

Employment Matters

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Saatchi v. Burns: How to Prevent, and Respond to, A Mass Departure of Key Executives

In a recent case that has attracted widespread comment, the New York Supreme Court issued a ruling threatening a high level executive with a potentially massive damage award for organizing a mass departure of his subordinates and attempting to steal one of his employer’s largest clients. While the decision gives employers a potent deterrent against disloyal executives in some circumstances, the Court’s refusal to grant injunctive relief to enforce non-solicit and non-compete covenants highlights the importance of both careful drafting and effective advocacy.

The Allegations Against Burns

Saatchi & Saatchi sued Michael Burns, a 25 year employee who had served his last 9 years as Vice Chairman of Saatchi’s New York office and head of the team for the General Mills account, which generated \$500 million in annual billings. Passed over for promotion to CEO of Saatchi’s New York office, Burns announced his resignation effective February 11, 2005, a date he later extended to March 15, 2005. However, on February 14, 2005 – three days after the date of Burns’ originally planned departure – 17 of Saatchi’s senior employees, all of whom worked with Burns on the General Mills account, left en masse to join Foote Cone & Belding, a subsidiary of Saatchi rival, Interpublic Group. Saatchi fired Burns on March 11, 2005, claiming that he had breached

his fiduciary and contractual obligations to the firm by soliciting the departure of the 17 high level employees, and by trying to lure away the General Mills account. Saatchi then sued Burns, seeking damages and an injunction to stop Burns from taking the General Mills account to Foote Cone & Belding.

Breach of Fiduciary Duty

The Court ruled the Complaint against Burns stated claims for breach of fiduciary duty, breach of the duty of loyalty and breach of contract, but dismissed its claim for an injunction. The duty of loyalty prohibits an employee from taking actions against the interests of the employer during the course of employment. As a high level executive of the agency, Burns was under a duty not to act in any manner inconsistent with his employment, and he was obligated to exercise the utmost good faith and loyalty in the performance of his duties. If Saatchi can prove that Burns organized employees to leave Saatchi to join a competing agency, and that he attempted to coax one of Saatchi’s biggest accounts to switch shops, all while he was on Saatchi’s payroll, Burns will have breached his fiduciary duties to Saatchi, as well as his contractual obligation to devote his full and exclusive business time and efforts to Saatchi’s business.¹

Burns could face a substantial damage judgment if Saatchi is able to prove its case at trial, including:

- forfeiture of all compensation he received during his period of disloyalty;
- repayment of the cost of hiring replacement employees on short notice;
- repayment of costs caused by Saatchi's diversion of key personnel to fill gaps left by the abrupt departure of 17 key employees;
- payment for lost management time spent undoing the damage done by Burns.

All in all, the potential liability that Burns faces should serve as a significant deterrent to any executive thinking about organizing a similar en masse defection on company time, and gives employers a potentially potent weapon in such situations.

In contrast to the Saatchi case, a three person NASD arbitration panel recently dismissed a raiding case against four traders who jointly left their employer to join a competitor, a securities dealer. The four were collectively responsible for generating 35% of one line of the claimant's business. The panel found that the most senior departing employee was not a manager, and therefore did not have a fiduciary duty to refrain from participating in the group's departure. The panel also held that the competitor was under no duty to investigate how its hiring of the four would harm the competitor, and was unmoved by the fact that the departing employees were responsible for 35% of their department's revenues. However, the panel left open the possibility that a competitor could be held liable if its actions are motivated solely by the desire to do harm. *Baird Patrick & Co. v. Maxtor Financial*.

Drafting Errors that Cost the Injunction

Money damages, though potent, may prove small consolation to Saatchi and other similarly situated employers, because the Court refused to give Saatchi what it really wanted – an injunction prohibiting Burns from soliciting Saatchi's clients, particularly General Mills, in violation of his non-solicit and non-compete covenants.

Saatchi's claim for injunctive relief was rejected on several grounds. First, the Court found that Burns did not violate the non-solicitation clause in his contract, which only prohibited him from soliciting the firm's clients for one year *after* the termination of his employment. Because the only evidence before the Court was that Burns had attempted to win over General Mills *before* he left Saatchi, the Court found no breach of this contractual provision as drafted.

