When a Contractor Turns Into an Employee: An Analysis of Risks Around the Globe

In most jurisdictions, the question of whether an individual service provider is an independent contractor or an employee is a question of fact, looking at the nature of their relationship with the service recipient and the way in which the services are performed. The question is a significant one, as employees often have much more valuable rights than independent contractors, and so a misclassification of an employee as an independent contractor can have significant consequences for the service recipient, involving additional costs and liabilities.

There have been some significant legal decisions and regulatory changes in this arena in both France and the US in recent times. In the article below, Latham & Watkins' attorneys examine the implications of those developments for service recipients, and consider ways in which the risks they face may be mitigated.

France

By Agnès Cloarec-Mérendon and Matthias Rubner

In France, many well-known branded networks have been sued by independent contractors using their brands claiming to be employees. Some of these organizations have found that their apparent commercial agreements have been redefined by French judges as employment contracts — as the nature of the relationship under French law is a matter of fact, not contract. These judges base their decisions on the existence of the so-called "bond (or obligation) of obedience", characteristic of an employment relationship. In the relationship between the branded network and the brand users, this "bond" has been found in the way that the brand owner imposes strict standards on the individuals using its brand and the way they operate their businesses.

It is hard for the brand owner, facing this type of claim from the brand user, to predict the outcome. The same kind of contract operated in a similar way can be analyzed differently by different judges. One judge can consider that there is no employment contract between them and refer the matter to a commercial court, but another may find that the brand users who are apparently independent contractors are in fact employees, and that, as a consequence, the employment court has jurisdiction over the case. The French Supreme Court seems unwilling to closely scrutinize the conclusions of the lower courts, on the basis that these cases commonly turn on the facts. As a consequence, the case law is inconsistent — and a source of considerable uncertainty in business operations.

This risk is faced by a wide range of industries, including, but not limited to, hospitality (e.g., restaurants and hotels), taxis, cosmetics retailers, insurance brokers and cell phone network operators.

Recent cases have often involved business chains, where a number of businesses share the same brand name and provide similar services or products, following common standards. Each business
identifies itself through the same brand, uses the brand logo and graphics, and complies with precise rules and procedures when delivering the branded products or services. Customers can thus readily identify the brand, and trust that the branded product or service will meet the same standards in each and every business location belonging to the branded network. The network of separate businesses each comply with these rules in return for relying on that brand’s existing goodwill to more easily develop their business. From the brand owner’s perspective, these strict rules are necessary to preserve that goodwill, however, it may expose the brand owner to claims from the individuals using the brand that they are employees of the brand owner.

These arrangements fall mainly into two categories in France: (i) “gérance-mandat”, where a principal appoints an agent, which can be a natural person or a company, in order to run a business (commonly used in the hospitality, cosmetics and cell phone network industries); and (ii) franchises, where a franchisor entrusts the marketing of a service or a product in a specific location to a franchisee.

**Risk Factors**

The determining element of an employment contract as opposed to a commercial agreement is the “bond of obedience” between the principal or franchisor on the one hand, and the agent or franchisee on the other. This “bond of obedience”, in particular, by expressly determining that the principal or franchisor can direct the manner in which the agent or franchisee must sell its product or service; and (ii) the power of the principal or franchisor to instruct the agent or franchisee and penalize disobedience of those instructions.

Some key indicators of employment are where the brand users cannot determine their schedule of work; are not able to determine details of the products or services; and are required to closely conform to a brand communication or business strategy.

It is worth noting that, even if they can sub-contract the selling or distribution of the products or services, brand users recruit as many employees as they need, the so-called agents or franchisees may still be considered employees if they lack independence and have no ability to tailor their products/services or the way their businesses are run because of detailed management by the principal or franchisor.

**Misclassification Risks**

In addition to the unpredictability of the judges in these cases, there are a variety of forms of actions which can be brought against the branded network, and the financial stakes are high. Most of the actions in this field are brought by the alleged employees (the “agents” or “franchisees”) who commence proceedings against the principal or franchisor (the brand owner) when their apparently commercial agreement is terminated. If they are successful in their claims, they are entitled to receive unemployment insurance, damages for unjustified dismissal, back wages, overtime payments, damages for unpaid vacation, etc. The de facto employer may even face criminal sanctions, with fines of up to €225,000 for a company and €45,000 for individual employers.

**Possible Solutions**

Latham & Watkins Paris can assist businesses in mitigating these risks by:

- Drafting standard commercial agreements in a manner designed to show that there is no “bond of obedience”, in particular, by expressly allowing the agents or franchisees to recruit their own personnel and sub-contract, and by advising on the pricing structure so as to ensure it is unrelated to hours of work performed by the agent or franchisee.
- Advising on the implementation of such agreements so as to leave sufficient autonomy and independence to the agents or franchisees, e.g. by addressing the issue raised by quality controls and compulsory charges, sanctions on franchises/agents, etc.
- By providing professional training for staff who are in contact with the independent contractors in order to avoid behaviors which could considered too intrusive.

We have extensive experience of litigating in this area, particularly in what has become known as “mass actions” — when multiple contractors bring claims against the same business. Latham & Watkins has also been successful in lobbying for a number of clients for a change in the law.

**US**

By Linda Inscoe and Scott Thompson

With federal and state governments facing mounting budget deficits and pressure from labor unions, the misclassification of workers is becoming an increasingly hot topic. Both federal and local governments are focusing their attention on additional payroll tax revenues to be obtained by challenging classifications of workers as independent contractors. President Obama’s 2010 budget assumes that federal enforcement action in this area will yield at least $7 billion in Federal tax revenue over the next 10 years. We could also see an increase in civil actions against businesses by workers who feel they have been wrongly classified as independent contractors.
Enforcement Actions

- The Internal Revenue Service (the IRS) is currently in the process of auditing work classifications by some 6,000 companies.
- In New York, a task force of state agencies has conducted almost 2,500 misclassification investigations since 2007 and has assessed some $25 million in unpaid state taxes and wages against employers.
- California’s attorney general is aggressively pursuing claims of misclassification, recently securing a $13 million judgment against companies for misclassifying janitors as independent contractors, and pursuing similar claims against members of the construction industry.
- In Ohio, the attorney general estimates that misclassification of employees as independent contractors costs his state as much as $360 million a year in lost tax revenues and workers’ compensation premiums.
- More than two dozen other states are also taking action and establishing task forces to recover potential tax revenues lost through the misclassification of employees as independent contractors.

