

BKD Blueprint



Experience clear guidance on the issues you face from BKD National Construction & Real Estate Group.

BKD's construction & real estate practice takes a new step

by Jerry Henderson,
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As a client or friend of BKD, you probably know for many years we have been focused on meeting the needs of the construction and real estate (C&RE) industry through tools such as this Blueprint newsletter, specialized annual training for our professionals and selective involvement in other leading industry organizations.

But recently, we have made a decision to step up this commitment. In summer 2008, C&RE was formally named as one of BKD's five leading industry focuses.

Keep a close eye on your company's financing agreements

by Trent Parten, tparten@bkd.com

With the ongoing banking crisis and the country's overall economic woes, many companies are trying to understand how their financing needs will be

What does this industry designation mean?

For starters, it means even more resources devoted to meeting the needs of our clients and friends with timely information. One example of this is BKD's C&RE webcast series, which we launched in January, to provide at least quarterly webcasts on topics timely to your current operating environment (see www.bkd.com/industry/construction-realestate/Webcast/ for upcoming webcasts).

It also means we are working hard behind the scenes to develop even more tools for the benefit of our clients, such as proprietary benchmarking and enterprise

risk management tools for contractors and developer/operators that will be launched later this year.

Additionally, it means an increased commitment to involvement in key industry trade organizations at all levels—local, regional and national. This involvement will not only mean we are aware of emerging trends, but also will ensure we have a voice in helping shape the debate on issues that will affect our clients and friends.

Finally, later this year, we begin moving toward electronic communication tools. As we move in this direction, it will give us the opportunity to share relevant information on developing issues even more quickly.

Our commitment to you

As we advance our commitment to the C&RE industry, we are fully aware many of you are facing unprecedented economic challenges. We know even more of you will begin to face new challenges as this year unfolds. During these tumultuous economic times, we will stay focused on the issues that are important in helping you deal with these challenges and will continue to look for ways to bring solutions that will be a true benefit to you. That is one thing that hasn't changed. ■

affected. Banks are under heavy scrutiny from federal regulators and this will lead to some changes in banking relationships. Credit markets are tight and any company

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BKD to email news & alerts

Because we want to keep you informed and conserve valuable resources, BKD news and alerts will be distributed via email. We will use this method to send you important information about the construction and real estate industries: **therefore, July 2009 will be the last printed edition of BKD Blueprint.**

To ensure you continue to receive accounting, tax and other important news and commentary from BKD, **we need your email address.**

See inside for instructions on updating or providing your email address and look for more information regarding emailed news and alerts soon. If you have already provided your email, thank you and please disregard this notice.

Inside

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Tenant bankruptcy can affect relationship

by Thomas W. Rogers, special contributor,
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As the economy pushes more businesses into financial trouble, many tenants are seeking bankruptcy protection. This article will provide a brief overview of the bankruptcy process and its effect on the landlord-tenant relationship.

The process

Bankruptcy permits the tenant to shake off unprofitable financial relationships without the usual unpleasant consequences. A tenant commences a bankruptcy case by filing a petition seeking bankruptcy relief. The date on which a petition is filed is referred to as the petition date. Events and transactions before the petition date are generally referred to as pre-petition matters while claims, events

and other actions occurring or arising after the petition date are called post-petition matters. Within a few days of the filing, the bankruptcy clerk serves a notice on parties the tenant identifies as creditors.

Filing the petition establishes a bankruptcy “estate” over which the court gains jurisdiction. All of the tenant’s property, including leasehold interests, make up the estate. Once a tenant has filed bankruptcy, an automatic stay goes into effect that prohibits the landlord from proceeding with collection or eviction efforts, regardless of whether the landlord has been notified of the filing.

Violations of the automatic stay, including any demand for pre-petition rent or late fees, can sometimes subject the violator to harsh penalties. Thus, it is imperative the landlord honor the automatic stay and refrain from taking any action

against the tenant outside the bankruptcy proceeding.

Subject to certain exceptions, and provided the tenant complies with a number of related requirements, the tenant may either assume or reject an unexpired lease. The decision to assume or reject the lease is a matter within the sound business judgment of the tenant. After the tenant has filed for bankruptcy, it has up to 120 days to decide the fate of its lease. Thereafter, the tenant can ask the court for an extension of up to 90 days. This means a tenant has up to 210 days to decide whether to assume or reject the lease.

