

# K&LNGAlert

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## Mortgage Banking/Consumer Finance Commentary

### HUD Strengthens and Streamlines its Requirements— the Department Finalizes Treble Damages for Failure to Engage in Loss Mitigation and Introduces New Electronic Payment and Reporting Obligations

On April 26, 2005, the U.S. Department of Housing and Urban Development (“HUD” or “Department”) issued a final rule (“Rule”) amending civil money penalty regulations for the failure to engage in loss mitigation in connection with mortgage loans insured by the Federal Housing Administration (“FHA”).<sup>1</sup> The Rule, which follows HUD’s issuance of a proposed rule (“Proposed Rule”) on April 14, 2004,<sup>2</sup> requires treble damages for a mortgagee’s failure to take required loss mitigation actions. The Rule adopts the Proposed Rule without change and finally implements Congress’ 1998 amendments to the National Housing Act. The Rule became effective on May 26, 2005.

Additionally, the Department issued two recent Mortgagee Letters requiring electronic payment of the annual mortgagee recertification fee<sup>3</sup> and instituting an electronic feature through Neighborhood Watch for the reporting of serious loan deficiencies and suspected fraud.<sup>4</sup> HUD indicated such changes are part of its “continuing commitment to make the federal government more efficient and more responsive to customers.”<sup>5</sup>

This Client Alert summarizes: (1) the statutory and regulatory history leading up to the Rule and the specific amendments to HUD’s civil money penalty regulations; and (2) HUD’s new electronic payment and recording requirements.

#### TREBLE DAMAGES AND LOSS MITIGATION

##### A. BACKGROUND

In 1998, Congress amended sections of the National Housing Act (“NHA”) to permit treble damages for a mortgagee’s failure to engage in appropriate loss mitigation.<sup>6</sup> Section 230 of the NHA requires a mortgagee to engage in loss mitigation actions upon the default of any FHA-insured mortgage in order to provide an alternative to foreclosure. Depending on an individual borrower’s qualifications, such actions may include: (1) special forbearance or a temporary repayment plan; (2) modification to reduce the monthly payment or extend the term of the loan; (3) partial claim to reinstate the loan; (4) pre-foreclosure sale; and (5) deed-in-lieu of foreclosure.<sup>7</sup> Section 536 of the NHA permits the imposition of civil money penalties against a mortgagee for various knowing and material violations of the Act, including servicing violations.<sup>8</sup> Specifically, with respect to a mortgagee’s failure to engage in loss mitigation activities, Section 536 authorizes a penalty in the amount of three times the amount of any insurance benefits claimed by the mortgagee for any mortgage for which the mortgagee failed to uphold its duty to engage in loss mitigation.<sup>9</sup>

Ultimately, these amendments make no distinction among servicers and provide that all servicers in violation of loss mitigation requirements, regardless of the nature of the violation, may be subject to treble damages. The Department recognized that implementation of the new statute would invite criticism from the mortgage industry absent specific criteria to ensure that treble damages would be applied only to those servicing mortgagees with a pattern and practice of failing to engage in loss mitigation. For this reason, HUD issued an advanced notice of proposed rulemaking in December 2000 to express its intent to implement the changes made to the NHA.<sup>10</sup> At the same time, the Department launched a pilot program to test its proposed Tier Ranking System (“TRS”) to analyze a mortgagee’s loss mitigation efforts on a portfolio-wide basis and rank the mortgagee on performance ratios of loss mitigation actions divided by real estate owned. Specifically, the Department proposed to divide lenders into four tiers and subject only those lenders in the bottom tier to treble damages. HUD designed this system to compare a lender’s loss mitigation actions to its loss mitigation actions plus foreclosures.

Four years later, the Department issued the Proposed Rule, which responded to many of the industry’s concerns and described HUD’s intent to apply treble damages only against those servicing mortgagees categorized in the lowest tier. After considering public comments to the Proposed Rule, HUD issued the Rule without any change. We summarize below the components of this Rule.

## B. THE FINAL RULE

The Rule amends several provisions of HUD’s regulations related to civil money penalties and a mortgagee’s servicing obligations to implement changes made to the NHA.

