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Pillsbury Winthrop Shaw Pittman LLP

Energy Consumption Data Reporting in California – AB 1103 and 531

by Eric A. Kremer and Carmela D. Nicholas

The English philosopher Sir Francis Bacon once said that "knowledge is power." New energy reporting requirements in California may soon give different credence to this quote by requiring that knowledge about power, specifically energy consumption in commercial buildings, becomes an inescapable part of the knowledge necessary to own, lease and finance a non-residential building in California.

California Assembly Bills 1103 and 531 were enacted on October 12, 2007, and October 11, 2009,[1] respectively, and require non-residential building owners and operators to record and disclose energy consumption data to prospective purchasers, tenants and lenders for the 12-month period preceding the disclosure. The benchmarking and disclosure requirements of these bills were originally scheduled to take effect on January 1, 2009, but, after a series of delays, they currently are scheduled to commence on July 1, 2013.[2]

This article explores the potential pitfalls of AB 1103 and 531 and provides recommendations for commercial building owners and recipients of the energy consumption data.

General Requirements of AB 1103 and 531

The basic framework for the legislation is in California Public Resources Code Section 25402.10. The statute provides in part as follows:

> (a) On and after January 1, 2009,[3] electric and gas utilities shall maintain records of the energy consumption data of all nonresidential buildings to which they provide service. This data shall be maintained, in a format compatible for uploading to the United States Environmental Protection Agency's ENERGY STAR Portfolio Manager, for at least the most recent 12 months.
>
> (b) On and after January 1, 2009,[4] upon the written authorization or secure electronic authorization of a nonresidential building owner or operator, an electric or gas utility shall upload all of the energy consumption data for the account specified for a building to the United States Environmental Protection Agency's ENERGY STAR Portfolio Manager in a manner that preserves the confidentiality of the customer.
>
> (c) In carrying out this section, an electric or gas utility may use any method for providing the specified data in order to maximize efficiency and minimize overall program cost, and is encouraged to work with the United States Environmental Protection Agency and customers in developing reasonable reporting options.
>
> (d) (1) Based on a schedule developed by the commission pursuant to paragraph (2), an owner or operator of a nonresidential building shall disclose the United States Environmental Protection Agency's ENERGY STAR Portfolio Manager benchmarking data and ratings for the most recent 12-month period to a prospective buyer, lessee of the entire building, or lender that would finance the entire building.

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> If the data is delivered to a prospective buyer, lessee, or lender, a property owner, operator, or his or her agent is not required to provide additional information, and the information shall be deemed to be adequate to inform the prospective buyer, lessee, or lender regarding the United States Environmental Protection Agency's ENERGY STAR Portfolio Manager benchmarking data and ratings for the most recent 12-month period for the building that is being sold, leased, financed, or refinanced.

The Proposed Regulations dated March 2012 (the "Regulations") of the California Energy Commission (the "Commission"), set forth the schedule and procedure for implementing AB 1103 and 531. Under the current Regulations, the commencement dates for implementation are based on square footage, as follows: (i) January 1, 2013, for a building of more than 50,000 square feet; (ii) July 1, 2013, for a building of more than 10,000 square feet up to 50,000 square feet; and (iii) January 1, 2014, for a building between 5,000 and 10,000 square feet. (There are currently no express benchmarking or disclosure requirements for a non-residential building of less than 5,000 square feet.) According to the Commission's website as of November 14, 2012, however, the initial compliance date will be postponed to July 1, 2013, under new proposed regulations containing an updated schedule of implementation to be made available by November 27, 2012. The Commission's website currently indicates there will be no substantive changes from the March 2012 Regulations.

Monitoring the implementation dates for the bills is important, because under Section 1685(a) of the Regulations, once implemented, a building owner must do the following at least 30 days before a disclosure is required: open an account at the EPA's Energy Star Program Portfolio Manager website; provide the owner name, building name, address and other identifying information; identify all sources of energy use data for the entire building for at least the most recent 12 months; and request that all utility and energy providers serving the building release energy use data for the entire building from the most recent 12 months to the owner's Portfolio Manager Account or manually enter all data to such account. Under Sections 1685(b) and (c) of the Regulations, a utility company is required to upload the data within 15 days of an owner's request, and the owner or operator has 30 days thereafter to access the data for disclosure purposes.