Overbroad Restrictions

The Court also found the non-compete and non-solicitation covenants in Burns' contract to be unenforceable because they specified no geographical limitation, effectively preventing Burns from earning a livelihood in his profession. Noting that post-employment restrictive covenants are disfavored by the law, the Court took a narrow view, holding that they will be enforced "only if reasonably limited temporally and geographically . . . , and then only to the extent necessary to protect the employer from unfair competition

which stems from the employee's use or disclosure of trade secrets or confidential customer lists."

Not only were the covenants overbroad, but Saatchi presented no evidence that Burns had competed unfairly by misappropriating confidential business information. Instead, Saatchi tried to argue that the restrictive covenants were valid because Burns' services were "unique or extraordinary." A line of New York cases dating back to 1963² permits enforcement of post-employment restrictions, even without evidence that the employee took confidential information or trade secrets, if the employee's services are so special, unique or extraordinary that replacement would be impossible or would cause the employer irreparable injury. The Courts have tended to restrict these cases to artists, performers and employees involved in learned professions. The Saatchi court rejected this argument summarily.³

The Wrong Litigation Strategy?

In arguing that Burns' services were "unique or extraordinary," Saatchi's counsel may have overlooked its strongest argument: that enforcement of Burns' restrictive covenants was necessary to protect Saatchi's good will and customer relations, under the landmark 1999 New York Court of Appeals decision in *BDO Seidman v. Hirschberg*.⁴ In that case, the Court ruled that an employer has a legitimate interest in preventing former employees from exploiting the goodwill of a client or customer

to the employer's competitive detriment, if the goodwill had been created and maintained at the employer's expense. There, the Court held that an accounting firm could justifiably restrict its former employee from soliciting the firm's clients to whom he had been introduced during his employment, but that it could not prohibit the employee from dealing with clients that he had brought with him to the firm.

Saatchi's more than 80 year relationship with General Mills was initially developed by Saatchi, and was maintained at Saatchi's expense, with Burns' assistance. Because Burns was the person primarily responsible for maintaining Saatchi's relationship with General Mills, Saatchi's goodwill was arguably embodied in Burns more than in anyone else at the agency. Had Saatchi made the argument that an injunction was required to preserve the goodwill and customer relationship that it had created, and which it entrusted to Burns, the Court might have granted Saatchi an injunction prohibiting Burns from soliciting its major client, General Mills.⁵

In March, another New York County Supreme Court Justice enforced non-compete and non-solicitation covenants against an account manager who left his employer – a developer of software for trading applications used by financial institutions – to join a competitor.⁶ The account manager had been responsible for client development for the employer. The court found that the employer had a

legitimate interest in protecting itself against the competitive use of any customer relationships and goodwill that were developed during the account manager's employment. As a result, the Court enjoined the account manager from dealing with customers whom he first contacted while employed by the software developer, but refused to prevent him from continuing to make use of relationships that he had developed on his own, either prior to or after his employment with the software developer.

Lessons Learned

Litigation involving post-employment restrictive covenants are often won or lost long before the employee decides to leave. In many cases, they are decided at the time the employee is hired, when his or her employment agreement is being drafted. Boilerplate, overly broad post-employment restrictions are risky, but such restrictions can be made enforceable -- even in New York -- by careful drafting based on a realistic evaluation of the employer's legitimate interests justifying the restrictions. Such restrictions should be tailored to protect justified business interests, without making them overbroad, and potentially unenforceable. Employers must understand that shrewd counsel for an employee, knowing their unenforceability, may not resist overly broad restrictive covenants demanded by the potential employer.

The employer's counsel needs to ask the right questions and

draft accordingly.