Pending Legislation

In addition to increased enforcement action, a number of legislative and regulatory proposals threaten to make misclassification of employees as independent contractors more risky. In particular, there are currently bills pending in the US Congress that would:

- Increase the penalties for filing a tax return which incorrectly states an individual’s employment status or fails to otherwise comply with the applicable reporting requirements.
- Impose new reporting requirements for businesses that pay more than $600 in a year to corporate providers of goods and services, requiring them to file an information report with the IRS regarding such transactions.
- Require the IRS to notify both the employee and the Secretary of Labor about any misclassification, which could prompt additional enforcement action by the Department of Labor (the DOL), as well as possible civil action by the misclassified employee.
- Replace the current Internal Revenue Code (the Code) independent contractor safe harbor provision, that for 30 years has allowed companies to classify as independent contractors workers who they once had a belief were properly classified.

Some states are also considering legislative solutions to the perceived problem of misclassification. For example, in Connecticut, a state commission recently proposed an increase in penalties for misclassification from $300 per violation to $300 per day, and the introduction of criminal sanctions.

Independent Contractors vs. Employees

The reasons for using independent contractors are varied. Start-up or small companies may lack the administrative and supervisory infrastructure to engage employees. In some industries, it has become common practice for certain classes of workers to only be willing to provide services as independent contractors as the worker wants to (i) protect intellectual property rights that would otherwise be claimed by the company to which they are providing services, and (ii) claim potential “above the line” tax deductions. Other companies intentionally classify workers as independent contractors in order to manage workforce costs relating to both benefits and taxes. Whichever circumstance applies, companies which engage independent contractors, particularly those which engage large numbers, now face heightened audit risk and potential liability with respect to misclassification.

Misclassification Risks

When a worker is classified as an independent contractor, their income is reported on a Form 1099, no social security or Medicare payments are made by the company, and no income taxes are withheld. In addition, independent contractors are typically ineligible to receive benefits, reimbursement of business expenses and overtime pay, all of which companies provide to employees. As demonstrated by several high profile civil cases against Microsoft, Federal Express, Time Warner and SmithKline, some of the biggest financial risks a company faces for misclassifying workers are claims for missed pension, profit sharing and medical benefits, missed equity compensation participation, reimbursement of business expenses and overtime pay.

One of the most significant modern misclassification cases arose out of an IRS investigation of classification by Microsoft of a large group of workers as “freelancers.” These workers were not eligible to participate in employer-sponsored savings and stock purchase plans, and ERISA benefit plans. After it was established that the freelancers, who worked at Microsoft sites on teams with regular employees, performed identical functions to regular employees, and maintained the same hours as regular employees, should have been classified as employees, Microsoft settled their claims for $97 million. Vizcaino v. Microsoft Corp., No. C93-178C (W.D. Wash. preliminary approval of settlement December 12, 2000). Similarly, in Estrada v. Fed-Ex, 154 Cal. App. 4th

Latham & Watkins | The Working World—Issue 8, 2010
Federal Express was held to have misclassified drivers as independent contractors where the drivers worked full time, were paid weekly, had regular schedules and regular routes, received many standard employee benefits, wore uniforms, used company-specific scanners and forms, and were required to work exclusively for the company. The court held that the drivers were, therefore, entitled to reimbursement of business-related expenses. Finally, Wal-Mart is currently defending a case brought under the Fair Labor Standards Act on behalf of a class of undocumented workers who worked for a third-party janitorial service and were denied overtime pay. Zavalaa v. Wal-Mart Stores, 393 F.Supp. 295 (D.J.N. 2005).

Other substantial risks of misclassification include liability for unpaid federal, state and local income tax withholding, social security and Medicare contributions, and unpaid workers’ compensation and unemployment premiums, together with attendant penalties and interest for the unpaid amounts.

Finally, a company’s tax-qualified benefit plans may be at risk of losing their tax-qualified status for failure to meet the nondiscrimination requirements where workers are excluded from participation as a result of their classification as independent contractors.

Classification Determinations
Determining whether a worker should be classified as an employee or an independent contractor is often difficult. IRS reviewers look at the following three categories of factors:

- **Behavioral Control.** The more control the worker has over the means and manner by which the work is completed, the more likely the worker is an independent contractor.
- **Financial Control.** This factor looks at whether the service recipient has the right to control or direct the business aspect of a worker’s performance of services.
- **Relationship of the Parties.** Some of the relevant questions are:
  - How do the parties classify the relationship?
  - How long has the worker provided services to the recipient?
  - Does the worker receive employee benefits?
  - Does the worker provide services for multiple recipients?
  - Is the relationship permanent or for a fixed period of time, and who has rights to terminate the relationship?
  - Are the services provided by the worker a core part of the service recipient’s business?

What Companies Should Be Doing Now
Companies with independent contractors should consider an internal audit of their existing independent contractors to ensure that those relationships meet the common law test and guidelines promulgated by the IRS and the DOL. We recommend that companies discuss with their accountants and legal counsel the results of any internal audit to determine if any re-classifications will have an impact on tax returns, financial statements and/or benefit plans.

Companies may also wish to revisit their hiring philosophy and existing intake procedures, to cut back on high risk use of independent contractors and ensure that newly engaged workers are properly classified. This is most easily achieved by training a gatekeeper for new independent contractor relationships to recognize risks with respect to these classifications, and by creating intake forms with questions designed to highlight the factors considered in making a determination as to a worker’s status as an independent contractor.

For some workers currently classified as independent contractors, companies may want to revisit and document the factors that support the classification. It may be useful to consider how the relationship can be restructured to give the independent contractor additional control over how a project will be completed, such as by allowing the contractor to have a flexible work schedule or permitting the contractor to work remotely, or by giving the contractor more control and responsibility for expenses related to the work performed.

Endnotes
1 California already requires companies to file a report with the State Employment Development Department within 20 days of paying or contracting of $600 or more with an independent contractor.
Employees or Consultants: Comparing Some of the Tests Around the Globe

By Norma Studt, Hiroki Kobayashi and Kathryn Donovan

The tests for determining whether an individual service provider is an employee or an independent contractor are similar — but subtly and significantly different — in a number of jurisdictions.