The statute does not define the term "building operator," so it is unclear which entities, apart from property owners, would fall under this definition.

Affected Parties

Building Owners and Operators

Notably, the benchmarking and disclosure requirements and the Regulations apply only to transactions between non-residential building owners and operators, and prospective buyers, tenants and lenders. The statute does not define the term "building operator," so it is unclear which entities, apart from property owners, would fall under this definition. AB 1103 does not expressly apply to transactions between sublandlords and subtenants, but if a sublandlord is leasing the entirety of the building under a triple-net lease, it could constitute an "operator" that must disclose the energy usage data to potential subtenants of the entire building.

Buyers, Tenants and Lenders

Section 1684 of the Regulations requires owners to disclose the data to the prospective buyer, tenant or lender "as soon as practicable" before execution of the purchase and sale agreement or lease, or submittal of the loan application, as applicable. Section 1684 also clarifies that the disclosure is required only to a buyer, tenant or lender financing the *entire building*. Accordingly, any prospective tenant looking to occupy less than the entire building would legally not be entitled to obtain the data. It also is unclear whether a construction lender that is financing improvements for only a portion of the building would be entitled to the energy consumption data, even if the loan is secured by a deed of trust that encumbers the entire building and property.

Energy Consumption Data Reporting in California – AB 1103 and 531 (continued)

No Updates Required

Neither the statute nor the Regulations require the owner to update the data after the initial disclosure. The Legislative Counsel's Digest for AB 1103 provides:

> *After the benchmarking data and ratings are disclosed, the property owner, operator, or his or her agent would not be required to provide additional information regarding the benchmarking data and ratings. The information disclosed would be considered adequate to inform the prospective buyer, lessee of the entire building, or lender that would finance the entire building of the benchmarking data and ratings for the building.*

The absence of an obligation to update the data could present a problem for a prospective tenant, buyer or lender where the closing is scheduled to occur several months after the initial disclosure. For this reason, a recipient of the data would be well served to require the owner to update the disclosure in a purchase agreement, lease or loan agreement, as applicable, on a quarterly or semi-annual basis. In addition, a lender or buyer may wish to consider including an express negative covenant against the energy rating falling below the initial rating in its agreement with the building owner if the energy rating is a material attribute of the building's value.

Tenants' Data

Risk of Misuse

One of the reasons for the delayed implementation of AB 1103 and 531 is the concern over the privacy of a tenant's energy usage data. Under Section 1685(b) of the Regulations, if more than one account exists in a building, such as a multi-tenant building with separately metered utilities, a utility company must aggregate or "use other means to reasonably protect" the account holder's data from uses other than compliance with Public Resources Code Section 25402.10. However, it is unclear from the Regulations to what extent an owner could use the data, and the Regulations do not set out penalties for any owner's misuse of an account holder's information. For instance, it is unclear whether a building owner's use of the data to enforce "green" lease provisions against a tenant, such as to establish a violation of excessive energy consumption requirements, would violate the Regulations. If the Regulations are construed narrowly, such use would not be in compliance. In addition, protection of a tenant's data and identity is difficult, if not impossible, in multi-tenant buildings occupied by few tenants.[5] For example, in a multi-tenant building with three or fewer tenants, a landlord could ascertain a new tenant's increased energy usage by comparing it to usage data for periods before such tenant's occupancy, and, in single-tenant buildings, there is no means of protecting the identity of the tenant from the building owner or operator.[6]

One of the reasons for the delayed implementation of AB 1103 and 531 is the concern over the privacy of a tenant's energy usage data.