### 1. A Mortgagee That Fails to Engage in Loss Mitigation May Be Liable for Treble Damages.

The Rule amends 24 C.F.R. § 30.35(a) to explicitly provide that the knowing and material failure to engage in loss mitigation is a ground for the imposition of a civil money penalty and amends Section 30.35(c) to state:

*(c) Amount of penalty. (1) Maximum penalty.* Except as provided in paragraph (c)(2) of this section, the maximum penalty is \$6,500 for each violation, up to a limit of \$1,250,000 for all violations committed during any one-year period. Each violation shall constitute a separate violation as to each mortgage or loan application.

*(2) Maximum penalty for failing to engage in loss mitigation.* The penalty for a violation of paragraph (a)(15) of this section shall be three times the amount of the total mortgage insurance benefits claimed by the mortgagee with respect to any mortgage for which the mortgagee failed to engage in such loss mitigation actions.

These amendments are consistent with, and virtually identical to, the statutory language contained in the NHA.<sup>11</sup> Note that the language in both the NHA and the Rule indicates that loss mitigation violations will trigger only the treble damages provision, and not the provision allowing for \$6,500 per violation up to a \$1,250,000 yearly cap. The Department received a public comment asking HUD to make an express statement explaining the cap to treble damages.<sup>12</sup> In response, the Department stated that “HUD does not believe the annual limitation to the amount of civil money penalties applies to treble damages imposed for failure to engage in loss mitigation,” as the 1998 legislation enacting a civil money penalty for failure to engage in loss mitigation makes no mention of an annual cap on loss mitigation penalties.<sup>13</sup> In fact, HUD noted that “a loss mitigation penalty for a single loss mitigation failure will likely be assessed at hundreds of thousands of dollars as the average claim to HUD is roughly \$98,500.” Servicers, therefore, should be aware that the Department has positioned itself with this Rule to take an “aggressive and effective” stance with loss mitigation penalties.

Additionally, the Rule adds the following language to Section 30.80, which lists the factors to be considered in determining the appropriateness and amount of civil money penalty:

- (l) HUD may consider the factors listed in paragraphs (a) through (k) of this section to determine the appropriateness of imposing a penalty under Section 30.35(c)(2); however, HUD cannot change the amount of the penalty under Section 30.35(c)(2).

The Department, therefore, has two options in a case where a servicer fails to engage in loss mitigation: (1) HUD can decline to impose a civil money penalty based on relevant factors; or (2) HUD must impose treble damages.

As stated in the Proposed Rule, in determining whether a mortgagee violated loss mitigation requirements such that treble damages are appropriate, HUD will first consider whether the servicing mortgagee took any loss mitigation action.<sup>14</sup> The Department will not question what action was taken, so long as the mortgagee used loss mitigation options within the FHA guidelines. In addition, as affirmed in the preamble to the Rule, if, despite documented attempts to evaluate or provide loss mitigation, implementation could not occur due to the borrower's refusal or failure to cooperate with the mortgagee, the mortgagee generally would be considered in compliance with FHA guidelines.<sup>15</sup> As a result, a servicer should take care to engage in and document all instances of loss mitigation to ensure the Department never deems treble damages to be appropriate.

## **2. Non-Compliance with General Mortgage Servicing Requirements May Result in Civil Money Penalties.**

The Rule also amends Section 204.500, consistent with Section 30.35, to provide that non-compliance will be a cause not only for withdrawal, but for the imposition of civil money penalties. Previously, this section required a pattern of non-compliance to trigger withdrawal. Now, however, a single act of non-compliance can trigger both withdrawal and civil money penalties. As a result, a servicer should be aware that treble damages may be imposed for each loan in a servicer's portfolio where a servicer fails to engage in loss mitigation actions in accordance with FHA guidelines. As acknowledged by HUD, such a penalty could quickly amass hundreds of thousands of dollars, unless a servicer remains diligent in its loss mitigation efforts. To date, we are unaware of any treble damages imposed on an FHA-approved mortgagee under these circumstances.

