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December 20, 2010

## Proposed Increase in Dollar Threshold for Coverage by Regulation Z

By Joseph Gabai

### BRIEF SUMMARY

On December 13, 2010, the Federal Reserve Board (“Board”) proposed an amendment to Regulation Z to increase the threshold for exempt consumer credit transactions from \$25,000 to \$50,000. Under the proposal, future increases in the threshold will be tied to changes in the Consumer Price Index for Urban Wage Earners and Clerical Workers. At present, credit secured by real property or by personal property used or expected to be used as the consumer’s principal dwelling and private education loans are not subject to the threshold amount exemption. A separate proposal issued by the Board on the same date will increase the threshold amount for exempt consumer leases under Regulation M from \$25,000 to \$50,000. The proposals reflect changes mandated by Section 1100E of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (“Dodd-Frank”). This Client Alert summarizes the Regulation Z proposal and discusses its ramifications.

### HISTORY AND SCOPE

- Currently, a consumer credit transaction with an amount financed in excess of \$25,000, or an express written commitment to extend credit in excess of \$25,000, is exempt from the federal Truth-in-Lending Act (“TILA”) and Regulation Z so long as the credit (i) is not secured by real property or by personal property used or expected to be used as the consumer’s principal dwelling, and (ii) is not a private education loan. See Section 104(3) of TILA (15 U.S.C. § 1603(3)) and Section 226.3(b) of Regulation Z (12 C.F.R. § 226.3(b)).
- On July 21, 2010, Dodd-Frank was enacted. Section 1100E of Dodd-Frank increases the amount of the threshold amount exemption from TILA to \$50,000 and requires annual adjustments in the threshold to reflect the effect of inflation. A brief discussion of Section 1100E is found in our Dodd-Frank Consumer Financial Protection User Guide. See <http://www.mofo.com/files/Uploads/Images/101111-Dodd-Frank-Consumer-Financial-Protection.pdf>.
- The Board’s proposal incorporates the requirements of Section 1100E into Regulation Z. However, the Board does not simply propose to substitute “\$50,000” for “\$25,000” in the existing regulation. Rather, the Board is using this as an opportunity to provide more detail regarding how the threshold amount exemption works. Most of the additional detail is set forth in the Federal Reserve Official Staff Commentary to Regulation Z (“Commentary”). The Board’s proposal is found at 75 Fed. Reg. 78636 (December 16, 2010).
- The comment period for the Board’s proposal ends on February 1, 2011. Comments on the Board’s Paperwork Reduction Act analysis must be received no later than February 14, 2011.
- Section 1100E of Dodd-Frank is effective on the Designated Transfer Date of July 21, 2011. The Board has stated that it intends to make its final regulation amending the threshold amount exemption effective on that same date.

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## HIGHLIGHTS OF THE PROPOSAL AND ANALYSIS

### 1. Change in the Threshold Amount Exemption

- The Board proposes to amend Section 226.3(b) of Regulation Z to increase the threshold amount for exempt transactions from \$25,000 to \$50,000. Once this amendment is effective, a consumer credit transaction in excess of the new threshold will be exempt from Regulation Z, except as noted below.
- At present, the following types of credit transactions will not be eligible for the threshold amount exemption. These transactions will be subject to Regulation Z regardless of their dollar amount, unless they are covered by some other exemption.
  - Credit transactions that are secured by any real property.
  - Credit transactions that are secured by personal property used or expected to be used as the principal dwelling of the consumer.
    - ❖ A loan secured by a mobile home that is personal property under applicable law and that is used or expected to be used as the principal dwelling of the consumer is not eligible for the Section 226.3(b) exemption.
  - A private education loan.
    - ❖ For this purpose, a “private education loan” is defined in Section 226.46(b)(5) of Regulation Z.
- The dollar amount of the exemption no longer will be stated in the regulation itself. Instead, that amount will be stated in the Commentary, which will be amended annually to identify the current amount of the exemption. The regulation will simply refer to the applicable “threshold amount.”
- Currently, many consumer credit transactions – including many auto loans and lines of credit – are in excess of the \$25,000 threshold and therefore are not subject to Regulation Z. As a result of Dodd-Frank and the Board’s implementing regulations, a large number of these previously exempt transactions will become subject to Regulation Z.
  - For some loan products, this will have little effect. Creditors typically offer auto and certain other loan products in amounts that are both below and in excess of the current \$25,000 threshold. These creditors are already subject to Regulation Z when they provide loans below this threshold and they typically use the same loan documents – including Regulation Z disclosures – regardless of the dollar amount of the loan. These creditors are already complying with Regulation Z for loans of any dollar amount, which means that the revised threshold amount will not impact their operations.
  - Other creditors offer loan products that always exceed the current \$25,000 threshold and, accordingly, are not currently complying with Regulation Z. For example, some banks offer lines of credit secured by securities accounts, where every line is in excess of the \$25,000 threshold. These creditors will need to decide whether to increase the minimum loan amounts of their products to exceed the new \$50,000 threshold (which will increase with inflation over the years) or, instead, to provide Regulation Z disclosures for their loans that fall below the new threshold amount. Further, these creditors will need to