Obstacles to Obtaining Tenants' Data

There also are difficulties with obtaining the required disclosure data where a tenant is unwilling to provide a written release to the utility company. A landlord may require that a tenant consent to disclosure by the utility company in future leases, but for existing tenants (or tenants that occupied the building within the last 12 months, but no longer occupy the building) that have not previously consented to disclosure of energy usage records, it may be difficult for an owner to obtain the data. Under the California Public Utilities Code, a utility company may not disclose a customer's electrical or gas consumption data without the consent of the customer, unless all information regarding the individual identity of a customer has been removed or where required or permitted under state or federal law or by order of the Public Utilities Commission.[7] As noted above, removal of all identifying information is not possible

Energy Consumption Data Reporting in California – AB 1103 and 531 (continued)

where there is a single-tenant building or where there are few tenants and aggregation may not conceal the identity of the tenant. Although the statute requires the building owner to comply with the reporting requirements, it does not require the tenant to consent to disclosure of its account.[8] In order to resolve this problem, building owners should include provisions in future leases, amendments or lease termination agreements that expressly require tenants to provide written consent to disclosure of energy usage records in the form required by the applicable utility company.

Conclusion

Until the Commission issues additional regulations that clarify the ambiguities and other issues identified in this article, building owners and operators should err on the side of strict compliance. Parties entitled to receive the energy usage data should be mindful of the shortcomings of the existing reporting requirements and insist on including provisions that require updates to the data or covenants relating to energy ratings in the underlying agreements with the owner. It remains to be seen if knowledge about power consumption equates to knowledge that gives power, but California non-residential building owners, lenders and tenants are on notice that they need to devote some energy to ascertaining an answer.

Endnotes

1 *See http://www.energy.ca.gov/ab1103/documents/ab_1103_bill_20071012_chaptered.pdf; http://www.energy.ca.gov/ab1103/documents/2011-09-12_workshop/2011-09-12_Assembly_Bill_531.pdf*

2 *See http://www.energy.ca.gov/ab1103/*

3 *As noted above, the law will be implemented commencing on July 1, 2013.*

4 *As noted above, the law will be implemented commencing on July 1, 2013.*

5 *"Demonstrating Value and Overcoming Data Privacy Obstacles to Achieve Universal Benchmarking: Key Lessons Learned from California," Amy Barr and Douglas Mahone, Heschong Mahone Group, Inc., Andrew Burr, Institute for Market Transformation, Theda Silver-Pell, Pacific Gas and Electric Company (©2012 ACEEE Summer Study on Energy Efficiency in Buildings), at http://www.aceee.org/files/proceedings/2012/data/papers/0193-000083.pdf*

6 *Id.*

7 *California Public Utilities Code Section 8380(b), (e).*

8 *There is a safe harbor for building owners that are unable to obtain energy usage information, which should include unwilling or unresponsive tenants. Section 2685(e) of the Regulations permits the owner to approximate the information, if the owner has "made a reasonable effort to ascertain the missing information," and the approximation is reasonable and based on the best information available to the owner and not for purposes of evading compliance. However, where an owner has a single-tenant building, or the building has been occupied by more than one tenant for an extended period of time, this information could be difficult to approximate.*

Eric A. Kremer is a partner in Pillsbury's San Diego North County office. He can be reached at 858.509.4021 or at eric.kremer@pillsburylaw.com

Carmela D. Nicholas is a senior associate in Pillsbury's San Diego North County office. She can be reached at 858.509.4058 or at carmela.nicholas@pillsburylaw.com

Real Estate and Construction Risk Management: Tips to Ensure Your Status as an Additional Insured

by James P. Bobotek

Whether you are a lender, owner or contractor, your success hinges largely on the development of, and adherence to, effective risk management practices. Among the most important risk allocation tools are properly drafted indemnity and insurance provisions in project documents. This article describes the basics of additional insured requirements, which are frequently overlooked but are central elements of these provisions, and identifies ways to ensure that additional insured status is properly documented.

What Is an Additional Insured?

There are three categories of insureds under a typical commercial general liability policy: (i) named insureds; (ii) automatic insureds; and (iii) additional insureds. Named insureds are those individuals or entities to whom the policy is issued. Named insureds typically have more rights and responsibilities than additional insureds and are also subject to more exclusions. Automatic insureds are individuals or entities who are automatically provided with insured status in the policy by virtue of having close ties to the named insured, such as the named insured's directors, officers, and employees. Additional insureds are individuals or entities who require insured status under another party's insurance program in conjunction with a business relationship.

