CARRINGTON COLEMAN

CAPITAL

Editor: Sally Longroy

Issue No. 4 - Winter 2009

IN THIS ISSUE

FOR MORE INFORMATION ABOUT OUR PRACTICES, PLEASE CONTACT:

David Drumm
214.855.3032
ddrumm@ccsb.com

Josh Imhoff
214.855.3013
jimhoff@ccsb.com

Charles Jordan
214.855.3021
cjordan@ccsb.com

Sally Longroy
214.855.3001
slongroy@ccsb.com

Mike Sutherland
214.855.3069
msutherland@ccsb.com

Protecting the Value of Letters of Credit

By Laura Hebert

Letters of credit are used frequently in many types of business and real estate transactions. They are often accepted and sometimes even preferred as, for example, security deposits for leases, collateral for commercial real estate and business loans, and as guarantees of payment on purchase agreements. A landlord, a lender, or the seller in an asset purchase agreement may require that a letter of credit be provided because, at the time of default after a payment becomes due, the letter of credit will allow its beneficiary to draw the money owed directly from a specified bank rather than having to seek payment from the tenant, borrower, or purchaser. Thus, payment is ensured, even if the party that is obligated to pay is no longer willing or able to do so. But in times of financial instability like the one we are experiencing now, the holder of a letter of credit may find that his or her "guarantee" of payment is worth no more than the paper it is written on.

When a bank fails and is taken over by the Federal Deposit Insurance Corporation (FDIC), the FDIC may not honor the letters of credit issued by the bank.

The danger to holders of letters of credit arises from the ongoing epidemic of bank failures. When a bank fails and is taken over by the Federal Deposit Insurance Corporation (FDIC), the FDIC may not honor the letters of credit issued by the bank. Whether the FDIC will honor a given letter of credit can depend on the type of account established to support it. If the letter of credit is not secured by collateral —and many are not—or is undersecured, the FDIC may view it as an unfunded loan commitment, which it may repudiate. A bank failure is more than a remote possibility these days. The FDIC has taken over 130 U.S. banks or savings and loans so far in 2009, compared to 25 in all of 2008 and three in all of 2007.

A letter of credit is often used to secure a payment obligation arising from an underlying contract. A bank, or "issuer," issues a letter of credit at the request of the party obligated to pay under the contract, often referred to as the "applicant" or the "account party." The applicant will promise to reimburse the issuer for amounts paid on the letter of credit and may also be required to deliver cash or other collateral to secure such payments. The party to whom the letter of credit is issued, and who will be authorized to draw on it under certain stated conditions, is the "beneficiary." The letter of credit becomes a direct obligation of the issuer to the beneficiary. The underlying contract will typically set forth requirements for the letter of credit, specifying, at a minimum, the amount it must cover, the circumstances under which draws may be made, and the documents that the beneficiary must present in order to draw on the letter of credit.

Letter of credit beneficiaries should routinely check certain important details, even in strong economies. For example, beneficiaries should make sure that the draw requirements are clear to all parties because the strictest compliance with the draw requirements will be necessary. To avoid having the issuer reject the draw for noncompliance, the documents necessary to draw on the letter of credit should be agreed upon in advance and attached as exhibits. Also, letters of credit always have expiration dates, which can be a trap for the unwary. Beneficiaries should make sure that the date upon which payment will or may become due is not only within the life of the letter of credit but also permits time to submit a draw and then a redraw if the first is rejected. In difficult economic times like these, an additional important concern is the financial health of the issuer.

Letter of credit beneficiaries can take steps to mitigate the risks presented by bank failures. First, the underlying contract should require that the letter of credit be issued by a specific bank that is satisfactory to the beneficiary or by a bank whose financial strength meets certain criteria such as having a high rating from a rating service like Fitch, Moody's, or Standard & Poor's. Second, the underlying contract should require that the applicant obtain a replacement letter of credit from a different bank if the issuer falls below the required ratings or other criteria. The letter of credit should permit the beneficiary to draw against it if not replaced within the specified time period, even if payment is not yet otherwise owed. Finally, letter of credit beneficiaries should check the financial health of issuers on a regular basis. While the risk of a bank failure can never be eliminated completely, a little extra vigilance can help prevent a beneficiary from being left empty handed.

SPEs - Bankruptcy Remote? Not So Much

By Don Hanmer

As a result of the experiences of the 80s and 90s, lenders became sensitive to delays and problems incurred in connection with bankruptcy of commercial real estate entities and attempted to eliminate or minimize such problems in the future by requiring creation of special purpose entities ("SPEs") to own real estate assets collateralizing a loan. In addition, with respect to a variety of collateralized financial transactions, SPEs were required by investors and rating agencies for the same reasons.

