

EXECUTIVE ALERT

May 19, 2009

In This Alert

PLANNING IN LIGHT OF THE OBAMA ADMINISTRATION'S LEGISLATIVE AND ENFORCEMENT INITIATIVES

Taking the new legislative, regulatory and enforcement outlook into account in decision-making ranges in difficulty from merely routine to nearly impossible.

With the President's stimulus plan enacted, and his budget, including details of his tax proposals released on May 11, 2009, "Change we can believe in" has already begun—and at a break-neck pace. This updated Alert highlights fundamental changes already signed by the President, announced by the Administration, or expected from Congress and from new regulatory and enforcement officials that should be considered when making business decisions.

The American Recovery and Reinvestment Act of 2009

On February 17, 2009, exactly four weeks after his inauguration, President Obama signed into law the economic stimulus plan, named the "American Recovery and Reinvestment Act of 2009" (the "Stimulus"). The Stimulus just squeaked by, receiving no Republican votes in the House and only three in the Senate. The Stimulus is large—\$787 billion—including approximately \$301 billion of tax cuts and the rest in increased spending. Approximately \$116 billion—the same amount of stimulus payments made in 2008—of the tax cuts are in the form of so-called "Making Work Pay" individual payroll tax credits for 2009 and 2010. These credits are in the amount of 6.2 percent of earned income, not to exceed annual amounts of \$800 per family or \$400 per individual, and phase out at annual adjusted gross income levels of \$150,000 per family and \$75,000 per individual. On February 21, the IRS issued revised employer withholding tables to implement the credits and asked employers to start using these new tables not later than April 1. In addition, the Stimulus provides for "economic recovery" credits for certain retirees. Other individual tax cuts enacted include enhancements of the child care credit, earned income credit and Hope tuition credit (named the American Opportunity Tax Credit); extension and enhancement of the first-time homebuyer credit; exclusion of \$2,400 of unemployment benefits; deduction for sales taxes on purchases of new motor vehicles in 2009; and an AMT "patch" for 2009. In addition, the Stimulus offers subsidies for health insurance premiums paid for COBRA continuation coverage of unemployed workers.

The Stimulus also provides approximately \$13 billion in tax benefits for businesses, mostly for small businesses, including a five-year carryback of 2008 net operating losses for businesses with gross receipts of \$15 million or less (under present law, a two-year carryback is permitted) and extensions of the 50 percent bonus depreciation and the \$250,000 capital write-off.

There are several provisions relating to business restructuring. First, corporations, partnerships and certain others that reacquire a debt instrument previously issued by

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Tax

Jeffrey H. Paravano
jparavano@bakerlaw.com
202.861.1770

Paul M. Schmidt
pschmidt@bakerlaw.com
202.861.1760

Jeffrey J. Erney
jerney@bakerlaw.com
202.861.1770

Allen J. Littman
alittman@bakerlaw.com
202.861.1686

Stuart J. Bassin
sbassin@bakerlaw.com
202.861.1736

John R. Lehrer II
jlehrer@bakerlaw.com
202.861.1620

Private Wealth

Robert R. Galloway
rgalloway@bakerlaw.com
216.861.7423

Edward J. Beckwith
ebeckwith@bakerlaw.com
202.861.1646

them for cash, stock or debt at a discount, or have that debt instrument completely forgiven, are subject to income tax on the amount of the discount or the forgiveness. The Stimulus allows these taxpayers to elect to include this discharge of indebtedness income ratably over a five-year period beginning in 2014 for debts reacquired in 2009 and 2010. Second, the Stimulus turns off the Section 382 limitation on the utilization of net operating losses for automobile manufactures that undergo a Section 382 ownership change pursuant to a restructuring plan which is required in order to obtain funds or a line of credit under the Emergency Economic Stabilization Act of 2008. Finally, under present law, before the Stimulus, taxpayers could not deduct the disqualified portion of the original issue discount on an applicable high yield debt obligation and the allowed portion of the original issue discount could not be deducted until paid. The Stimulus suspends these requirements for applicable high yield debt obligations received in exchange for debt obligations which are not applicable high yield debt obligations during the period beginning September 1, 2008, and ending December 31, 2009, from the same issuer (or obligor). The deduction for original issue discount, consequently, is allowed currently on these applicable high yield debt obligations.