- Will the employee have access to highly confidential materials, such as non-public financial data, business plans, or marketing programs?
- Is the employee going to be working closely with existing clients, so that he will become the face of the company in the eyes of the client?
- Is the employee being hired to bring his existing know-how or relationships to the firm?
- Are the employee's talents so special and unique that he would be virtually impossible to replace?
- Where is the employee going to be working? If he is going to be working with clients, where are they located, and where do they do business?
- If litigation becomes necessary, will the courts of a particular state follow the parties' choice of law, particularly where that choice may conflict with important public policy?
- In states that are employee friendly, like New York, are there ways to increase the chances of enforcement, such as by paying the employee during any period in which he will be restricted from working?

By carefully analyzing these issues at the drafting stage, litigation may be avoided entirely, and the likelihood of success in litigation is greatly increased. Each situation requires a unique approach.

Beyond drafting, once the employer detects the disloyal employee, he must engage counsel capable of quickly litigating an injunction action on the right theories. An employer may still prevail despite a poorly-drafted contract. However, a missed litigation opportunity can doom the effort to enforce even a properly drafted restrictive covenant, leaving the employer with only a protracted and expensive litigation over damages.

The Saatchi case is a cautionary tale of the importance of both proper drafting and effective litigation strategy to achieving the right outcome for the injured employer.

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1 *Purchasing Associates, Inc. v. Weitz*, 13 N.Y.2d 267, 196 N.E.2d 245, 246 N.Y.S.2d 600 (1963).

2 Judge Cahn, who denied Saatchi's motion for an injunction, previously had issued a decision enjoining a securities broker from soliciting his employers' clients because he was considered unique and special, due to the close relationships that he had developed with his employer's clients. *Maltby v. Harlow Meyer Savage, Inc.*, 166 Misc.2d 481, 633 N.Y.S.2d 926 (Sup. Ct. 1995). In that case however, the contract required the employer to continue paying the broker during the period of restriction, a critical provision

common in investment banking and brokerage employment agreements but not found in Burns' contract, and which courts view as making injunctive relief more palatable.

3 93 N.Y.2d 382, 690 N.Y.S.2d 854 (1993).

4 Even if the geographic scope of the restriction was found to be too broad (though a world-wide restriction in the case of General Mills would arguably be justified), a New York court can modify a restriction to make it enforceable, and might have limited enforcement in this case to a restriction involving only General Mills.

5 *Portware, LLC v. Barot*, 2006 WL 516816 (Sup. Ct. N.Y. Co. Mar. 6, 2006).

Employers Must Dot Their "i"s And Cross Their "t"s When Performing Background Checks

Employers frequently perform background checks on applicants and employees either as a condition of getting and/or keeping a job. Whether the employer is interested in checking an employee's prior employment history or wants to know if the employee has been convicted of a crime, when an employer hires a credit reporting agency to perform a background check, employers must be mindful of and compliant with the U.S. federal Fair Credit Reporting Act ("FCRA") and applicable New York law. The FCRA and the NYFCRA exist to protect the applicant/employee from an improper adverse employment action, such as not being hired as a result of erroneous information contained in a consumer report. Failure of an employer

to dot its "i"s and cross its "t"s when obtaining and using such a report, could result in employer liability.

There are two types of reports that employers typically obtain from credit reporting agencies: a consumer report and an investigative consumer report (see sidebar for definitions). Whether you request a consumer report or an investigative consumer report, the U.S. federal and/or the New York Fair Credit Reporting Acts require employers to:

- make certain disclosures to applicants/employees;
- receive consent from applicants/employees; and

- make certain certifications to the credit reporting agency prior to conducting the background search.

In addition, employers must comply with additional statutory consent requirements when obtaining an investigative consumer report (as opposed to a consumer report), given that the report, by its nature, requires more investigation into an applicant's/employee's background. If an adverse action is taken based in whole or in part on a consumer report (i.e. employment is not offered), the federal law requires that employers provide notice to the employee,

including:

- Enclosing a copy of the report;
- Giving certain information regarding the credit reporting agency; and
- Enclosing a Summary of the Consumer's Rights Under the Fair Credit Reporting Act.

Failure to follow the statutory requirements is just too costly for employers. Even a negligent violation can result in actual damages, costs of the action and reasonable attorney's fees. At a minimum, employers could expend significant fees defending an action.