Additional insured status provides a party with the benefits of insurance coverage obtained by another party, usually under the latter's commercial general liability (CGL) insurance. While the requirement for such status has become commonplace, especially in the construction and commercial leasing arenas, the extent of coverage received by the additional insured depends on what the party requires in its contracts and what the other party's insurer is willing to provide. The actual scope of coverage is determined by reference to the policy's additional insured endorsement, as well as the other terms of the policy. Generally speaking, there is no premium cost associated with securing this status.

Why Seek Additional Insured Status?

There are myriad reasons for requiring additional insured status under another party's liability policies. Additional insured status under another party's insurance shifts the risks to the party that is undertaking activities independent from and unsupervised by the additional insured. For example, it reinforces indemnity provisions by providing the additional insured with protection in the form of direct rights under the indemnitor's policy. Additional insured status also provides the additional insured with the right to an immediate defense (without affecting policy limits) by the named insured's insurer, rather than seeking reimbursement of defense costs from an indemnitor. Further, if a court finds that an indemnification clause is unenforceable, the putative indemnitee may still enjoy the intended protection through its status as an additional insured (subject, of course, to the terms and conditions of the indemnitor's policy).

Real Estate and Construction Risk Management: Tips to Ensure Your Status as an Additional Insured (continued)

Other reasons to require additional insured status include the following:

- It may prohibit the indemnitor's insurer from subrogating against the indemnitee when a loss is caused by the indemnitee's acts or omissions.
- Insured losses may not affect the "loss history" of the additional insured, thus enabling it to avoid related increases in insurance premiums.
- It may substantially increase the limits of insurance available to the additional insured for a given operation or project.
- It may lessen the chance that the additional insured will be forced to sue the indemnitor directly to be made whole following a claim or suit.
- It may increase the chances of cooperation between the indemnitor and indemnitee in the event of a claim or suit.

How Does an Entity Become an Additional Insured?

Under most circumstances, a person must be an insured under a liability insurance policy to obtain protection under that policy. Generally speaking, one cannot attain additional insured status under a liability policy without some specific language establishing that status. Such status is usually conferred by way of a policy endorsement. Some endorsements, known as "blanket" endorsements, create additional insured status without specifying the precise person or entity who will qualify as an additional insured. For example, some create additional insured status where the named insured agrees in a contract to include another party as an additional insured. While standard Insurance Services Office (ISO) additional insured endorsements have been available for use in conjunction with CGL policies for many years, in the early 1990s, ISO began scaling back the coverage provided under the endorsements. Because of this, the specific edition date of each endorsement may play a critical role. For instance, while the most frequently used ISO "blanket" additional insured endorsements are the current CG 20 10 and CG 20 37 forms, the CG 20 10 11 85 (the November 1985 version) endorsement provides by far the most comprehensive additional insured coverage available.

Ensure that Completed Operations Coverage Is Properly Addressed.

An additional insured will want coverage for liability associated with the indemnitor's work in progress (e.g. a project owner, for the work being performed by the general contractor, or a general contractor, for the work being performed by a subcontractor). But the additional insured also faces a continuing liability exposure from the indemnitor's work even after that work is completed. Damage to the project itself (or to contents) from faulty construction and bodily injury to occupants of a building from defects or dangerous conditions associated with the construction can occur after the project is turned over to the owner. Additional insured coverage for this "completed operations" exposure is one of the most important issues in construction risk management.

When they were introduced in 1986, standard construction-industry additional insured endorsements like the CG 20 10 provided coverage to the additional insured in connection with the named insured's "work." The CGL policy defines the named insured's work, "your work," in such a manner as to include work that has been completed. In other words, additional insured endorsements originally included completed operations coverage. In 1993, however, the CG 20 10 was revised in an effort to remove completed operations coverage from the endorsement. In response, in 2001 ISO promulgated an endorsement (the CG 20 37 form) designed specifically to insure an additional insured's liability in connection with the named insured's completed operations. Thus, it is now necessary to seek additional insured coverage either under the 1986 version of the CG 20 10 (which includes completed operations coverage) or to insist that both the CG 20 10 and CG 20 37 forms are endorsed to the policy.