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comply with the new transition provisions discussed below for loans that are exempt under the current \$25,000 threshold.

- An individual state is permitted to apply to the Board to exempt a class of transactions within the state from the requirements of Chapter 2 (credit transactions) or Chapter 4 (credit billing) of TILA and the corresponding provisions of Regulation Z. See Section 226.29 of Regulation Z. A state that does so is permitted to set a higher dollar threshold than the amount that is provided by TILA and Regulation Z.
- Nothing in the proposed revisions to Regulation Z or the Commentary prohibits a creditor from qualifying for the threshold amount exemption on a loan-by-loan basis. That is, a creditor can continue to offer credit programs where some loans qualify for the exemption and other loans do not.

## 2. Adjustment of the Threshold Amount Exemption for Inflation

- The threshold amount will be adjusted on January 1 of each year by any annual increase in the Consumer Price Index for Urban Wage Earners and Clerical Workers as published by the Bureau of Labor Statistics (“CPI-W”) that was in effect on the preceding June 1.
  - The threshold amount can only increase. It can never decrease. If the CPI-W decreases, the threshold amount will not be reduced.
  - Section 1100E of Dodd-Frank did not specify which CPI-W report should be used to determine the annual adjustment. The Board’s selection of the CPI-W reported for June 1 is consistent with the approach used to determine the adjustment in the points and fees test used for loans that are subject to the Home Ownership and Equity Protection Act of 1994 (“HOEPA”). See Section 226.32(a)(1)(ii) of Regulation Z. The Board noted that this approach will provide creditors with sufficient notice before the new dollar threshold becomes effective on the following January 1.
- Any increase will be rounded to the nearest \$100. The proposed revision to the Commentary provides the following example:
  - If the annual increase in the CPI-W would otherwise mandate an increase of \$950, the threshold amount will be increased by \$1,000.
  - If the annual increase in the CPI-W would otherwise mandate an increase of \$949, the threshold amount will be increased by \$900.
- As a result of the current and proposed rules, the threshold amount will be set as follows:
  - The threshold amount is currently \$25,000.
  - The threshold amount will remain at \$25,000 through and including July 20, 2011.
  - The threshold amount will be \$50,000 from July 21, 2011 through and including December 31, 2011.
  - Effective January 1, 2012, the threshold amount will be increased, if necessary, to reflect the annual increase in the CPI-W as of June 1, 2011.

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- Thereafter, on each January 1, the threshold amount will be increased, if necessary, to reflect the annual increase in the CPI-W that was in effect on the preceding June 1.
- Observation: Even with modest inflation, the threshold amount will increase substantially over the years. This same index is used to determine increases in the points and fees test used for HOEPA loans. The points and fees threshold was originally set at \$400 in 1995 but will increase to \$592 – an increase of nearly 50% – by 2011.