## **3. Mortgagees Have a Duty to Mitigate and Will Be Ranked According to Their Loss Mitigation Performance.**

The Rule alters Section 203.605 to emphasize a servicing mortgagee's duty to engage in loss mitigation and rank mortgagees based on their loss mitigation performance. Prior to the Rule's enactment, Section 203.605 read as follows:

No later than when three full monthly installments due on the mortgage are unpaid, the mortgagee shall evaluate all of the loss mitigation techniques provided at Section 203.501 to determine which, if any, are appropriate, and shall reevaluate monthly thereafter. The mortgagee shall maintain documentation of such evaluations. Should a claim for mortgage insurance benefits later be filed, the mortgagee shall maintain this documentation in the claim file under the requirements of Section 203.365(c).<sup>16</sup>

The Rule now details a mortgagee's duty to mitigate and clarifies how HUD assesses a mortgagee's loss mitigation performance.

### **a. The Duty to Mitigate**

With respect to a mortgagee's duty to mitigate, the Rule requires that, before four full monthly installments due on the mortgage have become unpaid, the mortgagee must evaluate loss mitigation options on a monthly basis and take appropriate loss mitigation action. The mortgagee is required to maintain documentation for both the initial and all subsequent evaluations resulting in loss mitigation actions. The preamble to the Rule defines fail-

ure to engage in loss mitigation “as a mortgagee’s failure to evaluate a loan for loss mitigation before four full monthly mortgage installments are due and unpaid to determine which, if any, loss mitigation techniques are appropriate . . . , or subsequent failure to take appropriate loss mitigation action(s).”<sup>17</sup>

b. The Tier Ranking System

Moreover, with respect to HUD’s assessment of a mortgagee’s loss mitigation performance, the Rule directs that HUD will use its current TRS to measure and advise mortgagees of their loss mitigation performance. HUD will review each servicing mortgagee’s loss mitigation efforts for all loans in its portfolio on a quarterly basis. Each review will cover a rolling 12-month period and scores will be computed based on a mortgagee’s loss mitigation attempts, defaults, and claims. HUD will then divide mortgagees into four different tiers based on their scores, and mortgagees in the lowest (fourth) tier will have an opportunity to appeal their ranking if faulty data is used.

This system, which HUD detailed in its Proposed Rule, remains unchanged with the Rule and can be amended only after opportunity is given in the Federal Register for notice and comment. Thus, the current formula for determining TRS scores requires the division of a mortgagee’s loss mitigation actions by its loss mitigation actions plus foreclosures (*i.e.*, the WO ratio), as follows:<sup>18</sup>

$$\frac{\text{Forbearances} + \text{Loss Mitigation Retention Claims} + \text{Pre-Foreclosure Sale Claims} + \text{Deed in Lieu Claims} + \text{Accelerated Claims Disposition}}{\text{Forbearances} + \text{Loss Mitigation Retention Claims} + \text{Pre-Foreclosure Sale Claims} + \text{Deed in Lieu Claims} + \text{Accelerated Claims Disposition} + \text{Foreclosure Claims}}$$

After determining each servicing mortgagee’s WO ratio, HUD will divide the mortgagees into four tiers, with Tier 1 representing the best loss mitigation performance and Tier 4 including those mortgagees with the worst loss mitigation performance. The current tier stratification is as follows:<sup>19</sup>

Tier 1 = WO ratio greater than 80%

Tier 2 = WO ratio greater than or equal to 60% and less than 80%

Tier 3 = WO ratio greater than or equal to 40% and less than 60%

Tier 4 = WO ratio less than 40%.

Based on this formula and benchmark rankings, the Department released Round 19 TRS rankings on May 13, 2005. Of the 217 mortgagees ranked in Round 19, 7.4% or 16 total mortgagees were categorized as Tier 4.<sup>20</sup> Notably, this is an overall decrease in the number of Tier 4 mortgagees, particularly after a spike in the Tier 4 rankings at 9.8% with Round 17 scores. The names of the ranked mortgage companies are not made public, but the general rankings of all mortgagees may be tracked on the Department’s website.

