been a written resolution circulated, perhaps with a number of different pieces of paper being signed; or it might have been passed at a trustee meeting and recorded in the minutes, in which case we recommend you prepare a formal extract to keep separately. Some schemes with individual trustees included the resolution in an amending deed that was executed at the time.

If the trustees did not pass such a resolution at the time they can still do so now. If they do not pass it before 6 April 2011, however, pre-A Day IR limits will stop applying on that date. That may mean members whose benefits were restricted by IR limits get a windfall. Those members might consider that a good thing but employers and members who do not benefit may have a different view. The consequences will depend on how a scheme's rules are drafted, and what rule amendments have been made since A-Day, but in theory:

- the earnings cap could cease to apply (on past and future service accruals);
- where the scheme's rules restrict any other benefit to an amount which does not prejudice Revenue approval, that restriction could be removed;
- that could mean that trustees have to let members commute their entire pension on retirement, and might be obliged to make other "unauthorised payments", which would expose the scheme as well as the member to substantial tax penalties; and
- the trustees might not be allowed to recover a lifetime allowance charge from a member's benefits.

If you would like any help in addressing these issues please get in touch with your usual Mayer Brown contact.

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August 2010