Assumption

Assumption is the legal continuation of the landlord-tenant relationship. If the tenant is in default on the date, it elects to assume the lease and continue the relationship, the tenant must do the following before the assumption will be approved: cure the default, compensate the landlord and convince the landlord, in the future, the tenant will perform as expected under the lease. However, the Bankruptcy Code shields tenants from the application and effect of certain nonmonetary provisions and “disincentive clauses.” These clauses include provisions in the lease that make the tenant’s insolvency or bankruptcy an event of default. Such provisions are unenforceable against a tenant in bankruptcy.

In the case of a shopping center lease, the tenant also must convince the landlord that, among other things: any percentage of rent will not decline substantially; the assumption of the lease is subject to all of the tenant’s obligations under the lease, including any radius, location, use or exclusivity provision and the assumption will not disrupt any tenant mix or balance in the shopping center.

Rejection

Rejection is a process by which the tenant actually breaches the lease. If a tenant rejects a lease, the rent owed pre-bankruptcy becomes part of the landlord’s pre-petition claim. The Bankruptcy Code provides streamlined procedures for the tenant’s initiation of the lease rejection. It

One more threat to your cash flow: governmental contract withholding

by Tom Pretti Jr., tpretti@bkd.com

You may recall during the summer of 2006, many contractors became concerned about legislation indicating contractors performing services or selling property to federal, state or local governments would have income tax withheld on their contract payments. National construction trade groups, journals and interested parties spoke out about the burden this placed on the industry and vowed to see the legislation repealed.

Fast forward to December 5, 2008, and to the frustration of contractors across the nation, the Internal Revenue Service (IRS) issues proposed treasury regulations providing guidance on the implementation of such a withholding practice.

This article will help contractors understand the source of this new law, its impact, key concepts and how to prepare for its coming implementation.

Internal Revenue Code Section 3402(t) was created in May 2006 as part of the *Tax Increase Prevention and Reconciliation Act*

of 2005 (TIPRA). TIPRA was primarily enacted to modify the Alternative Minimum Tax (AMT) on individuals for 2006, extend the favorable capital gains and qualified dividends tax rates through 2010 and to increase the amount of the Section 179 provisions allowing the current expensing of certain depreciable property. However, with the good came the bad, and TIPRA also included a provision for withholding requirements on government contracts.

Section 3402(t) of the Internal Revenue Code specifically indicates the federal government, state governments and every political subdivision thereof are required to withhold 3% on any payment to any person providing property or services after December 31, 2010. (Note: *The American Recovery and Reinvestment Act of 2009* (ARRA) stimulus bill provided a one-year reprieve by delaying the enactment until after December 31, 2011.) The regulations clarify which government entities are affected, when withholding is

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with landlord

also outlines the way to calculate claims for damages arising from the breach and indicates how the resulting claim will be treated.

Upon the rejection of a lease, damages are calculated by taking the greater of either the rent reserved by the lease for one year or 15% of the remaining rent under the lease, but not to exceed the rent reserved by the lease for three years and then adding any unpaid pre-petition rent to that amount. Courts also have applied the damage calculation to lease termination damages when the debtor is a guarantor of the lease and not the tenant. Security deposits are included within the bankruptcy

estate. As a general rule, if the landlord applies the security deposit post-petition, the security deposit will be subtracted from the landlord's rejection damages claim.

Assignment

The Bankruptcy Code renders unenforceable the provisions in the lease that prohibit assignment. If the tenant wants to assign the lease, it must first assume the lease and provide adequate assurance of future performance by the assignee of the lease, regardless of whether there has been a default under the lease.

Conclusion

This article is intended to provide an overview of the bankruptcy process and its effect on the landlord-tenant relationship. However, it is not designed to substitute for the legal advice of an experienced bankruptcy professional. If you are a landlord or tenant and you are confronted with a bankruptcy case, you are encouraged to contact an attorney, preferably a bankruptcy attorney, for advice on protecting your rights. ■

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Keep a close eye on your company's financing agreements

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with external financing should be prepared for its lender to take a thorough look at existing financing agreements.