The Stimulus also includes a number of energy tax incentives, particularly in the areas of renewable energy and energy efficiency, totaling approximately \$20 billion. In addition, several new state and local government bond enhancements are included to assist with an infrastructure rebuilding effort.

On the spending side, the Stimulus is intended to create or save up to three or four million jobs, mostly in construction and manufacturing, through the construction or major renovation of lasting infrastructure, including roads, bridges and mass transit. Other key projects include computerizing the healthcare system, doubling renewable energy production and making public buildings energy efficient. The Stimulus also includes Federal aid for increased unemployment benefits, Medicaid enhancement or subsidies for laid-off workers and food stamps. The spending plan details and monitoring have been put online on a special website and an official oversight board has been created to oversee the spending.

Finally, the Stimulus subjects all entities that have or will receive financial assistance under TARP to tighter executive compensation standards.

President Obama's 2010 Budget

On February 26, President Obama released a preliminary budget document entitled "A New Era of Responsibility—Renewing America's Promise." On May 7, the President transmitted his full Fiscal Year 2010 Budget to the Congress (the "2010 Budget"). On May 11, the Department of the Treasury released its "General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals" (known informally as the "Greenbook"). The Greenbook describes the Administration's tax proposals in more detail, including international tax reform proposals aimed at curbing deferral and enhancing offshore compliance. Although some of the 2010 Budget provisions are already reflected in the enacted Stimulus, many of the proposals described in the Greenbook will require further development during the legislative process.

Individual Tax Cuts

The 2010 Budget proposes to make permanent some of the benefits in the Stimulus: the Making Work Pay Credit; the enhancements to the child care credit and the earned income credit; and the American Opportunity Tax Credit. The 2010 Budget also expands the saver's credit and provides for all employees not covered by a retirement plan to be automatically enrolled in a direct-deposit IRA outside of Social Security. Providing a permanent Making Work Pay credit may signal the Administration's intent that employers bear a larger proportion of social security taxes in the future.

Raymond L. Sutton Jr.
rsutton@bakerlaw.com
303.764.4103

George T. Mooradian
gmooradian@bakerlaw.com
714.966.8800

Executive Compensation and 409A Compliance

John M. Gherlein
jgherlein@bakerlaw.com
216.861.7398

Suzanne K. Hanselman
shanselman@bakerlaw.com
216.861.7090

Raymond M. Malone
rmalone@bakerlaw.com
216.861.7879

John J. McGowan
jmcgowan@bakerlaw.com
216.861.7475

William M. Toomajian
wtoomajian@bakerlaw.com
216.861.7569

Georgeann G. Peters
gpeters@bakerlaw.com
614.462.4769

Terry Connerton
tconnerton@bakerlaw.com
202.861.1613

Federal Policy

Tom McDonald
tmcDonald@bakerlaw.com
202.861.1664

Michael G. Oxley
moxley@bakerlaw.com
202.861.1663

William H. Schweitzer
wschweitzer@bakerlaw.com
202.861.1531

E. Mark Braden
mbraden@bakerlaw.com
202.861.1504

Lucy J. Calautti
lcallautti@bakerlaw.com
202.861.1739

William J. Weber
wweber@bakerlaw.com
202.861.1681

Subprime Lending Litigation

Frederick W. Chockley III
fchockley@bakerlaw.com
202.861.1680

Environmental and Energy

Ben L. Pfefferle III
bpfefferle@bakerlaw.com
614.462.2601

Higher Top Individual Tax Rates

The 2010 Budget also allows most of the key Bush-era high-income individual tax cuts to expire at the end of 2010. For taxpayers earning over \$250,000 (married) and \$200,000 (single), 2011 will see the reinstatement of:

1. The top 36 percent and 39.6 percent rates (up from 33 percent and 35 percent);
2. The personal exemption phaseout (“PEP”) and limitation on itemized deductions (“Pease”); and
3. The 20 percent top capital gains rate (up from 15 percent). The top rate on dividends will also be set at 20 percent.

The Greenbook reduces the \$250,000 (and \$200,000) threshold(s) by the amount of the standard deduction and two (or one) personal exemption(s). It is not clear whether Congress will adopt this apparent modification to the original 2010 Budget.