Although the TRS has been in place for some time, in light of the statutory and regulatory language subjecting all servicing mortgagees that violate loss mitigation requirements to treble damages, commenters to the Proposed Rule voiced their concern that servicers who systematically comply with loss mitigation requirements could face treble damages for only isolated incidents of non-compliance. As a result, they urged the Department to assess treble damages only for Tier 4 mortgagees. HUD, however, emphasized that the civil money penalty statute does not allow the Department to exempt any group of servicers. The Department stated that “this rule provides appropriate notification that HUD will focus on Tier 4 mortgagees for review purposes” and “treble damage penalties are more likely where there is a pattern of non-compliance as opposed to an isolated servicing mistake.”<sup>21</sup> HUD reiterated that it will continue to primarily concentrate on those mortgagees that engage in little or no loss mitigation. Thus, while the Department has provided some assurance that isolated instances of non-compliance will not trigger treble damages for Tier 1 – Tier 3 mortgagees, lenders should ensure that their servicing staff is intimately familiar with the FHA loss mitigation requirements and the Rule’s consequences for

failure to follow these requirements. Additionally, as HUD has expressed its intent to rely on such data to assign civil money penalties for failure to engage in loss mitigation, servicers should be familiar with the formula used and be able to calculate its own probable categorization.

c. Low TRS Scores and the Appeal Process

Section 203.605 of the Rule also indicates that HUD will issue quarterly TRS notices. Before these notices are issued, however, HUD will review the number of claims paid to mortgagees. If the Department determines that a servicer's low TRS score is the result of a small number of defaults or a small number of foreclosure claims, or both, HUD may decide not to designate the mortgagee as Tier 3 or Tier 4 and the mortgagee will remain unranked.

Additionally, within 30 calendar days after the date of a TRS notice, a mortgagee that is ranked in Tier 4 may appeal its ranking to HUD and request an informal conference with HUD officials. A Tier 4 mortgagee, however, may appeal its ranking only if it disagrees with the data that HUD used to determine the ranking. If the ranking was based on incorrect or incomplete data, HUD will reevaluate the mortgagee's performance and issue a corrected TRS ranking. Thus, to avoid the appeal process and treble damages altogether, servicing mortgagees may wish to calculate their own tier ranking on a regular basis to determine if they are at risk for Tier 4 categorization.

C. **MORTGAGEE LETTER 2005-18**

Although not issued in connection with the Rule or involving treble damages, HUD stated in the Proposed Rule that it would review incentive levels and any change to loss mitigation program incentives would be announced in future notices.<sup>22</sup> The Department released Mortgagee Letter 2005-18 on April 26, 2005 to announce an increase in incentive payments in connection with a servicer's loss mitigation actions. In this letter, the Department recognizes the increased costs that lenders experience when engaging in loss mitigation and the resulting savings to HUD as a result of these actions. As a result, the Department is permitting the following:

- Effective for loan modifications and partial claims received by HUD on or after June 1, 2005, all lenders will be entitled to claim an additional financial incentive of \$250 when submitting a claim type 32 for mortgage modifications, and an additional incentive of \$250 when submitting a claim type 33 for partial claims. The total financial incentive that will be payable is \$750 for mortgage modifications and \$500 for partial claims.
- These additional financial incentives are in addition to reimbursement of actual allowable expenses, such as the cost of a title search or recording fees, up to the Department's applicable limits.
- HUD will begin using the TRS, rather than the Loss Mitigation Performance Assessment ("LMPA"), as the basis for payment of these additional incentives following the release of TRS Round 20 scores. The Department, however, will continue to conduct the LMPA and publish the scores annually.
- After publication of TRS Round 20 scores, lenders who rank in Tier 1 will receive: (1) an additional \$100 payment for each Special Forbearance Agreement executed on or after the effective date to be announced by HUD; (2) pre-foreclosure sale time frames may be extended an additional two months without prior HUD approval; and (3) for loans endorsed on or after February 1, 1998, lenders will be able to claim reimbursement of 75% for foreclosure costs (an increase from the current allowance of 66%).

**ELECTRONIC PAYMENTS AND REPORTING**

In an effort to make HUD more efficient and more responsive, the Department is attempting to eliminate often cumbersome paperwork and introduce more electronic features to mortgagees. The Department recently took two such actions, which are summarized below.