By way of example, Latham & Watkins attorneys in Germany, Japan and the UK have described below: (i) the legal tests for establishing an employment relationship in each jurisdiction, (ii) the consequences of incorrectly classifying an employee as an independent contractor and (iii) ways in which the risks associated with misclassification can be mitigated.

(i) The Legal Tests

In all three jurisdictions, whether an individual is an employee or an independent contractor is a question of fact.

Germany: The key question when assessing whether an individual working in Germany is an employee is: Does the company give instructions regarding the (a) content, (b) time and (c) place of work?

Japan: There are two questions relevant to whether an individual working in Japan is employed by the service recipient (company): (a) Does the individual work “in a business or office”, i.e., under the direction and supervision of the company?, and (b) Is the individual paid a salary? Where the payment is determined by the time worked, not by the service provided, the individual is more likely to be an employee.

The UK: There are also two main questions relevant to whether an individual working in the UK is an employee: (a) Is there “mutuality of obligation”, i.e. is there an obligation on the company to provide work and on the individual to carry out that work?, and (b) In performing the services, is the individual subject to the control of the company?

Factors that are relevant when considering whether these tests have been satisfied in each of the jurisdictions include:

• Does the company give instructions to the individual regarding the form/content, time and place of work?, i.e. does the company effectively supervise the day-to-day work of the individual?
• Is the individual integrated into the company’s organization?
• Do employees of the company perform roles comparable to that of the individual?
• Does the company pay the individual for vacation, reimburse expenses or allow the individual to participate in employee benefit programs?
• Is the fee payable to the individual based on time rather than output?
• Does the individual only work for the company?
• Are the services performed on the company’s premises?
• Does the company procure, and bear the expenses of, the raw materials and equipment used to perform the services?
• Does the individual only work for the company?
• Are the services performed on the company’s premises?

Positive responses to the questions indicate an employment relationship in all three jurisdictions.

(ii) Consequences of Incorrect Classification

There are many professions in which companies engage consultants to produce work products or perform services. Particularly in difficult economic times or during hiring freezes, companies often engage individuals as self-employed “consultants” or “freelancers”, when in reality those individuals should be regarded as employees.

De facto employers may find themselves facing claims for wage taxes, social security liabilities, paid leave, sick pay, maternity leave and pay, and participation in benefit plans. They may also face claims from third parties for the actions of the de facto employees for whom they may be vicariously liable. One of the most common circumstances in which a person’s status as an independent contractor is questioned is when the contract under which their services are provided is terminated. The person concerned may claim that they were in fact employed by the service recipient and therefore that the termination of their services is in fact an unfair dismissal.
The question may also arise if the local tax or social security authorities claim that the company should have paid employer’s social security contributions on the fee paid to an apparently independent contractor, and that it should have withheld income tax and employee’s social security contributions from that fee. In the event of incorrect classification, the employer is liable to the authorities for both the employee’s and the employer’s social security contributions, and for the income tax it should have deducted from the fee, and the fee will be deemed to have been “grossed up” if these amounts are not reimbursed by the de facto employee. In the UK, HM Revenue & Customs may claim backpay (and interest and possibly penalties) for the past six years; in Japan, the social insurance authority may look back two years and the tax authority will generally claim for the past five years; but in Germany this lookback period can be up to 30 years!

In Germany, the works council representing company employees may also dispute an individual freelancer’s status. For example, it may claim for certain rights that depend on the number of employees it represents.

(iii) Mitigating the Risks

Although the question of an individual’s employment status is one of fact and not of contract, the drafting of the contract is still relevant, as the factors indicating an employment relationship can be excluded (the performance of the contract would, of course, have to be consistent with this!). In addition, the language used to describe the relationship should avoid the implication that the individual is an employee. Careful drafting of the contract, while not determinative, is important.

In Germany, a company seeking certainty may wish to ask the tax and social security insurance authorities to conduct a “status procedure” to determine an apparent freelancer’s employment status, but this will generally not be conducted unless the parties have already entered into an agreement. Latham & Watkins can assist with this process.

In the UK, it is common for contracts with independent contractors to contain an indemnity for the company in these circumstances, but of course such an indemnity is only as valuable as the solvency of the person giving it. However, this solution will not work perfectly in Germany, as the German courts will not enforce such indemnities in relation to social security contributions (and wage taxes may be claimed from the employee without such an indemnity) — and therefore indemnities such as this are uncommon in German freelancer contracts. In Germany, the employer only has a three month window following the reclassification within which to deduct the employee’s social security contributions from the fee paid to the employee. In Japan, indemnities such as these are also not commonly used, but the employer has a longer period to deduct, or claim for reimbursement of, social security contributions and tax that should have been withheld from employees’ fees.

In the UK and Germany, one way to reduce (although not extinguish) the risk of claims that individuals are in fact employees of the company would be for the individual to form his own personal services company (a PSC) and put in place an employment contract between himself and that PSC. The PSC would then enter into the consultancy contract with the company, specifying the individual as the person who will perform the services on the PSC’s behalf. The UK tax authorities, or the individual, would then need to prove that the contract between the PSC and the company is a sham before the company could be deemed to employ the individual. In Germany, these principles generally also apply. However, the onus is on the company to prove that there is no employment if the German authorities serve them with a demand for unpaid wage taxes or social security contributions. This approach will not mitigate the risk in Japan.

As set out above, the question of whether an individual is an employee or an independent contractor is fact-specific, but timely advice can mitigate the risk of a service recipient being deemed to be an employer of such a person. ■
Clawing Back Incentive Compensation

By David Della Rocca, Holly Bauer, Stephen Brown, Jeff Ii, Richard Nettles and Kathryn Donovan

A "clawback" is a policy or agreement that permits an employer to recover certain compensation paid to an employee, typically because the employee engaged in misconduct or because the employee received compensation as a result of incorrect financial results reported by the company. Clawbacks are becoming increasingly popular with employers, regulators and legislators. The article below outlines some of the key issues concerning the design and enforcement of clawback policies in the US and the UK.

Though simple in concept, a clawback can quickly become complex as an employer attempts to draft and implement a right to reclaim all or part of compensation paid to an employee as part of its employee incentivization programs. This complexity is a result of the wide variety of design features that should be considered when structuring clawbacks. These design features must also make sense in light of each employer’s particular circumstances and goals.