Understanding where your company stands with its financing agreements is key to preparing for these changes. Financing agreements can vary widely by financial institution, but most loans have some level of debt covenants. A debt covenant is a clause included in the financing agreement to protect the lender. These covenants can range from minimum insurance coverage and limits on distributions of the company's earnings to restrictions on changes in management of the company.

Many financing agreements include financial covenants. Financial covenants are typically measured using the company's financial statement information. Failed financial covenants can give lenders the right to call the loans.

Financial covenants vary widely between lenders and set minimum financial performance thresholds. Some common examples include:

- **Debt service charge** – earnings before interest and depreciation divided by annual debt service requirements
- **Funded debt to EBITDA** – total interest bearing debt divided by earnings before interest, taxes, depreciation and amortization

- **Debt ratio** – total debt divided by total assets
- **Debt-to-equity** – total debt divided by total equity
- **Minimum net worth** – sets a minimum level the company's equity can reach (management should pay particular attention to how net worth is defined in each lender's agreement)
- **Interest coverage** – earnings before interest and taxes divided by interest expense

Focus on financial covenants regularly but do not forget to monitor nonfinancial covenants. A lapse in insurance coverage or disposing of certain assets can lead to default of nonfinancial covenants.

Management should go beyond simply reporting what the lender requires, though, and check compliance with debt covenants monthly. Monitoring covenants in the interim can give management time to adjust operations and ensure compliance by required reporting periods. These adjustments could include monitoring discretionary spending, evaluating the need for additional capital from shareholders or cleaning up the balance sheet by repaying shareholder loans.

It is common to pay little attention to these covenants once an agreement is signed. This may not be a problem during prosperous times, but during an economic slowdown it may become harder to meet

these requirements. Bank regulators will take a closer look at your loan if you do not meet these covenants. This could mean halting further borrowings or requiring immediate payment of all outstanding borrowings. Failed covenants at a company's year end also could require all related debt to be classified as a current liability.

So management can efficiently monitor financing issues, the company should create a summary document listing details and specific calculations of all covenants related to outstanding financing agreements. Monthly financial results should be compared to these covenants for compliance. This will allow management to determine how much margin the company has to maintain compliance. Management also should continually update internal forecasts for reported results and compare the forecasted figures to the covenant requirements. Should issues emerge, management can make adjustments to planned operations or consider alternative sources of capital for financing operations.

Another key step to preparing for lean times is maintaining a relationship with your lender. The better your lender understands your business and management team, the easier it will be to work through difficulties your company may face. Should you face hard times, be proactive by taking a plan of action to your lender. Demonstrate to them you are aware of the issues at hand and are prepared to survive tough times. ■

One more threat to your cash flow . . .

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required, how the entities pay the tax, how contractors claim the tax withheld and what tax liability of the taxpayer this withholding satisfies.

Generally, the government bodies that will have contract withholding include (with broad general exceptions noted):

- Any contracts for the federal government—all branches, federal agencies, etc. (exception for confidential/classified contracts and certain public assistance/welfare programs with income-based eligibility)
- Any contracts for state governments—including the District of Columbia (exception for Native American tribal governments)
- Any contracts for political subdivisions of the state governments: county, local, municipal governments (exception for political subdivisions making payments of less than \$100 million annually)
- Withholding on payments for real property and interest has a general exception

Persons subject to withholding include any individual, estate, trust,

partnership, association, company or corporation providing property or services to the above government bodies. The regulations clarify the payment must be \$10,000 or greater to generate a withholding requirement. The \$10,000 requirement is based on the payment issuance by the government subdivision, not on invoicing practices of the contractor and is subject to anti-abuse provisions.

How does this affect your business?

Before entering into contracts that continue past the December 31, 2011, cut-off date, consider the following:

- What cash reserve requirements will you have if 3% of these post December 31, 2011, contracts are withheld until the filing of your tax return (potentially greater than one year)?
- Do you need to modify your contractual requirements for payments with subcontractors for this withholding?
- Does the governmental contract qualify for an exemption from the withholding requirements?
- Should your business plan be modified to pursue or avoid these types of public works contracts?
- Do you need to plan for increases in your working capital lines of credit to

cover this new withholding requirement?

Although you have some time before December 31, 2011, construction companies and business owners need to adequately plan for these changes. Contact your BKD advisor for more help with this issue. ■

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