In addition to the changes above, the 2010 Budget proposes to limit the tax rate at which itemized deductions may reduce tax liability to 28 percent in order to fund healthcare initiatives. How the proposed 28 percent limitation on itemized deductions will be applied and interact with the proposed reinstatement of the limitation on itemized deductions (Pease) initially was not clear. The Greenbook clarified, however, that any new 28 percent limitation should apply after the reduction of itemized deductions under the Pease limitations.

Planning considerations include:

1. Accelerating income to beat the rate increases.
2. Accelerating itemized deductions, including charitable deductions, to beat the limitations.
3. Avoiding Section 409A traps against acceleration.
4. Deferral of deductions, including by current AMT taxpayers who may no longer be subject to AMT as regular tax rates increase.
5. Taxpayers intending to sell capital gain property within the next two years should make such sales as soon as practicable.
6. Taxable portfolios that generate significant capital gains or dividends should be re-positioned. Taxpayers should consider including tax-free bonds and growth stocks held for longer periods to defer taxation.
7. Income producing assets in general should be converted to long-term capital growth vehicles. Debt should be increased in appropriate cases to leverage capital growth while taking advantage of current deductions for interest expenses.
8. Individual capital losses should be deferred in appropriate cases to offset capital gains subject to higher tax rates.
9. Companies should consider accelerating a dividend payment to beat the effective date of the rate change.

Corporate and Business Tax Benefits

The 2010 Budget contains a number of business tax proposals. Expiring provisions, including active financing and subpart F “lookthrough,” would be extended through calendar year 2010. The research and experimentation tax credit would be made permanent. The Greenbook also contains a proposal providing that “the

David B. Rivkin
drivkin@bakerlaw.com
202.861.1731

Darin R. Bartram
dbartram@bakerlaw.com
202.861.1735

International Trade

Elliot J. Feldman
efeldman@bakerlaw.com
202.861.1679

John J. Burke
jburke@bakerlaw.com
202.861.1625

Michael S. Snarr
msnarr@bakerlaw.com
202.861.1710

Healthcare Industry

Thomas W. Kahle
tkahle@bakerlaw.com
513.929.3414

Christopher J. Swift
cswift@bakerlaw.com
216.861.7461

Susan Feigin Harris
sharris@bakerlaw.com
713.646.1307

Employment and Labor

Ronald G. Linville
linville@bakerlaw.com
614.462.2647

M.J. “Mike” Asensio
masensio@bakerlaw.com
614.462.2622

White Collar Defense and Corporate Investigations

John J. Carney
jcarney@bakerlaw.com
212.589.4255

George A. Stamboulidis
gstamboulidis@bakerlaw.com
212.589.4211

Jonathan R. Barr
jbarr@bakerlaw.com
202.861.1534

Financial System Regulatory Reform

Michael G. Oxley
moxley@bakerlaw.com
202.861.1663

Tom McDonald
tmcdonald@bakerlaw.com
202.861.1664

Administration looks forward to working with the Congress to make a lengthened NOL carryback period available to more taxpayers,” which is budgeted for roughly the size of the Senate-passed Stimulus that was scaled back by the Stimulus Conference Committee. The Senate bill would have allowed a five-year carryback with no gross-receipts requirement. The Greenbook also proposes to increase the percentage exclusion for gain on qualified small business stock issued after February 17, 2009, from 75 percent (which the Stimulus increased from 50 percent) to 100 percent. This increased exclusion would continue to apply to individual and other non-corporate taxpayers.

Corporate Tax Increases

The 2010 Budget provides for several tax increases that appear to be aimed at corporations, including the reinstatement of Superfund taxes, the taxation of carried interest as ordinary income, codification of the economic substance doctrine and the repeal of LIFO inventory accounting. According to the Greenbook, the proposal that addresses carried interests (i.e., profits interests in partnerships) appears to apply to any partnership profits interest held by a person who provides services to the partnership, and is not limited to investment services partnerships.