In addition to the specific design issues discussed below, companies implementing a clawback should pay special attention to the enforceability of a clawback policy under applicable labor and employment laws, which can vary significantly by jurisdiction, not only within the US and the UK (considered in this article), but elsewhere in the world. Because clawbacks have been rarely used until recent years, there is a dearth of case and statutory law concerning them, but existing laws may impact clawbacks in unexpected ways. While some broad enforceability concerns are discussed in this article, it is important that any company implementing a clawback consult with local labor and employment counsel to review the clawback in light of the relevant jurisdiction’s particular laws.

Recent Clawback Initiatives

As recently as five years ago, clawbacks were uncommon among US public companies. However, between 2006 and 2009, the percentage of Fortune 100 companies with clawback policies grew from 17.6 percent to 72.9 percent, according to a 2010 report published by Equilar, Inc., an executive compensation research firm. Clawbacks are also gaining favor among US legislators as a major element of corporate governance reform. In 2002, the Sarbanes-Oxley Act introduced a very limited clawback, which was only enforceable by the Securities and Exchange Commission. Recently, the Troubled Asset Relief Program imposed a clawback on participating companies and an even more rigorous clawback would be required at every US public company under a financial reform bill proposed by US Senator Chris Dodd.

In the UK, Sir David Walker’s recommendations following his review of corporate governance in UK banks and other financial institutions were published. These included a recommendation that incentive payments should be deferred for “high end” employees, with clawback used to reclaim amounts in limited circumstances of misstatement and misconduct. This has been incorporated into the Financial Services Authority’s draft Remuneration Code, which provides guidance for UK banking institutions rather than requiring compliance — however it is far from clear how the banks are expected to provide for clawback, particularly in light of the legal difficulties in the UK of doing so (discussed further below).

Clawback Design Issues

Form of the Plan or Policy

A clawback might be designed as a company-wide policy, typically giving the board of the company broad authority to administer the policy. At the opposite end of the spectrum, a clawback can be written into each specific employment agreement, incentive compensation plan, individual incentive award agreement and/or other compensation agreement. While a company-wide policy may be appealing because of its relative simplicity in design and administration, the enforceability of a clawback is likely to be strongest where the provisions of the clawback are directly included or expressly incorporated into an agreement to which an employee is a party.

Clawback Triggers

The scope of the events or conduct that trigger the recovery of compensation is perhaps the most significant design element of any clawback policy. Broadly, there are two categories of...
clawback triggers, both of which can be included in the same policy: (1) “fault” triggers, which require some level of misconduct on the part of an employee, or (2) “no-fault” triggers, which only require that an employee received compensation to which he or she was otherwise not entitled at the time of the grant or payment.

Within these two categories, there can be a large amount of design variation. For example, a fault-based trigger may require only that an employee have engaged in some pre-defined type of misconduct (e.g., conduct sufficient to result in a termination for “cause” under an applicable employment agreement, the breach of a restrictive covenant and/or other ethical misconduct), or the threshold might be higher, requiring a restatement of the company’s financial statements as a result of misconduct by an employee.

In contrast, a no-fault trigger is one that provides for recovery of compensation regardless of whether the employee engaged in misconduct. For example, a no-fault clawback could be triggered where an employee received an overstated bonus because the company materially misstated its financial results. While fault-based clawbacks typically seek to recover any incentive compensation that was paid to the employee during the applicable lookback period (which is discussed below), the amount recovered under a no-fault trigger is generally limited to the compensation the employee would not have received but for the applicable trigger event (e.g., the company materially overstating profits).

**Employees Covered**

The categories of employees covered by clawback policies also vary. However, clawbacks are generally designed to cover key executives and employees whose conduct can most significantly impact a company’s financial performance.

**Compensation Covered**

The scope of compensation covered by a clawback is an essential design element, particularly for enforcement purposes. Clawbacks should generally only apply to incentive compensation. In some US jurisdictions, a clawback that purports to reach an employee’s base salary or wages would be wholly unenforceable, and in the UK, unless expressly permitted by the individual’s employment contract, clawback of salary or wages is prohibited by statute. Within these limits, a broad clawback policy would be designed to reach all “incentive compensation”, broadly defined to cover both cash and equity-based incentives. Alternatively, the scope might be narrowed by covering only specific types of incentive compensation.

Employers should also consider whether to recover compensation net of taxes and social security contributions paid by the employee and/or whether to charge interest on amounts subject to recoupment, to the extent that there are delays in recovering the compensation.

**Administration**

Given the complexity of clawbacks, it is unrealistic to design a policy without appointing an administrator. An employer needs to consider (1) who will enforce and administer the policy, and (2) the amount of discretion that the administrator will have. Typically, a committee of independent directors is given the discretion to administer the clawback policy, since members of management may be personally subject to the policy. Varying degrees of discretion may be granted to the administrator on a number of issues, such as whether a triggering event has occurred, whether recovery will be sought under the policy, how much compensation is subject to recovery and the manner of recovery for any amounts subject to clawback. The administrator might be granted “sole and absolute” discretion to administer the policy, or this discretion might be limited.

**Lookback Period**

A lookback period is the period for which the incentive compensation is subject to clawback after it has been paid to an employee. Clawback policies typically have a specific application period (such as 12 or 24 months), but some policies might be designed with an unlimited lookback period. For instance, the lookback period under the Sarbanes-Oxley clawback is one year, while the lookback period for the clawback proposed in the Dodd financial reform bill is three years.

**Enforcement**

**US Enforcement Issues**

The major clawback enforcement issue among US jurisdictions is the scope of compensation that may be subject to a clawback policy. Though applicable labor laws can vary widely among states, a number of states have statutes or case law which dictate that an employee must be paid all of his or her earned wages. If an employer fails to pay such earned wages, or attempts to recover already-paid wages pursuant to a clawback, it may cause the employer to be liable for penalties and/or attorney’s fees in certain jurisdictions. Whether different types of compensation, such as commissions, vacation pay, bonuses, equity awards or other types of incentive compensation, constitute earned wages for the purposes of these laws varies between states. As a result, the scope of compensation covered by a US clawback should be the result of careful drafting, after a close consideration of the applicable wage statutes and case law in the relevant jurisdiction.
UK Enforcement Issues
In the UK, the idea that an employer may clawback remuneration paid to an employee is difficult and controversial (although more frequently used in recent times). It is far more common to “holdback” portions of bonus payments or equity incentives, spreading payment over, for example, a three or five year period, during which performance may be reassessed and the amount of bonus ultimately due adjusted.