### 3. How the Threshold Amount Exemption Will be Applied to Open-End Credit

- There are two different ways that an open-end credit can qualify for the threshold amount exemption:
  - First, where the creditor makes an initial advance of credit at account opening that exceeds the threshold amount then in effect.
    - ❖ This differs from the current provision, which simply requires that the initial advance of credit exceed the threshold amount, regardless of when that initial advance of credit occurs.
    - ❖ For example, if an open-end account is established on March 1, and an initial advance in excess of the threshold amount is not made until two years later, the current account will be exempt from Regulation Z. In contrast, under the proposed rule, this account would not be exempt from Regulation Z because the initial advance was not made at the time the account was opened. The proposed rule would exempt the account from Regulation Z only if the initial advance is made on March 1.
    - ❖ The Board stated that the rationale for the proposed approach is to eliminate the uncertainty that may currently exist at account opening as to whether the account is subject to Regulation Z. In practice, there is no such uncertainty because creditors that rely on this exemption provide in their loan agreements that the initial advance, whenever taken, must exceed the threshold amount.
    - ❖ Creditors often provide credit lines to borrowers who do not intend to draw on them immediately. At present, creditors are exempt from the burdens of Regulation Z so long as they make sure that the initial advance, whenever taken, exceeds the threshold amount. Under the proposed regulation, creditors that offer credit lines to borrowers who do not intend to draw on them immediately will be obligated to comply with Regulation Z, unless another exemption is available. This will eliminate the flexibility currently enjoyed by creditors and borrowers alike. The Board has asked for comments on this approach.
  - Second, where the creditor makes a firm written commitment at account opening to extend a total amount of credit that exceeds the threshold amount then in effect. To come within this exemption, the creditor may not require any additional credit information for any advances on the account other than that which is permitted for open-end accounts generally under Section 226.2(a)(20) of Regulation Z.
    - ❖ This differs from the current provision, which does not state that the firm written commitment must exist at account opening, although this might be implicit.

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- ❖ Under Section 226.2(a)(20) of Regulation Z, creditors may occasionally or routinely verify credit information such as the borrower's continued income and employment status. However, this may not be done as a condition of granting a borrower's request for a *particular* advance of credit from the account.
- ❖ The "firm written commitment" exemption has always been dicey because of a lack of guidance regarding how it applies. Other than the continued reference to Section 226.2(a)(20), the proposal does not shed any further light on the use of this exemption. For example, it remains unclear exactly how "firm" the "firm written commitment" must be. Is it permissible to cut off advances if the borrower is in default, without thereby losing the ability to use the "firm written commitment" exemption? This certainly appears reasonable, given that safe and sound banking practices could preclude a bank from continuing to provide advances at that point. But, what if the borrower is not in default and has simply failed to adhere to customary financial covenants? The fact that Section 226.2(a)(20) allows the creditor to verify credit information suggests that the creditor can use such information for reasonable purposes, including withholding advances from a borrower who fails to adhere to customary financial covenants. However, these issues are not addressed in the proposed revisions to Regulation Z or the Commentary.

## 4. How the Threshold Amount Exemption for Open-End Credit is Affected by Subsequent Events

- If an open-end account initially qualifies for the threshold amount exemption, the exemption can be lost as described below. If the exemption is lost, the creditor must comply with Regulation Z within a reasonable period of time.
  - Compliance with Regulation Z includes providing all required disclosures, such as initial account disclosures under Section 226.6 and periodic statements under Section 226.7. All other requirements of Regulation Z will also become applicable, such as Section 226.11, relating to the treatment of credit balances, and Section 226.13, governing billing error resolution.
  - As an alternative to compliance with Regulation Z, the creditor has the option of freezing further credit advances and allowing the borrower to repay the outstanding account balance on the existing account terms. However, this alternative is permitted only if it is consistent with applicable state or other law and the account contract. On a going forward basis, creditors may wish to add appropriate language to their open-end credit contracts to allow the use of this alternative, provided it is permissible under applicable law.
- If an open-end account has an initial advance at the time of account opening that exceeds the threshold amount, then the account is and remains exempt even if one or more of the following occur:
  - There are no further advances of credit.
  - The subsequent advances of credit are below the threshold amount.
  - The threshold amount increases.
  - The account balance subsequently falls below the threshold amount, such as through loan repayments.

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- The credit limit for the account is subsequently reduced below the threshold amount.

Any of these subsequent changes must be bona fide. For example, if the creditor makes an initial advance of credit at the time of account opening in excess of the threshold amount, and arranges for the borrower to pay down the account balance below the threshold amount immediately or shortly thereafter, this will likely be regarded as a sham. As a result, the exemption will not apply and the account will be subject to Regulation Z from its inception.