The Greenbook also describes in more detail the international tax reform proposals that were summarized in the preliminary budget document under the rubric “implement international enforcement, reform deferral and other tax reform policies” and scored at a massive \$210 billion. There are several international tax reform proposals. One would defer interest and other deductions, except for research and experimentation, that are allocable to foreign income that is deferred until the allocable income is repatriated. Under another proposal, deemed paid foreign tax credits would be determined on an aggregate basis for all foreign subsidiaries, thus limiting taxpayers’ flexibility to credit taxes on high-taxed income while keeping low-taxed income offshore. These two proposals closely follow the 2007 proposals by Ways and Means Chairman Charles Rangel, although there are some differences (for example, Mr. Rangel’s foreign tax credit proposal applies to all foreign income taxes). The Greenbook also proposes a rule to “match” creditable foreign taxes and associated foreign income.

The Greenbook also proposes to reform the check-the-box rules by treating as a per se corporation a foreign single-member disregarded entity owned by a company organized in a country other than that in which the disregarded entity is organized. The disregarded entity rule would not apply to domestic disregarded entities or to foreign disregarded entities wholly owned by a U.S. person. Other international proposals (i) “clarify” that intangible property for transfer pricing purposes includes workforce in place, goodwill and going concern value; (ii) tighten the limits on interest deductions by certain expatriated entities; (iii) repeal the “boot-within-gain” limitation of current law in the case of certain foreign reorganizations; (iv) repeal the “80/20 rules” applicable to dividends and interest paid by certain domestic companies; (v) treat certain equity swap income as U.S. source for withholding purposes; and (vi) allow foreign tax credits of certain “dual-capacity” taxpayers only if the foreign country generally imposes an income tax. These international proposals are proposed to be effective January 1, 2011.

The Greenbook also includes twelve proposals intended to improve taxpayer compliance with respect to offshore income. These proposals include enhanced requirements for qualified intermediaries, increased taxpayer and third-party reporting, additional withholding requirements in certain instances, negative factual presumptions for failure to make certain required reporting, extensions of the statutes of limitations to six years for certain reportable cross-border transactions and foreign entities and doubling (to 40 percent) of accuracy-related penalties attributable to undisclosed foreign accounts.

The President’s 2010 Budget also proposes to eliminate several “oil and gas company preferences,” including the levying of an excise tax on the production of oil and gas on the Outer Continental Shelf, the repeal of expensing of intangible drilling costs, the repeal of the domestic manufacturing tax deduction for oil and natural gas companies, the increase in the amortization period for geological and geophysical costs to seven years and the repeal of percentage depletion for oil and natural gas.

The Greenbook also includes 29 proposals to “reduce the tax gap and make reforms.” Revenue from these proposals, along with revenue from the proposal to limit the tax rate at which itemized deductions reduce tax liability to 28 percent, are to be dedicated to healthcare reform. These proposals include five proposals increasing information reporting and related penalties; two proposals to improve compliance by businesses, eight proposals strengthening the IRS’s hand in administering taxes, two proposals expanding certain miscellaneous penalties, and 12 substantive reforms “to close tax loopholes.” These loophole-closing proposals include (i) the accrual of interest on forward contracts to issue corporate stock; (ii) ordinary income treatment for dealers in securities, commodities, commodities derivatives, and equity options; (iii) several life insurance proposals; (iv) the denial of deductions for punitive damages; (v) the repeal of the lower-of-cost-or-market inventory accounting method; and (vi) several estate and gift tax proposals. Finally, the Greenbook proposes to enhance the ability of the IRS to collect taxes owed by Federal contractors and vendors.

Lower Corporate Tax Rates, At a Cost, and the Need to Begin Action Steps Now

There seems to be growing support for reducing the corporate tax rate. Unfortunately, there also is growing support for paying for any rate reduction by eliminating various deductions. Thus, to the extent rate reductions occur at all, there likely will be winners and losers. The most obvious losers may be U.S. companies that take advantage of the manufacturing deduction, as any general rate reduction is likely to result in the elimination of that benefit. As noted above, Ways and Means Chairman Charles Rangel has a proposal under which deductions that are attributable to unrepatriated foreign income would be deferred until such income is repatriated. Two companion proposals would effectively put an end to high-tax/low-tax foreign tax credit planning and eliminate worldwide interest allocation for foreign tax credit purposes. Many multinationals have put in place complex corporate structures that include “check-the-box” foreign disregarded entities, which may need to be restructured prior to January 1, 2011, under the Greenbook proposal.