Need for Clear Drafting
Clawback will not be possible in the UK without clear drafting expressly setting out the employer’s right to clawback the bonus or share incentive in appropriate circumstances. If an express condition of payment is that the employer has the right to reclaim all or part of it in certain (clearly defined) circumstances, it may be possible for the employer to recover the award. The High Court in the recent decision of Tullett Prebon plc v BGC Brokers L.P. [2010] EWHC 484 (QB) held that a retention bonus which was expressly stated to be “repayable immediately to the Company if during the initial minimum term, [the employee’s] employment is terminated”, was recoverable by the employer in those circumstances.

Challenging Clawbacks: Unenforceable “Penalties”?
Even if a clawback provision is clearly and carefully drafted, UK-based employees have several grounds for attacking the validity of a clawback provision. They may argue that it is an unenforceable penalty, not calculated as a genuine pre-estimate of the employer’s loss flowing from the employee’s breach. The employee may point to the unequal bargaining position of the parties and assert that the clawback was forced upon him.

In Tullett, the clawback provision was challenged by the employees as a penalty, but the Court found that on those facts, the employees were given large sums on this express condition, and if the condition is breached, the amount becomes repayable. The Court noted that the employees in question were intelligent, successful men capable of driving a bargain with their employer, and therefore “the law should not look for ways for them to avoid the provisions of their contracts.”

Challenging Clawbacks: Unlawful Restraint on Trade?
A second avenue of attack would be for the employee to characterize the clawback provision as a restrictive covenant that goes further than required to protect the employer’s legitimate interests. This attack may be used where the clawback applies if the employees breach non-compete or non-solicitation provisions, or if they refuse to comply with notice periods. The employee may argue, for example, that the clawback provision triggered, on facts such as those in Tullett — if the employee resigns the employer’s employment within a set period following the award (a “no-fault” trigger) — is an unlawful restraint of trade, unfairly penalizing (and thereby restricting) the employee from commencing work with an alternative employer. Whether a clawback provision operating in this way is justified will depend on the particular facts and circumstances of the case, but it will be for the employer to demonstrate that the restriction goes no further than is necessary to protect its legitimate business interests when compared to the restrictions it places on the employee. In Tullett, where the employees challenged the clawback provision of their retention bonuses on this basis, the Court considered that there was no restraint of trade, as the employees were not prevented from working after they left Tullett’s employment — they were simply obliged to repay their retention bonuses, which the Court characterized as substantial sums paid to highly-paid employees as a reward for loyalty.

Practical Difficulties
Ultimately, even if clawbacks are enforceable (in the UK, “fault” clawbacks are more likely to be so than “no fault” clawbacks if carefully drafted), employers will face the practical difficulties of seeking to recover money or share-based incentives from individual employees. Litigation concerning the validity or otherwise of such provisions is likely to be expensive and difficult, and related recovery of income tax and social security/National Insurance contributions paid on the clawed back sums adds to the level of complication.

Arguably, a much more attractive route for employers is to stagger the awards in the first place, using clear and unambiguous drafting that allows the employee’s performance to be reassessed over the payout period of, for example, three or five years. This “holdback” mechanism is probably only appropriate for highly-paid individuals who will still be incentivized by staggered payments, and whose performance could be reassessed by the employer over the payment period. “Holdback” clauses are certainly on the increase in the US and the UK, and while they are vulnerable to the same challenges as are described for clawbacks, properly-drafted holdbacks are much more ingrained in employment culture in both these jurisdictions, being commonly used in the arena of equity-based incentives, company share option schemes and executive long-term incentive plans.
1. What Are the Sources of Japanese Labor Law?
Japanese labor law derives from statute, e.g., the Japanese Labor Standards Act and Labor Contract Act, and the precedents established by the Japanese courts.

2. Who is an Employee?
The Japanese Labor Standards Act defines an employee as "a person who (i) is used in a business or office, regardless of the occupation, and (ii) gets paid salary." In practice, the distinction between an employee and an independent contractor, and between an employee and a non-employee director, is not always easy to determine.

As noted in the first article of this issue, the distinction between an employee and an independent contractor is a question of fact, and will depend on, among other things, the level of discretion afforded to the individual as to when and how they perform work for the service recipient/employer, whether the individual is personally obliged to provide the service and how the individual is remunerated for the work that he does.

A Japanese company must have at least three directors on its board. One or more of those directors are appointed as Representative Directors, who have unlimited authority to sign documents on behalf of, and to otherwise represent, the company. Ordinarily, a Representative Director is not an employee, although a non-representative director may have a hybrid status as both an employee and a director.

3. Are There Restrictions on Employing Non-Japanese Nationals?
A working visa is necessary for a non-Japanese national to work in Japan. Otherwise, there are no restrictions on employing non-Japanese nationals.

4. Are There Any Minimum Terms on Which Employees Are Employed in Japan?
- **Wages:** The government determines the minimum hourly wage applicable to each region and industry, which is reviewed annually. For example, the current hourly minimum wage for employees in the retail sector working in Tokyo is ¥792.
- **Overtime rate:** An employer is required to pay an additional 25 percent of average hourly salary for overtime work, an additional 25 percent for work between 10 p.m. and 5 a.m. and an additional 35 percent for work on holidays. These are cumulative (e.g., an additional 60 percent for work between 10 p.m. and 5 a.m. on holidays).
- **Notice period:** An employer must give an employee a minimum of 30 days’ prior notice (or payment in lieu of 30 days’ notice) before dismissal.
- **Vacation:** An employee who has worked for an employer for six months is entitled to 10 days of paid vacation per year. The minimum days of paid vacation increases annually up to a maximum of 20 days per year.

5. Which Rules Apply When Dismissing an Employee in Japan?
Employees in Japan have a high level of protection from termination. "At will" employment is not permitted, even with an employee’s consent.

There are broadly two types of employees in Japan: regular employees, employed for an indefinite period until they reach mandatory retirement age (which is, typically, 60 or 65), and contract employees, who are employed for a limited term of usually less than three years. The difference between a regular employee and a contract employee primarily relates to the level of protection local law affords them from dismissal.