Imagine that you hire an applicant and properly advise the employee that you will be performing a background check, including obtaining a consumer report and or investigative report. The employee signs a form acknowledging the disclosure and gives her consent. Shortly thereafter, the employer learns that the employee misrepresented her employment history during the interview process and terminates the employee. The employer never sends the employee a copy of the credit report or a description in writing of her consumer rights as required by law. Employee sues for violations of the FCRA. The employer claims, among other things, that

the decision to terminate the employee was not based on the credit report and, therefore, the employer did not have to comply with the statutory requirements. A New York federal court disagrees. The court refuses to dismiss the FCRA claim, finding that the termination may have been based on the credit report, and if so, the employer very well may have violated the statutory requirements of the FCRA.

This scenario is not fiction, but, in fact, what a New York federal court found as recently as March 2005 (*Woodell v. United Way of Dutchess County*, 357 F. Supp. 2d 761 (S.D.N.Y. 2005)). If the employer had simply provided the report to the employee and complied with the other statutory conditions when deciding to terminate the employee, dismissal (or avoidance) of the FCRA claim altogether would have been a more likely result.

The lesson for employers is simple: employers must rigorously comply with the U.S. federal and New York FCRA requirements. If anything, employers should err on the side of caution when: performing background checks, informing applicants and employees about obtaining credit reports, receiving consent, and providing the report should adverse action be taken.

Background checks are an important and helpful tool at an employer's disposal as long as they are conducted properly.

Definition of Report Under The New York FCRA

A "Consumer Report" is "any written, oral or other communication of any information by a consumer reporting agency bearing on a consumer's credit worthiness, credit standing, credit capacity, character, general reputation, personal characteristics, or mode of living which is used or expected to be used or collected in whole or part for...employment purposes."

An "Investigative Consumer Report", is one in which "information on a consumer's character, general reputation, personal characteristics, or mode of living is obtained through personal interviews with neighbors, friends, or associates of [the applicant/employee] or with others with whom he is acquainted or who may have knowledge concerning any such items of information."

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Misclassifying An Employee Under the FLSA Can Be Costly For Employers

In fiscal year 2005, the Department of Labor Wage and Hour Division recovered more than \$119.4 million in back wages for 188,959 employees as a result of Fair Labor Standards Act ("FLSA") violations. In addition to having to pay back wages, employers were assessed \$4.3 million in FLSA civil money penalties, an increase of 22 percent from fiscal year 2004, according to the Department of Labor.

Classifying employees in accordance with the FLSA and applicable New York law can be a daunting task for employers. Failure to do so properly can result in the employer being investigated and/or sued for violations under the federal and state statutes.

The FLSA among other things, imposes duties and obligations upon employers when classifying employees as exempt or non-exempt. Non-exempt employees must be paid time-and-a half for overtime for hours worked beyond the standard 40 hour workweek.

The FLSA applies to all private employers, among others, who have workers engaged in interstate commerce and whose annual gross volume of sales made or business done is at least \$500,000 (not including excise taxes that are separately stated).

Often employers believe that they have properly classified employees under the FLSA, but the analysis can be complex (see

side bar). Failure to properly classify an employee, even if unintentional, can result in having to pay back-wages, liquidated damages and, if litigated, attorney's fees and court costs. Under New York law, employees may seek liquidated damages of an additional 25% of the amount due for willful violations.

Certain employees are exempt from the overtime and minimum wage provisions of the FLSA, but these exemptions are narrowly defined. The main exemptions include the following categories of employees:

- White Collar or Executive
- Administrative
- Professional
- Highly Compensated
- Computer
- Outside Sales

Simply classifying an employee in one of these exempt categories does not shield an employer from liability (i.e. calling a person a manager, when in fact their duties are ministerial). Employers should be aware that their actions will be examined under a microscope should they be charged with misconduct and take all precautions to make sure they are properly performing under the Act.

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Summary of Federal Exemption Requirements

Executive

- Receive a minimum, regular, predetermined salary of not less than \$455 per week;
- Direct the work of two or more other employees;
- Manage a department etc. as a primary duty; and
- Either have the authority to hire/fire or carry weight to recommend hiring/firing/advancement etc.