If an open-end account has an initial advance at the time of account opening that is equal to or less than the threshold amount, and no other exemption applies, the account will be subject to Regulation Z from its inception. Even if the account balance subsequently exceeds the threshold amount, the account will remain subject to Regulation Z.

- If the creditor makes a firm written commitment at account opening to extend a total amount of credit that exceeds the dollar threshold then in effect, then the account is and remains exempt (except as noted below) even if the amount of credit advanced never actually exceeds the threshold amount.

In contrast, if the firm written commitment at account opening does not exceed the threshold amount then in effect, the account will be subject to Regulation Z from its inception. Even if the account balance subsequently exceeds the threshold amount, the account will remain subject to Regulation Z.

- If the creditor makes a firm written commitment at account opening to extend a total amount of credit that exceeds the threshold amount then in effect, but the amount of the firm commitment is subsequently reduced below the threshold amount, the exemption will be lost and it will be necessary for the creditor to comply with Regulation Z within a reasonable period of time.
  - For example, assume that the threshold amount is \$50,000 and that there is a firm written commitment at account opening to provide a line of credit of \$55,000. If the creditor subsequently reduces the firm commitment to \$40,000, the exemption will be lost.
- If the creditor makes a firm written commitment at account opening to extend a total amount of credit that exceeds the threshold amount then in effect, but the threshold amount is subsequently increased as a result of the annual inflation adjustment, the amount of the firm commitment must be increased as well to continue to exceed the new threshold amount in order to retain the exemption. If the amount of the firm commitment is not so increased, the exemption will be lost and it will be necessary for the creditor to comply with Regulation Z within a reasonable period of time.
  - For example, assume that the threshold amount is \$50,000 and that there is a firm written commitment at account opening to provide a line of credit of \$55,000. If the threshold amount subsequently increases to \$51,000, the account will remain exempt. If the threshold amount thereafter increases to \$56,000, the account will lose its exemption unless the creditor increases the firm commitment to an amount in excess of \$56,000 on or prior to the date that the \$56,000 threshold amount becomes effective.
- Overall, when there is a subsequent event, the treatment of the exemption for a firm written commitment in excess of the threshold amount is not as favorable as the treatment of the exemption for an initial advance that exceeds the threshold amount.

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- In some instances, an open-end account will have a firm written commitment at account opening to extend a total amount of credit that exceeds the threshold amount then in effect *and* there will be an initial advance that exceeds the threshold amount in effect at the time it is made. That initial advance may or may not occur at account opening. Let's assume that the initial advance does not occur until some time after the account opening. In this situation, the account will initially qualify for the exemption based on the firm written commitment, and that firm written commitment must continue to exceed the threshold amount from time to time in effect in order to retain the exemption. However, once an initial advance is made that exceeds the threshold amount in effect at the time it is made, the account will remain exempt even if the threshold amount subsequently exceeds the amount of that advance or the firm commitment is subsequently reduced below the then-applicable threshold amount. The proposed Commentary provides several examples of the application of the exemption in this situation.
  - As a practical matter, many creditors would find it operationally challenging to implement this set of exemption rules. In effect, it would require the creditor to initially apply the firm written commitment rule, monitor the amount of the first advance and compare it to the threshold amount then in effect, and on that basis determine whether it is then appropriate to apply a modified flavor of the initial advance rule. This is conceptually possible but not terribly practicable.
- In practice, most open-end accounts that qualify for the new threshold amount exemption will likely to do so on the basis of the firm written commitment provision. Many creditors may be reluctant to require their borrowers to take initial advances in excess of \$50,000 (or more) at the time of account opening. Creditors that rely on the firm written commitment provision will need to monitor changes in the threshold amount standard and decide whether they are willing to increase the amount of their firm commitments where necessary to maintain the use of the exemption. If they are not, or if the amount of the firm commitment falls below the threshold amount for any other reason, they will need to comply with Regulation Z within a reasonable time.