A. Regular Employees
Japanese employment law provides that dismissal of an employee is void if such dismissal is not based on "objectively reasonable grounds" and is not "considered to be appropriate in general societal terms." The following have been recognized as "objectively reasonable grounds" for dismissal by Japanese courts and legal commentators:

- The employee commits a serious violation of the company’s written internal rules and that violation is stated in the rules to be a ground for dismissal.
- The employee commits serious misconduct.
- The employee continuously fails to perform his work at all, or continuously performs his work in a substantially deficient manner.

Traditionally, Japanese courts consider dismissals "to be appropriate in general societal terms" only if the ground is material, the employer has made efforts to avoid dismissal, and there are no extenuating circumstances. There is always a risk...
that if a dismissal is challenged, the court may order the employer to reinstate the dismissed employee.

Japanese courts also take a strict approach to termination of employees for redundancy, considering whether the redundancy is:

• Unavoidable because of extraordinary operational or financial difficulties faced by the employer

• The last resort (i.e. has the employer taken steps to avoid the redundancy by seeking to redeploys the employee, using temporary layoffs, requesting voluntary resignations for additional severance, etc.)

• Taken after a proper procedure has been followed, including objective and reasonable selection, the employer explaining the rationale, timing, scale and method of selection to the labor union or workers, and the employer discussing the redundancy in good faith with the employees

Because of the risk that the Japanese courts may consider these requirements have not been met in any particular case, employers often offer severance packages and seek employees’ voluntary resignations rather than making them redundant.

B. Contract Employees
The requirement for “objectively reasonable grounds” for dismissal does not apply to contract employees retained with a limited term of employment. Contract employees have stronger protection from termination during the agreed-upon term and no protection at the end of the term. During the term, the employer may terminate the employee only if there is an “unavoidable” reason, which is interpreted even more narrowly than “objectively reasonable grounds.” At the end of the term, the employer is not required to renew the employment agreement and may discontinue employment.

6. Are There Any Forms of Prohibited Discrimination?
The Japanese Constitution prohibits discrimination on the grounds of race, creed, sex, social status or family origin. In the context of employment, this means that employers may not discriminate with respect to salary, working hours and other employment terms on any of these grounds. In the case of job applicants (rather than employees), discrimination on the ground of sex or age is strictly prohibited, but discrimination for any other reason is not.

7. Do Japanese Employees Have Rights of Collective Representation?
Yes. The rights of employees to collective representation are contained in the Japanese Constitution (although these rights are more limited for government workers engaged in office work, and policemen, firemen, employees in the self-defense force and employees working in jails have no right of collective representation).

8. What are Typical Japanese Pension and Share Incentive Arrangements?
In Japan, there is a mandatory governmental defined benefit pension plan, where contributions are determined based on the employees’ salary. The employee and the employer are both required to contribute one half of those contributions. In addition to the government pension, smaller companies often provide a “retirement allowance” — a lump-sum amount payable upon departure from the company because of retirement or other reasons. The amount of allowance is calculated primarily by the employee’s salary at the time of departure and the number of years the departing employee has worked for the employer. Larger companies typically implement tax-qualified pension plans, which historically were defined benefit pension plans, but which are now shifting to defined contribution pension plans (known as the “Japanese version of the 401(k) plan.”)

Stock options are the most common form of share incentive for employees. It is said that 40 percent of listed Japanese companies have implemented stock options.

9. What Happens to Employees When Their Employer (Company or Business) is Sold?
This depends on the legal structure of the sale:

• Share sale: The employees continue to be employed by the employing entity, which is, post-sale, owned by the acquirer.

• Merger: Where all of the contracts, property and liabilities of a company are transferred to a buyer or into a new entity upon a merger, and the original company ceases to exist, the employees automatically move with the merged business and become employed by the merged entity on the same employment terms.

• Statutory spin-off: Where some, but not necessarily all, of the contracts, property and liabilities of a company are transferred to a buyer or into a new entity, the employees continue to be employed by the spun-off entity, and their employment terms are unaffected by the transaction.
• **Asset/business sale:** The employees do not automatically transfer to the buyer, and so if the buyer wishes to engage these employees, it needs to obtain individual consents from each employee. In addition, because the sale of a business does not necessarily enable the seller to terminate the employment of the employees by reason of redundancy (because the legal test for redundancy is so exacting), if the seller wishes to terminate the employees’ employment, it would probably need to seek the employees’ consent to voluntary resignation. It is common for the parties to a business sale to jointly seek employees’ agreement to resign from the seller’s employment and to enter into employment with the buyer, and to facilitate this, the seller often requires the buyer to agree to maintain employment terms for a certain period after the business sale completes.

10. **Are There Any Particular Issues to be Aware of When Looking to Hire Employees in Japan?**

The two key issues that typically arise in relation to employees in Japan are:

• The difficulty of terminating the employment of those employees (see Question 5 above) as well as seeking to change employment terms to the employees’ detriment. Generally, such changes are unenforceable unless deemed by the courts to be necessary and reasonable.

• The regulation and calculation of overtime work — it is often also difficult to track employees’ overtime entitlements, and disputes in relation to this are fairly common. Some senior employees may be excluded from entitlement to overtime, but this can be a complex area of Japanese law.
China: Foreign-Invested Enterprises Now Have to Compensate Employees for Patents

By Qiong (Lucy) Lu

As of February 1, 2010, amendments to the Implementing Rules of the Law of the People’s Republic of China on Patent (the Implementing Rules) went into effect. One of the changes under the Rules means that any employer in China, including a foreign-invested enterprise (an FIE), now has to compensate employees for any “service-related invention” they create for which their employer registers a patent. Previously, although PRC patent law required that an employer obtaining patents for service-related inventions give the employee-inventor a reward and “reasonable remuneration”, the value of that compensation was only stipulated for state-owned employers.

Under PRC patent law, if an employee invents something in the course of performing his employment duties, or mainly by using his employer’s resources, a so-called “service-related invention,” his employer has the right to apply for and hold the related patent. The Implementing Rules now provide that if any employer has not agreed with the employee, and has not specified in its rules and policies, how to reward and remunerate the employee for service-related inventions it must pay the employee:

1. Within three months of the date the patent is registered, a one-off bonus of at least CNY 3,000 for an invention patent or at least CNY 1,000 for an utility model patent or a design patent.