#### A. RECERTIFICATION FEE AND YEARLY VERIFICATION REPORT

On May 17, 2005, the Department issued Mortgagee Letter 2005-24 to introduce new electronic enhancements in connection with a mortgagee's recertification fee and yearly verification report. As stated in Mortgagee Letter 2003-03, dated February 25, 2003, nonsupervised mortgagees and loan correspondents are required to submit their annual recertification audit electronically. In accordance with this requirement, Mortgagee Letter 2005-24 provides the following:

- All recertification fee payments, for mortgagees whose fiscal year ended on or after July 31, 2004, will be made by assessing "pay.gov" via the FHA Connection and by using the "Pay Now" button that has been added to the Institution Profile page of each lender.
- Lenders can download the Yearly Verification Report ("V-Form") electronically. As a result, HUD has ceased mailing V-Forms for all mortgagees whose fiscal year ended July 31, 2004, or later. Once the V-Form is downloaded, a mortgagee must still submit a signed paper copy of the V-Form.
- Several smaller changes have been made to FHA Connection, including the ability of mortgagees to update their payee address, view the list of field office jurisdictions where they are authorized to originate single family mortgages, update an authorized principal/agent relationship by the authorized agent for mortgagees, and download the revised cover sheet for the payment of the fee required for adding a branch.
- The Department has indicated that the ability to pay other fees electronically will be added to FHA Connection in the future.

#### B. REPORTING OF LOAN DEFICIENCIES AND FRAUD

Furthermore, on May 27, 2005, the Department issued Mortgagee Letter 2005-26, which announces the addition of a Reporting Tool to the Neighborhood Watch Early Warning System Menu. This feature allows mortgagees "to report serious deficiencies, patterns of non-compliance, or suspected fraud, to HUD in a uniform, automated fashion." Mortgagees are directed to use this new feature in lieu of submitting a written report to the Quality Assurance Division within the HUD Homeownership Center having jurisdiction over the specific case. Mortgagee Letter 2005-26 also attaches detailed instructions that explain the specific information and how such information is to be entered into the reporting feature.

Notably, these instructions require a mortgagee to break out, in a separate section, its report of fraud from other loan deficiencies in its audit report. Specifically, a mortgagee is instructed that "the Audit Results Section should include all loan level serious deficiencies and/or noncompliance with HUD/FHA requirements, **except** fraud. Fraud or Suspected Fraud **must** be reported in the Suspected Fraud Results section."<sup>23</sup> If a mortgagee detects no fraud during its audit review, it should merely note such. Otherwise, a mortgagee must identify the party or parties to the fraud, explain the suspected fraud and corrective action, separately enter the date of the corrective action, and identify the agency to which a referral was made, if any. The Department provides no examples as to how such information should be entered and explained. Note that use of this feature will become mandatory within six months of the date of the Mortgagee Letter.

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***Ultimately, HUD has taken several recent regulatory actions with which mortgagees should be aware—both to strengthen civil money penalty regulations and to streamline mortgagee obligations. If you have any questions regarding loss mitigation requirements, or should you need assistance navigating the Department's new electronic payment and reporting features, please contact Phillip L. Schulman (202.778.9027 / pschulman@kling.com) or Holly M. Spencer (202.778.9853 / hspencer@kling.com).***