An SPE is created by inserting certain provisions in the borrower's governing documents to insure that the borrower is a single asset entity, to prevent activities that are likely to cause it to be substantively consolidated with other entities in the event of a bankruptcy, to prevent, to the extent possible, the borrower from filing bankruptcy and, if the borrower does file bankruptcy, to try to ensure that the lender will be able to lift the stay in an expeditious manner and proceed against its collateral. Generally, the provisions the special purpose entity must meet were provided by the lender, required by the rating agencies, and often were not negotiable.

However, some of the anticipated benefits to lenders of SPEs have been called into question by the recent case *In re General Growth Properties, Inc., et al*. 409 B.R. 43 (Bankr., S.D.N.Y. 2009). In this case various lenders sought to have the court dismiss chapter 11 cases filed by one or more debtors owned directly or indirectly by General Growth Properties, Inc. The lenders argued that the bankruptcies of certain SPEs should be dismissed on the grounds they were filed in bad faith. General Growth Properties, Inc. was a publicly-traded real estate investment trust and the ultimate parent of approximately 750 wholly-owned debtor and non-debtor subsidiaries and affiliates. Some of the entities were SPEs.

One argument made by the lenders was that the filings with respect to some of the SPEs were bad faith filings because on a standalone basis the SPE had ample cash flow and the debt encumbering its assets would not mature for some period of time. The court said, in analyzing this question, "However, contrary to the movant's contentions, the court is not required in these cases to examine the issue of good faith as if each debtor were wholly independent." It then analyzed the interests of the group of related entities as a whole in determining whether or not the bankruptcy filing by individual SPEs was in bad faith.

The court recognized that the SPE structure was intended to insulate the financial position of each of the subject debtors from the problems of its affiliates, to make the prospect of a default less likely, and to make the SPE debtor "bankruptcy remote." The court said, however, that the lenders knew that they were extending credit to a company that was part of a much larger group, that there were benefits as well as possible detriments to the structure, and if the ability of the group to obtain financing became impaired the financial situation of a subsidiary SPE would be impaired. The court held there is authority that where the parent was dependent on cash flow from the subsidiaries and had significant debt itself, the interests of the parent companies must be taken into account.

The typical SPE documents contained an obligation to retain one or more independent directors or managers, and provided that a decision to file bankruptcy had to be approved by the independent director or manager. The independent directors or managers were meant to be unaffiliated with the parent of the SPE or any entity related to the SPE and the lenders expected and believed that the independent director or manager would protect the interests of the lenders.

The court recognized that the drafter had attempted to create impediments to a bankruptcy filing. An officer of one of the loan servicers even testified that the real reason he was disturbed by the chapter 11 filings was the inability of the independent managers to prevent the filing: "Well, my understanding of the bankruptcy as it pertains to these borrowers is that there was an independent board member who was meant to, at least from the lender's point of view, meant to prevent a bankruptcy filing to make them bankruptcy remote, and that such filings were not anticipated to happen." The court, however, said that managers and directors owe their duties to the corporation or entity and ordinarily to the shareholders or owners notwithstanding any such provisions in the documents.

The court said although it is clear that the movants have been inconvenienced by the chapter 11 filings, inconvenience to a secured creditor is not a reason to dismiss a chapter 11 case. The salient point for purposes of these motions is that the fundamental protections the movant negotiated and that the SPE structure represents are still in place and will remain in place during the chapter 11 cases. This includes protection against the substantive consolidation of the project level debtors with any other. The court said a principal goal of the SPE structure is to guard against substantive consolidation but the question of substantive consolidation is entirely different from the issue of whether the board of a debtor that is part of a corporate group can consider the interests of the group along with the interests of the individual debtor in making the decision to file a bankruptcy case.

So the court found that . . . the independent directors and managers could not ignore their fiduciary duty to the entity and its owners or shareholders notwithstanding provisions in the documents.

So the court found that the provisions of the SPEs did not prevent the SPEs from being put into bankruptcy along with affiliates and related entities and that the independent directors and managers could not ignore their fiduciary duty to the entity and its owners or shareholders notwithstanding provisions in the documents. However, the court specifically said that this decision does not override another goal of the SPE structure which is to prevent substantive consolidation. That issue is preserved for another day. It is important for borrowers, lenders, servicers, and lawyers to be aware of both the limitations and benefits of the SPE structure in light of this decision.