2. During the term of the patent: (a) one or more payments which, in aggregate, amount to no less than, in the case of invention patents or utility model patents, 2 percent, or in the case of design patents, no less than 0.2 percent, of the operating profit derived from the exploitation of the invention, and (b) at least 10 percent of the royalty it charges for licensing the patent, if any.

An FIE engaged in research and development activities should pay special attention to this new requirement as the inventions derived from its R&D operations in China may trigger this mandatory reward.

France: French Data Protection Authority Cracks Down on Illegal Data Processing

By Matthias Rubner

The mantra of the French data protection authority, CNIL, is: investigate, investigate, investigate. CNIL investigators can arrive at a company’s premises without warning to audit the company’s data protection controls — reviewing the personal data it holds and processes, and the protections applied to that personal data. While blatant breaches will be sanctioned (perhaps even by criminal prosecution), CNIL’s response in a series of recent cases was to issue an order that the illegal processing cease immediately. These cases included:

- An agency that provided private tuition, whose registers regarding pupils and tutors included comments such as “he stinks,” “too damned stupid,” “his mother has cancer” or “attempted suicide.” CNIL issued an official warning letter and informed the public prosecutor.

- A military clothes wholesaler installed an access control system using a biometric fingerprint scanner. CNIL refused to authorize the system because it considered it excessive, and determined that the people whose data was being stored in this way had not been sufficiently informed about their rights. CNIL issued an order to suspend the illegal data processing until corrective action was taken and a new authorization obtained.

- A clothes retailer used CCTV cameras to film staff without their knowledge and without prior authorization from CNIL. CNIL ordered the retailer to modify the system, but the retailer complied insufficiently. CNIL then fined it €10,000.

- A sales and marketing company created a database which included comments on
Germany: European Court of Justice Rules on Notice Periods Legislation

By Norma Studt

In Germany, the length of statutory minimum notice that must be given to employees to terminate their employment depends on the employee’s length of service. Under the German Civil Code, notice periods vary from four weeks in the first year of service to seven months after 20 years’ service. However, the German Civil Code provides that any service accrued before an employee reaches the age of 25 is not counted towards his period of service for the purposes of calculating statutory notice.

In a recent decision, the European Court of Justice ruled that the failure to recognize years of service prior to an employee’s 25th birthday is indirect age discrimination against younger employees. It reached this conclusion despite the fact that the German legislator considered such differentiation appropriate because younger employees generally tend to deliberately change employment more often than older employees. This means that German courts must disallow this provision of the German Civil Code, and that employers in Germany must take into account the total length of an employee’s period of service when calculating the employee’s notice period.

Germany: Data Protection Law Scuppers Archive on Serial Litigants

By Norma Studt

In Germany, the General Equal Treatment Act (Allgemeines Gleichbehandlungsgesetz — AGG) prohibits discrimination on the ground of an individual’s race or ethnicity, gender, belief or ideology, severe disability, age or sexuality. Job applicants who are discriminated against by potential employers can claim damages and, in certain circumstances, compensation for non-pecuniary damage. However, there are some who abuse the anti-discrimination legislation by applying for a job where the employer has inadvertently failed to word the advertisement in, for example, a gender-neutral way, and then filing a claim for damages under the AGG when their application is unsuccessful. One German law firm’s “AGG hopper archive” recorded that some serial litigants had filed over 100 discrimination claims against employers. The estimated number of unreported cases is much higher.

In several court proceedings, employers have been able to successfully defend against such allegations by producing evidence of the claimant’s history of discrimination claims. However, in August 2009, around three years after its establishment, the AGG hopper archive was withdrawn because the law firm maintaining the archive failed to reach agreement with German data protection authorities as to a permissible form of the archive. From a data protection perspective, this is certainly the correct decision, however, the AGG hopper archive was a helpful tool for employers when defending vexatious claims. To avoid vulnerability to such claims, employers must now demonstrate the applicant’s clear lack of qualification for the role. Employers should take care when drafting job advertisements, bearing German anti-discrimination legislation in mind when doing so.
In Brief

Hong Kong: New Criminal Sanctions Against Employers That Fail to Pay Sums Awarded by the Labor Tribunal

By Jane Ng and Alexander Tang

On May 7, 2010, amendments to the Employment Ordinance were published. These amendments introduced criminal sanctions for an employer that willfully and without reasonable excuse fails to pay to an employee any ‘specified entitlement’ awarded by the Labor Tribunal and Minor Employment Claims Adjudication Board within 14 days of its due date. The maximum penalty is HKD 350,000 and three years’ imprisonment.

‘Specified entitlement’ includes most payments prescribed under the Employment Ordinance, such as wages, severance, long service payment, sickness allowance, maternity leave pay and other maternity-related entitlements. The offense applies to directors, partners, managers and other responsible persons who consent to non-payment, or who are shown to be neglectful in making such payments.

Employers should therefore ensure that they pay any amounts awarded to employees by either of the two adjudication bodies at the earliest opportunity. If no date is specified in the award, payment should be made within 14 days of the date of award. If there is any doubt as to whether the award refers to a ‘specific entitlement’, legal advice should be sought at the earliest opportunity.

The amendments will take effect on a day to be appointed by the Secretary for Labor and Welfare.

Russia: Employing Non-Nationals in Russia

By Sergey Shorin

Recent amendments to regulations governing non-nationals in Russia will result in changes to the work permits and visa issuance procedure for highly skilled workers from July 1, 2010. Under law No. 86-FZ of May 19, 2010, an individual employed by a Russian legal entity (or an accredited affiliate of a foreign entity) who receives an annual income of not less than RUB 2 million (approx. US $70,000), may take advantage of the new work permit application and visa issuance procedures.

The current procedure for hiring non-nationals has several stages, meaning that it can take three to four months to obtain a work permit. The new procedure for highly skilled workers is a one-stage process under which it is expected to take approximately 14 business days to obtain a permit. A permit may be requested either by the employer or by the employee, and will be valid for up to three years (in contrast to the 12 month validity of a permit obtained under the current procedure). A visa for a highly skilled worker may be obtained for up to three years.