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## ENDNOTES

- 1 70 Fed. Reg. 21572 (Apr. 26, 2005).
- 2 69 Fed. Reg. 19906 (Apr. 14, 2004).
- 3 Mortgagee Letter 2005-24.
- 4 Mortgagee Letter 2005-26.
- 5 Mortgagee Letter 2005-24.
- 6 See 112 Stat. 2461, 105 P.L. 276 (Oct. 21, 1998).
- 7 12 U.S.C. § 1715u(a); see 24 C.F.R. §§ 203.501, 203.605; Mortgagee Letter 00-05.
- 8 12 U.S.C. § 1735f-14(a)(1), (b).
- 9 12 U.S.C. § 1735f-14(a)(2).
- 10 65 Fed. Reg. 76520 (Dec. 6, 2000).
- 11 See 12 U.S.C. § 1735f-14(a)(2).
- 12 70 Fed. Reg. 21572, 21575 (Apr. 2, 2005).
- 13 70 Fed. Reg. at 21575.
- 14 69 Fed. Reg. 19906, 19907 (Apr. 14, 2004).
- 15 70 Fed. Reg. at 21573.
- 16 See 24 C.F.R. § 203.605 (2004).
- 17 70 Fed. Reg. at 21572.
- 18 See “Tier Ranking System (TRS)” at <http://www.hud.gov/offices/hsg/sfh/nsc/trsovrw.cfm>.
- 19 Id. Please note that these tier benchmark numbers were assigned at Round 14 of TRS rankings, which were released on February 18, 2004. Prior to these changes, only those mortgagees with a WO ratio of less than 15% were categorized as Tier 4. Not surprisingly, upon increasing the Tier 4 benchmark to less than 40%, the percentage of ranked mortgagees in Tier 4 increased from 2.7% in Round 13 to 9.5% in Round 14.
- 20 Id.
- 21 70 Fed. Reg. at 21573.
- 22 69 Fed. Reg. 19906, 19910 (Apr. 14, 2004).
- 23 Mortgagee Letter 2005-26, Attachment (emphasis in original).

## MORTGAGE BANKING/CONSUMER FINANCE PRACTICE

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### ATTORNEYS

Laurence E. Platt	202.778.9034	lplatt@klng.com
Phillip L. Schulman	202.778.9027	pschulman@klng.com
Costas A. Avrakotos	202.778.9075	cavrakotos@klng.com
Melanie Hibbs Brody	202.778.9203	mbrody@klng.com
Steven M. Kaplan	202.778.9204	skaplan@klng.com
Jonathan Jaffe	415.249.1023	jjaffe@klng.com
H. John Steele	202.778.9489	jsteele@klng.com
R. Bruce Allensworth	617.261.3119	ballensworth@klng.com
Daniel J. Tobin	202.778.9074	dtobin@klng.com
Nanci L. Weissgold	202.778.9314	nweissgold@klng.com
Phillip John Kardis II	202.778.9401	pkardis@klng.com
Stephen E. Moore	617.951.9191	smoore@klng.com
Stanley V. Ragalevsky	617.951.9203	sragalevsky@klng.com
David L. Beam	202.778.9026	dbeam@klng.com
Emily J. Booth	202.778.9112	ebooth@klng.com
Krista Cooley	202.778.9257	kcooley@klng.com
Eric J. Edwardson	202.778.9387	eedwardson@klng.com
Suzanne F. Garwood	202.778.9892	sgarwood@klng.com
Anthony C. Green	202.778.9893	agreen@klng.com
Laura A. Johnson	202.778.9249	laura.johnson@klng.com
Kris D. Kully	202.778.9301	kkully@klng.com
Drew A. Malakoff	202.778.9086	dmalakoff@klng.com
Christopher G. Morrison	202.778.9245	chris.morrison@klng.com
Erin Murphy	415.249.1038	emurphy@klng.com
Lorna M. Neill	202.778.9216	lneill@klng.com
Stephanie C. Robinson	202.778.9856	srobinson@klng.com
Holly M. Spencer	202.778.9853	hspencer@klng.com

### DIRECTOR OF LICENSING

Stacey L. Riggan	202.778.9202	sriggan@klng.com
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### REGULATORY COMPLIANCE ANALYSTS

Dana L. Lopez	202.778.9383	dlopez@klng.com
Nancy J. Butler	202.778.9374	nbutler@klng.com
Joelle Myers	202.778.9093	jmyers@klng.com
Marguerite T. Frampton	202.778.9253	mframpton@klng.com
Jeffrey Prost	202.778.9364	jprost@klng.com
Allison A. Rosenthal	202.778.9894	arosenthal@klng.com
Jonathon P. Schuster	202.778.9883	jschuster@klng.com
Brenda R. Kittrell	202.778.9049	bkittrell@klng.com
Joann Kim	202.778.9421	jkim@klng.com



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