## 5. How the Threshold Amount Exemption Will be Applied to Closed-End Credit

- There are two different ways that a closed-end credit can qualify for the threshold amount exemption:
  - First, where the creditor makes an extension of credit at consummation that exceeds the threshold amount in effect at the time of consummation.
    - ❖ Once this extension of credit is made, the loan is and remains exempt from Regulation Z, except as noted below. The exemption remains in place even if the balance of the loan is subsequently reduced below the threshold amount.
    - ❖ In applying this exemption, the credit must be extended, and the threshold amount is determined, on the date of consummation. Under Section 226.2(a)(13) of Regulation Z and Paragraph 226.2(a)(13)-1 of the Commentary, "consummation" occurs when the consumer becomes contractually obligated on the loan or contractually bound to the terms of the loan. Under the literal wording of the proposed Commentary provision, the exemption will not apply if the credit is extended after the date of consummation.
  - Second, where the creditor makes a commitment at consummation to extend a total amount of credit in excess of the threshold amount in effect at the time of consummation.

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- ❖ Once this commitment is made, the loan is and remains exempt from Regulation Z, except as noted below. The exemption remains in place even if the total amount of credit actually extended never exceeds the threshold amount.
- ❖ See discussion above regarding “consummation.”
- ❖ Most closed-end loans that involve commitments to make loan advances are construction loans. Any construction loans that are secured by real property cannot qualify for this exemption in any event.

## 6. How the Threshold Amount Exemption for Closed-End Credit is Affected by Subsequent Events

- If either of the exemptions for closed-end credit discussed above are applicable to a loan, then the loan remains exempt even if the threshold amount subsequently increases as a result of the inflation adjustment.
- If either of the exemptions for closed-end credit discussed above are applicable to a loan, then the loan remains exempt even if the loan balance is paid down over time to an amount that is less than the threshold amount.
- The proposed Commentary is silent regarding a situation in which the creditor makes a commitment at consummation to extend a total amount of credit in excess of the threshold amount at the time of consummation, but subsequently reduces the commitment to an amount that is less than the threshold amount. By analogy to the open-end credit context, it appears likely that the exemption would be lost in this situation.
- If a closed-end loan refinances a prior loan that was exempt from Regulation Z, the new loan's status under Regulation Z will depend on whether it can qualify for an exemption on its own merits. That is, the fact that the original loan was exempt is irrelevant to the question of whether the new loan is exempt.
  - For example, if the original closed-end loan was exempt because it was in excess of the threshold amount, and a subsequent closed-end loan that refinances the outstanding balance is equal to or less than the threshold amount then in effect, the new loan will not be exempt from Regulation Z.

## 7. Addition of a Security Interest in Real Property or a Principal Dwelling After Account Opening or Consummation

- In some instances, a security interest in real property or personal property used or expected to be used as the consumer's principal dwelling may be added after an exempt open-end account is established or after an exempt closed-end loan is consummated. In these situations, the treatment of the credit under Regulation Z will differ considerably, depending on whether the loan is an open-end credit or a closed-end credit.
- In the case of an open-end account, the addition of the security interest will require the creditor to comply with Regulation Z within a reasonable period of time. For example, this includes the providing of disclosures under Section 226.6 and periodic statements under Section 226.7. If the property is the principal dwelling of a consumer, the creditor must provide an appropriate set of notice of right to cancel forms to all consumers who are entitled to rescind.
- In the case of a closed-end loan, the addition of the security interest will not require the creditor to provide a

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Regulation Z disclosure statement under Section 226.18.

- However, if the security interest is in a consumer's principal dwelling, the creditor must provide an appropriate set of notice of right to cancel forms to all consumers who are entitled to rescind. Under existing footnote 47 to Regulation Z, the delivery of the rescission notice will start the rescission period. Consistent with the current rule, in these situations the consumer will have the right to rescind, but will not be receiving the loan disclosures that might, at least in concept, provide him/her with the information he/she needs to make an informed decision on the right to rescind. In these situations, it will be necessary to modify the Board's standard rescission form to delete references to the Truth-in-Lending disclosures. The right of rescission applies only to the added security interest, not the original obligation. Once again, it will be necessary to modify the Board's standard rescission form accordingly. In this regard, see, by analogy, Appendix G-8 of Regulation Z, which contains a rescission form that is used when adding a security interest to an existing open-end account.
- If an existing closed-end loan is exempt from Regulation Z, and this loan is refinanced by a new loan that is secured by real property or by personal property used or expected to be used as the consumer's principal dwelling, the new loan – regardless of the dollar amount – will not be exempt from Regulation Z. New closed-end Regulation Z disclosures will be required. In addition, if the new loan is secured by a consumer's principal dwelling, the creditor must provide an appropriate set of notice of right to cancel forms to all consumers who are entitled to rescind.