Construction Contracts - AIA v. ConsensusDOCS, An Owner's Perspective

By Kate Glaze

Any construction project involves a number of contract documents between various parties including the owner, architect, and contractor. The American Institute of Architects (AIA) has promulgated a set of standard documents that have historically been those most frequently used in complex construction transactions. Recently, owners, contractors, sureties, and others collaborated to design an alternate set of standard construction documents called ConsensusDOCS. The AIA declined to participate in the drafting project. The drafters describe the ConsensusDOCS as "contract documents based on best practices and proper risk allocation, for the benefit of organization members and the construction industry at large." Owners were represented at the ConsensusDOCS drafting table, but it is unclear whether the new documents truly favor owners more than the AIA document set.

Outside of the specific contract language differences, there are some key advantages and disadvantages to the two sets of documents:

- Sixteen editions of AIA documents have been available since 1911 resulting in frequent and longstanding court interpretation of the terms used in those documents. Thus, a court's interpretation of a given provision is somewhat predictable, whereas a court's interpretation of the ConsensusDOCS may be less certain.

- Most attorneys have developed their own set of suggested revisions to the standard AIA documents. When initially using the ConsensusDOCS, attorneys will need to develop a new set of standard revisions, potentially adding time and cost to the negotiation process. ConsensusDOCS developers argue the documents actually require fewer revisions because of their balanced approach and "check-the-box," pre-drafted alternative language.

- Some contractors, architects, and other industry professionals may be reluctant to use a new set of documents when they are already familiar and comfortable with the AIA documents they have been using for years.

The Construction Owners Association of America (COAA) has endorsed the ConsensusDOCS based on its determination that the forms are more owner-friendly than other industry forms, including the AIA's. They have identified several hot button provisions in the ConsensusDOCS that favor the Owner:

- *Delay Damages* – The ConsensusDOCS limit a contractor's damages for an owner-caused delay to direct costs only and prevent their recovery of "loss of business, loss of financing, principle office overhead and expenses, loss of profits not related to this Project, lost of bonding capacity, loss of reputation or insolvency." The AIA documents do not contain a similar waiver, though the AIA's mutual waiver of consequential damages may waive such losses.

- *Liquidated Damages* – The ConsensusDOCS provide a framework for liquidated damages. Parties must insert their own provision into the AIA form to include liquidated damages.

- *Ownership of Plans* – The ConsensusDOCS specify that the owner owns the design documents, except for their copyright, which it can opt to purchase. The AIA documents only allow the owner a non-exclusive license to use the deign documents.

- *Consequential Damages* – The ConsensusDOCS itemize categories of consequential damages that can be waived rather than including a blanket waiver, as is done in the AIA documents.

- *Dispute Resolution* – The ConsensusDOCS contemplate the owner and contractor communicating with each other directly when there is a dispute, while the AIA documents insert the architect or another third party into communication between those two parties.

Several other provisions that may favor the contractor, however, balance these potentially advantageous provisions. For example:

- *Indemnification* – The AIA documents require the contractor to indemnify the owner for the contractor's negligence regardless of whether the owner was contributorily negligent. The ConsensusDOCS provide for mutual indemnifications for each party's negligence.

- *Error Reporting* – The AIA documents require the contractor to report any errors in the construction documents that it discovers or that are made known to it and if it fails to do so, it is liable for extra costs that would have been avoided if it had reported such errors as required. In contrast, the ConsensusDOCS only require the contractor to report those errors that it discovers and it is only liable for those it "knowingly fails" to report.

- *Mitigation of Damages* – In the event that the contractor breaches the construction agreement, the ConsensusDOCS require that the owner take steps to mitigate its damages while the AIA documents do not impose this obligation.

- *Retainage* – The ConsensusDOCS provide the disbursement of retainage earlier in the project and no additional money is retained after 50% of the work is complete, while the AIA documents do not provide for retainage disbursement until substantial completion and money is retained throughout the project.

- *Termination* – If the owner wants to terminate the contractor for cause, under the AIA documents it must give the contractor one 7-day notice. The ConsensusDOCS require two notices to the contractor and an opportunity to cure, extending over 21 days.

Despite COAA's endorsement of the ConsensusDOCS there are clearly some provisions that an owner ought to consider modifying. Nevertheless, structurally, the ConsensusDOCS offer an interesting and possibly attractive alternative to the traditional AIA forms. It is important, however, that an owner choose its desired document set before contacting contractors or architects. All documents used on a project should come from one document set because the two sets are incompatible. Additionally, owners should develop a modified form document to send to interested contractors and architects before initially contacting them so later negotiations begin from an owner-friendly stance, initial pricing takes the revised contract terms into account, and there is no misunderstanding of the owner's intent to use a modified form of contract from the onset.

10% total recycled fiber

This publication is printed on Cougar recycled paper. It is a Forest Stewardship Council (FSC) certified stock using 10% post-consumer waste (PCW) fiber and manufactured in a way that supports the long-term health and sustainability of our forests.