Administrative

- Receive a minimum, regular, predetermined salary of not less than \$455 per week;
- Exercise discretion and independent judgment with respect to matters of significance; and
- Perform office/nonmanual work directly related to the management or general business operations of the employer or the employer's customers as a primary duty.
- Examples may include tax, finance, accounting, budgeting, auditing, insurance, marketing, human resources, advertising, research, personnel management etc.

Professional

There are two types of professionally exempt employees: learned and creative.

Learned

- Generally requires an advanced degree or some type of credential; and
- A minimum, regular, predetermined salary of not less than \$455 per week.

Creative

- Must have a primary duty of performing work requiring invention, imagination, originality or talent in a recognized field of artistic or creative endeavor (cannot be routine, manual, mechanical or physical work); and
- Earns a minimum, regular, predetermined salary of not less than \$455 per week.
- Examples would include actors, musicians, artists, screenplay writers etc.

Highly Compensated

- Must be paid a total annual compensation of \$100,000 or more, cannot be based entirely on (although may consist of) commissions and bonus payments and must include at least \$455 per week paid on a salary basis;
- The primary duty must include performing office or non-manual work;
- Must customarily and regularly perform at least one of the exempt duties or responsibilities of an exempt executive, administrative or professional employee.

Computer

- Earns at least a minimum, regular, predetermined salary of not less than \$455 per week, or, if paid on an hourly basis, a minimum of \$27.63 per hour; and
- Must be employed as a computer systems analyst, computer programmer, software engineer or other similarly skilled worker in the computer field (as defined by the statute);

Outside Sales

- Have a primary duty of making sales, obtaining orders or contracts for services etc.; and
- Must customarily and regularly work outside employer's place of business while performing such duties.

Use of Financial Software By Foreign National Employees May Trigger Export Controls

When a foreign national within the U.S. customs territory is provided access to software it is considered a “deemed export.” When a foreign national of a third country is provided access to software in the customs territory of a second country, it is considered a “deemed reexport” to the foreign national’s home country. Therefore, before giving a foreign national employee access to financial software, the following steps should be taken:

1. Make sure the employee’s visa and/or residency status is properly documented. Permanent residents and persons with a current working visa are not considered foreign nationals, and are exempted from the licensing requirements, unless identified on

one of the government’s restricted lists.

2. Check to see if the employee is listed on one of the following government watch lists:

a. Denied Persons List (www.bis.doc.gov/DPL/Default.htm);

b. Entity List (www.access.gpo.gov/bis/ear/ear_data.html);

c. Unverified List (www.bis.doc.gov/Enforcement/UnverifiedList/unverified_parties.html);

d. Specially Designated Nationals List (www.ustreas.gov/offices/enforcement/ofac/sdn/);

e. Debarred List (www.pmdtc.org/debar059intro.htm);

f. Nonproliferation Sanctions list (www.ustreas.gov/offices/enforcement

[/ofac/programs/wmd/wmd.shtml](http://ofac/programs/wmd/wmd.shtml)).

3. If the employee is a permanent resident, or has a current working visa, and is not on one of these lists, he or she may be given access to financial software without violating the export control regulations. If the person turns up on one of these lists however, additional steps may need to be taken.

Violations of these regulations can lead to civil and criminal liability and the employer being placed on a restricted list, thereby losing the ability to obtain software licenses.

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Employee and Customer Privacy Breaches

A 2005 survey of over 850 organizations indicated that nearly 60% had experienced a major security breach in the prior six months that resulted in the loss of confidential information or interruption in operations. In response to high-profile cases of identity theft and data breaches, nearly half of the states have enacted legislation that places the onus on businesses that are victims of such security breaches to notify the individuals whose personal information may have been compromised. New York, Connecticut and

Pennsylvania have enacted such legislation, and many more states have security breach legislation pending. These laws expose businesses to serious reputational risk. Prudence requires that companies plan not only to minimize the risk of a security breach of their own or a subcontractor’s computer system, but also how to react when one occurs to reduce both the negative publicity and the possibility of legal liability.