Corporate tax directors need to inform their boards of the potential impact on corporate earnings of these and other expected changes. Adverse effects of certain proposals may be lessened or eliminated with advance planning.

Healthcare Reform

The President has pressed Congress for healthcare reform in 2009 and is getting a positive response. On May 13, House Democratic leaders promised to pass a reform bill by the August recess. On May 12, the Senate Committee on Finance held a “roundtable” discussion on financing healthcare reform, and on May 14, held a closed-door meeting to consider policy options. These options and some key issues reportedly are whether (i) to create a new public plan that would be coordinated with Medicare in some way or would be administered through regional third-party administrators, (ii) to create a new public plan to be run by the states, (iii) to create an employer “play-or-pay” mandate under which non-participating employers above a to-be-determined size threshold would pay a charge or tax; (iv) to facilitate the creation of a private plan or plans, and (v) whether to eliminate or trim back the employee tax exclusion for employer-provided healthcare. Chairman Baucus has announced that he is in favor of modifying the tax exclusion—not eliminating it—and Secretary of Health and Human Services Sebelius has signaled the Administration’s flexibility in that regard. Secretary Sebelius also reiterated the President’s support for some form of play-or-pay while at the same time emphasizing his flexibility on healthcare financing options.

Blowing the Cap Off Social Security Earnings

At some point during the Obama Administration, we expect that Social Security taxes on wages exceeding \$250,000 may increase by at least two to four percent. The combination of that expected increase with the existing Medicare tax on all wage income will put pressure on high wage-earners to take steps to defer wage income or convert wage income into investment income.

Estate Tax Permanence and Coordination with the Gift Tax

One thing we can all be certain of is that our new leaders in the White House and Congress will not allow the estate tax rate to go to zero in 2010 and then spring back to life in 2011—which is what will happen under present law. Instead, the Greenbook assumes that the estate tax will be made permanent in 2009 at a top tax rate of 45 percent. We believe the exemption amount for 2010 will be retained at least at the 2009 amount of \$3.5 million per person or \$7 million per couple. We also believe, however, that the new legislation will allow any exemption not used by one spouse to be automatically available to the other spouse. In addition, beginning in 2010, the gift tax exemption amount will be increased to \$3.5 million (from \$1 million) to again become uniform with the estate tax exemption amount. Given the recent historic drop in market values of assets of all types and the seeming inevitability of the estate tax for years to come, 2009 will be an ideal time to plan for aggressive gifting in early 2010 using various techniques for those who desire to pass significant assets to their heirs.

Charitable Gifts from IRAs

Charitable gifts of as much as \$100,000 may be made from IRAs through the end of 2009 without any income inclusion to the account owner.

Conservation Easements

Charitable gifts of conservation easements may be deducted up to 50 percent of adjusted gross income for gifts made before the end of 2009. The limitation is removed entirely for farmers and ranchers. The IRS, however, has established a program intended to aggressively challenge any and all such deductions.

Energy Incentives

The 2010 Budget proposes a new “cap-and-trade” system for reducing greenhouse gas emissions. The Senate gave the cap-and-trade idea a cold reception; many believe the proposal is entirely dead there. However, cap-and-trade appears to be moving ahead in the House. With gas prices falling over the past year, economic incentives in the marketplace are dissipating for developing alternative, renewable and environmentally friendly energy sources. Congress seems determined to encourage alternative energy sources and environmentally friendly production and transport, and the Obama Administration is committed to that effort and has even touted government investments into eco-friendly research and investments as a type of “public works” project to help end the current economic recession. In addition to the energy component of the stimulus plan, it appears likely that a larger, more comprehensive energy bill may be developed later in 2009 or 2010.

Free Trade Issues

Colombia free trade, along with pending free trade agreements with Panama and South Korea, are stalled for now. Watch for Republicans to press for approval of these agreements in exchange for refraining from filibustering in the Senate various pieces of legislation to be sought by the Democrats.

The overall climate for international trade is deteriorating; both imports and exports are likely to be affected adversely.