The tax status of highly skilled workers will also change on July 1. Whereas non-nationals are currently subject to a 30 percent income tax rate for the first 183 days of their residence in Russia, the regular income tax rate of 13 percent will, from July 1, apply to highly skilled workers from the first day they reside in Russia. There will also be additional formalities for employers of non-nationals: they will be required to register these employees with the Russian tax authorities, and provide them with medical insurance.
Spain: Recent Developments

By Yoko Takagi

In a recent case before the Spanish Supreme Court, the Court found that an employee is entitled to claim unfair dismissal in the following transfer-of-business case: A Spanish governmental body had outsourced activities to an external provider through successive contracts. When the service provider lost the business and it was granted to a new service provider, the former service provider amended the employee’s contract of employment. According to the Spanish Supreme Court, the employment contract should have transferred to the new service provider with no amendment of the terms and conditions of the employment contract. This is one of the first decisions issued by the Spanish Supreme Court involving a contract entered into with a Spanish governmental body in particularly in the context of successive contracts.

In a separate case, the Supreme Court found that a worker was entitled to benefit from the stock options awarded by her former employer, despite the fact that she had been dismissed before she became entitled to exercise those options, because her dismissal was unfair. The stock option plan in question provided that the options were only exercisable if participants were employees at the time of vesting. It was significant in this case that at the time of her dismissal, the worker had expressly reserved the right to exercise her stock options on the date of vesting.

UK: Blacklisting and Dealing With Serial Litigants

By Sarah Dunkley

Two very different types of blacklisting have recently come under attack in the UK:

Trade Union Blacklisting Outlawed — The Employment Relations Act 1999 (Blacklists) Regulations 2010 came into force on March 2, 2010. These regulations make it unlawful for employers to compile, disseminate or use so-called “blacklists” of trade union members, and it is now unlawful to refuse to hire, dismiss or subject individuals to a detriment because they are blacklisted for their trade union membership or activities. Trade unions and individuals can now seek compensation from companies that compile, distribute or use blacklists, and the compensation can include compensation for injury to feelings.

Serial Litigants: A New Type of Blacklisting — On a different note, a UK law firm has come under heavy criticism for publishing a list of serial litigants, i.e., individuals who have previously brought claims against their employers. The list is said to have been compiled from publicly available information, but concerns have been expressed that the list could give rise to victimization of job applicants who previously litigated genuine employment claims. Supporters of the list have argued that steps need to be taken to protect employers against serial litigants, and in particular, against phony job applicants who apply for jobs they have no interest in so that when they are rejected for the role they can argue that they were unlawfully discriminated against. The recent decision in Keane v. Investigo and others UKEAT/0389/09 suggests that this could be a genuine problem. Keane involved an experienced 51-year-old accountant who responded to at least 20 job advertisements for roles for which she was overly-qualified. When she was not offered an interview, Ms. Keane brought age discrimination claims, even though the Employment Tribunal concluded that she did not genuinely want the jobs she applied for and therefore suffered no loss.

Although dealing with vexatious claims from job applicants is time consuming and expensive, there is clearly potential for genuine job applicants who have raised genuine claims against a previous employer to be unfairly treated by a claimant blacklist. These events serve as a useful reminder that job advertisements should be carefully worded bearing in mind UK discrimination legislation — and in particular the protections against age discrimination.
US: Health Care Reform Arrives in the US

By Sandy Chandrasekhar and Tom Asmar

In March 2010, President Obama signed into law highly anticipated legislation reforming the health care system in the United States. Before this new law, employers were generally free to choose whether to provide health coverage to their employees and, if they did, the terms and conditions of any such coverage. However, beginning on January 1, 2014, employer-sponsored health plans will be required to offer certain minimum health coverage to employees and their dependants. In addition, individuals will be required to enroll in qualifying minimum coverage or pay a penalty tax. Below is a summary of the significant provisions of the new law and its impact on employers with employees in the US.

Automatic Enrollment

Employers that offer an employer-sponsored health plan with more than 200 full-time employees will be required to automatically enroll new full-time employees (with the option for employees to opt out of such automatic enrollment).

Coverage for Children Under Age 26

Group health plans that provide coverage to employees’ children must continue to provide coverage to all children under age 26, whether or not the children are themselves married (generally effective January 1, 2011).

Prohibition on Certain Provisions

Plans can no longer apply lifetime coverage limits, unreasonable annual coverage limits on the value of certain benefits or waiting periods in excess of 90 days (effective dates vary). It will also be more difficult to rescind coverage once offered. Finally, although it is common place for plans to exclude coverage for a participant’s pre-existing health condition, under the new law, plans will no longer be able to apply pre-existing condition exclusions.

Employer Mandate

Effective January 1, 2014, most individuals will be required to obtain “minimum essential coverage” either through an employer-sponsored health plan or through the purchase of individual coverage. States will provide health care exchanges where individuals and employers with fewer than 100 employees may purchase health insurance. If an individual is not enrolled in qualifying minimum coverage, then the individual will be required to pay a penalty. Employers that have 50 or more full-time employees but do not offer “minimum essential coverage” must pay a penalty if any full-time employee receives subsidized coverage under a state-provided exchange plan (referred to as the “pay or play” or “free rider” penalty). In addition, employers that offer “minimum essential coverage” and have at least one employee who receives subsidized coverage under an exchange plan will be subject to a penalty (referred to as the “unaffordable coverage” penalty).

Grandfathering

Health plans that were in effect on March 23, 2010 will be either exempt or “grandfathered.” The grandfathered plans have the advantage of delayed effective dates on some requirements and the ability to avoid others. For example, grandfathered plans can still impose pre-existing condition exclusions for those over age 18.

Tax Issues

The new law imposes new taxes on employers most notably in the form of a 40 percent excise tax on high-cost health plans whose cost of coverage exceeds certain predetermined limits (generally effective January 1, 2018). It also imposes an increase in the Medicare tax for certain employees and an additional Medicare tax on net investment income (effective January 1, 2013). In addition, employer deductions for Medicare Part D subsidies (relating to prescription drugs) will be eliminated (effective January 1, 2011). Employers will be subject to a new strict liability penalty for transactions that lack economic substance which are entered into after March 30, 2010. Employers will also need to comply with new tax reporting requirements (effective dates vary).

Endnotes

1 For further information, see our May 2010 Tax Department: Benefit and Compensation Update entitled “IRS Guidance on Health Care Coverage for Employee’s Adult Children.”

2 For further information, see our April 2, 2010 Client Alert entitled “Significant Tax Provisions in Newly Enacted Health Care Reform Legislation.”
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