New York’s Information Security Breach and Notification Act

In December 2005, the Information Security Breach and Notification Act (the “Act”) took effect in New York State. The Act requires certain New York state government entities and persons conducting business in New York to provide notice to affected persons whenever the private information of New York

residents has been unlawfully acquired due to a security breach. The Act is a response to reported increases in security breaches and identity theft both on the state and national levels highlighted when the data broker ChoicePoint inadvertently exposed thousands of individuals' personal information to identity theft.

The Act requires any employer doing business in New York that owns or licenses computerized data containing private information, to disclose any breach in security regarding this information to any New York resident whose private information was acquired (or is reasonably believed to have been acquired), without valid authorization. This law covers disclosure of employee information, as well as information concerning consumers and customers.

If the entity whose security is breached does not own or license the computerized data, such as vendor, it must disclose any breach in the security to the owner or licensee of the information if the private information is reasonably believed to have been acquired by a person without valid authorization. In that case, the owner of the data must, in turn, notify all New York residents who are affected by such breach. Written or telephone notification is required unless the person affected has expressly consented to receiving electronic notice, or the quantity or cost of providing such written or telephone notice is excessive. The

Act also requires businesses to notify the New York State Attorney General. If more than five thousand New York residents are affected by a breach, businesses must notify consumer reporting agencies as well. A business which knowingly or recklessly violates the Act may be subject to civil penalties of up to \$150,000.

Other State Laws

At least twenty-two other states have enacted security breach notification laws in the past few years, many of which are similar to the New York Act. Pennsylvania and Connecticut have passed laws which track much of New York law on this subject. The Pennsylvania and Connecticut laws cover unauthorized access and acquisition of computerized data (New York law only contemplates acquisition). Pennsylvania's law covers only those security breaches that materially compromise the security or confidentiality of personal information that has caused or will cause loss or injury to any Pennsylvania resident, while Connecticut's law states that notification of a security breach shall not be required if, after appropriate investigation and consultation with relevant federal, state, and local law enforcement agencies, the business reasonably determines that the breach will not likely result in harm.

Although the New York, Pennsylvania and Connecticut statutes all apply to persons or entities who "conduct

business" in each respective state, these statutes do not explicitly define what it means to "conduct business." Therefore, application of these statutes does not appear to be limited to businesses physically located in the state. Indeed, employers that conduct business in multiple states may be subject to the varying laws of all of those states.

Conclusion

Employers must be vigilant about detecting and reporting breaches of information security protocols. The obligation to disclose information security breaches poses a significant monetary and reputational risk for an entity. To limit potential liability, employers should comply with the security laws of all states in which they operate. Businesses may want to set up protocols in advance for dealing with security breaches, rather than waiting for a breach to occur and reacting in "crisis mode". Moreover, if they choose to have outside vendors maintain their computerized data, they should be especially careful to select reputable vendors that have reliable data protection systems in place and make sure to obtain warranties from them. They should also consider revising, as needed, internal documents and contracts with sub-contractors and outside vendors to ensure compliance with the new state information security breach laws.

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Second Circuit Remands For Trial Hostile Environment Claim

On April 24, 2006, a New York federal appeals court held that a sexually hostile environment could be created by a male supervisor, who, among other things:

- told a female employee, who was dating a co-worker, that she was sleeping with the wrong employee;
- put his hand on her thigh at a company party and lifted her skirt as a “joke” in a company photograph;

- approached plaintiff from behind and put his hands on her neck or back; and
- leaned into her while she worked.

The Second Circuit, in *Schiano v. Quality Payroll Systems, Inc.*, Docket No. 05-4115-CV, found this conduct could be sufficiently “severe and pervasive” and stated that such decisions had to be made on a case by case basis. The Court found that the case was a pure hostile environment claim, dismissing the claims of

retaliation, quid pro quo harassment and constructive discharge.

The effect of this decision appears to make summary dismissal of hostile environment claims harder for employers to obtain.

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