## 8. Special Exemption for Open-End Accounts that were Exempt Prior to July 21, 2011

- In general, if an open-end account is opened on or before July 20, 2011 and the account is exempt from Regulation Z under the current \$25,000 threshold exemption, the account will remain exempt from Regulation Z until July 21, 2012. Beginning on July 21, 2012, the creditor must comply with Regulation Z with respect to the account.
  - However, if a security interest is taken in real property or personal property used or expected to be used as the consumer's principal dwelling, this special transition exemption is lost. Presumably, at that point it will be necessary to comply with Regulation Z within a reasonable period of time in accordance with the rule described above. If the property is the principal dwelling of a consumer, the creditor must provide an appropriate set of notice of right to cancel forms to all consumers who are entitled to rescind.
  - If there is an express written commitment to extend credit in excess of \$25,000, and this commitment is reduced to \$25,000 or less, the special transition exemption is also lost. Once again, it presumably will be necessary to comply with Regulation Z within a reasonable period of time in accordance with the rule described above.
- This special transition exemption was written to address a particular concern for creditors that provide open-end lines of credit that are secured by securities accounts, although the exemption is not by its terms limited to that context. These creditors are not broker-dealers that are separately exempt from Regulation Z under Section 226.3(d). These creditors typically provide credit lines using platforms that have no capability for complying with Regulation Z. Historically, these creditors avoided compliance with Regulation Z by adhering to the current

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exemption for credit over \$25,000. With the increase in the threshold amount to \$50,000 – and more, in future years – some of these accounts will no longer be exempt. The transition rule is designed to provide these creditors with additional time to build the infrastructure necessary to comply with Regulation Z or to provide firm written commitments in excess of the threshold amount.

- Notwithstanding the general rule described above, there are several specific situations that provide significant – but narrow – exceptions, as follows. All of these exceptions assume that no security interest is taken in real property or personal property used or expected to be used as the consumer's principal dwelling.
  - If, on or before July 20, 2011, the creditor makes an initial advance of more than \$25,000 on the account, the account remains exempt from Regulation Z. The account will remain exempt even if the threshold amount is subsequently increased as a result of inflation adjustment.
  - If the account terms require that the initial advance is more than \$25,000, and that advance is made on or before July 20, 2012, the account remains exempt from Regulation Z. The account will remain exempt even if the threshold amount is subsequently increased as a result of the inflation adjustment.
    - ❖ If, in this situation, the initial advance of more than \$25,000 is not made on or before July 20, 2012, the exemption is lost. However, if, on or before July 20, 2012, the creditor makes a firm commitment to extend credit in excess of the threshold amount in effect at that time, the account remains exempt from Regulation Z. As worded, it appears that the firm commitment must increase along with subsequent increases in the threshold amount, although there is ambiguity on this point.
  - If, on or before July 20, 2011, the creditor makes a firm commitment in excess of \$25,000, and the creditor makes an initial advance of more than \$25,000 on or before July 20, 2012, the account remains exempt from Regulation Z. The account will remain exempt even if the threshold amount is subsequently increased as a result of inflation adjustment.
    - ❖ If, in this situation, an initial advance of more than \$25,000 is not made on or before July 20, 2012, the exemption is lost on July 21, 2012. However, if, on or before July 20, 2012, the firm commitment is increased to an amount in excess of the threshold amount in effect at that time, the account remains exempt from Regulation Z. As worded, it appears that the firm commitment must increase along with subsequent increases in the threshold amount, although there is ambiguity on this point.
  - As written, there is a great deal of complexity and uncertainty in these exceptions. Hopefully, this will be cleared up in the final rule.

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