As the economy continues to decline, we expect what seems always to happen, a political inclination to target foreign imports for our problems. During the last eighteen months the trade front has been relatively quiet because typically contentious areas, such as agriculture and steel, have been prospering. That situation is rapidly changing. Domestic manufacturers of goods competing with imports will likely benefit from petitioning for trade relief, even when cases are more difficult to prove, because such petitions invariably disrupt the market in favor of domestic producers. Importers, by contrast, should try to diversify their sources of supply because of such possible disruptions. The Democratic Congress will continue to tilt toward trade protectionism, now supported by an increase in the number of “Blue Dogs” and by clearer majorities.

The Obama Administration, which seemed to uncomfortably lapse into vague protectionist positions during the campaign, is not likely to assign much priority to trade. It may, however, permit Congress to press forward a protectionist agenda: continued opposition to major trade agreements and continued pressure on China, particularly over alleged currency manipulation.

The export side of our trade relationships could be affected adversely by our own protectionist measures more than at any time since the 1930s. As we enforce our trade laws against foreign subsidies, for example, other countries are going to enforce their laws against our exports. The economic meltdown has led to a sweeping new government involvement that translates, in trade law, to subsidies. We are likely to impose more trade restrictions on goods that we claim are subsidized. Foreign countries are likely to do the same to our exports.

Leaders of Key Committees

The composition of both houses of Congress has shifted. The Democrats have a large majority in the House and have gained several seats in the Senate, but not quite enough to prevent a Republican filibuster. Under standing Senate rules, 60 votes are required to end a filibuster. With Senator Arlen Specter (R-PA; now D-PA) switching parties to become a Democrat, the Senate now consists of 59 Democrats (60 if Mr. Franken is seated) and 40 Republicans. While overall Congressional leadership will remain in place in the new Congress, some key changes have already occurred on the Republican side. Mr. Cantor has replaced Mr. Blunt as House Minority Whip. Mr. Camp has replaced Mr. McCrery as Ranking Member on the Committee of Ways and Means. Several new members have been added on both sides of the aisle to the Senate Finance and Ways and Means Committees.

In other areas, the following key changes have been made: Mr. Kerry has replaced Mr. Biden as chair of the Senate Foreign Relations Committee. Mr. Inouye has replaced Mr. Byrd as chair of the Senate Appropriations Committee. Mr. Waxman has replaced Mr. Dingell as chair of the House Energy and Commerce Committee.

Financial System Regulatory Reform

With the meltdown of the financial sector last fall, as well as the unfolding Madoff scandal (where a Baker Hostetler attorney serves as Trustee and the firm serves as Counsel to the Trustee), many fingers are being pointed at the current regulatory structure, which SEC Chairman Mary Schapiro described as “stove-piped” at her recent confirmation hearing.

Massive overhaul of the financial regulatory system is anticipated with various proposals to regulate financial products, participants and activities previously unregulated (including derivatives, hedge funds and perhaps even insurance). Congress is contemplating proposals to eliminate or combine one or more agencies, such as the SEC and the CFTC, into a single regulator to strengthen enforcement and to better detect overall “systemic risk.” Finally, credit rating agency reform is almost a certainty, with Banking Committee Chairman Christopher Dodd and Ranking Member Richard Shelby both citing inaccurate ratings and conflicts in the ratings process as key factors in failing to signal the approach of the current financial crisis. Nearly everything appears to be on the table as a potential target for reform in the financial services arena. As Schapiro stated during her testimony, there will be “no sacred cows” when she takes the helm at the SEC.

Labor

The Employee Free Choice Act (EFCA) will be a major focus of the Congressional agenda in 2009. EFCA would amend the National Labor Relations Act (NLRA) by substituting card check recognition for the secret ballot election as the means for employees to choose union representation. EFCA as originally proposed also would require binding arbitration of first contracts 120 days after a union is certified as the employees’ representative. That means that an arbitrator (not the employer) will have the power to set employees’ wages and benefits for the first two years of the bargaining relationship. Finally, EFCA would impose stronger penalties for employer violations of the NLRA during organizing drives or the negotiation of first time labor contracts. Passage of EFCA is assured in the House, however, it lacks sufficient support in the Senate given opposition of certain Senate Democrats and nearly all Senate Republicans. President Obama has promised to sign any such legislation into law. While the Senate has essentially killed the major provisions of this Act, watch for efforts by Congressional Democrats to attempt to negotiate some type of compromised version of the EFCA.

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