Real Estate and Construction Risk Management: Tips to Ensure Your Status as an Additional Insured (continued)

No Need to be Included as an Additional Insured Under Auto Policies; Coverage Already Exists Without Any Action.

The "Who is an Insured" section of most commercial auto policies creates three categories of insureds: (i) the named insured ("you"); (ii) various persons using a covered auto owned, hired or borrowed by the named insured with the named insured's permission (the "permissive user" category of insureds); and (iii) anyone liable for the conduct of an insured in either of the other two categories (i.e., the named insured or an insured permissive user) to the extent of that liability. It is the third of these categories that extends insured status to anyone who may incur vicarious liability for the conduct of another insured and that commercial auto policy insureds may look to in complying with contractual demands that they provide additional insured status to another party.

Note that the insured is not required to take any specific action to arrange insured status for "additional insureds" under a commercial auto policy. In this respect, the commercial auto policy is different from, and more convenient than, the CGL in the way it addresses insured status for the named insured's indemnitees. It builds such coverage into the form itself, without the need for an endorsement. In fact, because it automatically includes as an insured anyone liable for the named insured's conduct to the extent of such liability, no contractual requirement of additional insured status is even necessary to trigger this feature of commercial auto policy coverage.

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Don't Rely on Certificates of Insurance.

It is common for owners and contractors to rely on a cursory review of certificates of insurance to "confirm" compliance with insurance requirements. This practice is extremely risky, as many insurance certificates include incorrect and/or incomplete information, such as omitting mention of risk-changing exclusions or endorsements. In addition, most certificates of insurance are prepared using an industry-standard form. Courts have found that these forms are so replete with express disclaimers that they are not legally binding on the party providing them. As such, it is advisable to require not only a certificate of insurance and endorsements evidencing the proper additional insured status, but also a copy of the applicable insurance policies. Performing a diligent review of the information provided will greatly diminish, if not remove, the anguish, costs and lost time suffered upon discovery, after a claim is made, that the coverage identified in the certificate of insurance is not what the actual policies provide, and is not what was required under the relevant contract.

Confirm that the Additional Insured Status Meets Your Contractual Requirements.

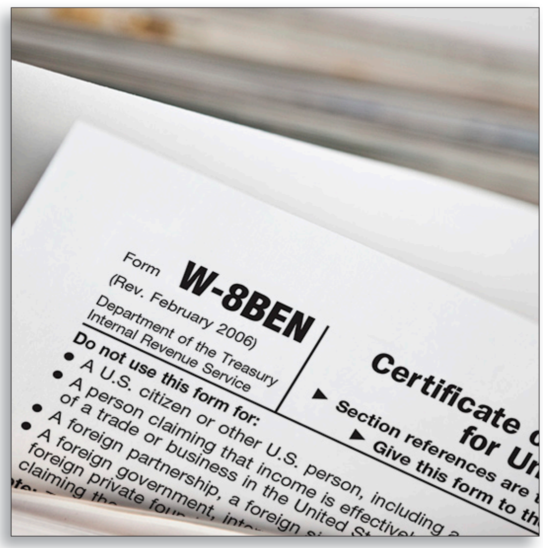
Additional insureds should confirm that the additional insured coverage is as broad, or broader, than the contractually required coverage. On the flip side, if you are obligated under a contract to include an entity as an additional insured under your CGL policy, make sure that you do not inadvertently provide additional insured coverage broader than that required. Many parties to a construction project fail to adequately confirm that insurance requirements have been satisfied, either upon execution of the contract or throughout the duration of the project. Additional insured provisions provide no benefit if they were not obtained or are permitted to lapse.

James P. Bobotek is a senior associate in Pillsbury's Washington, DC, office. He can be reached at 202.663.8930 or at james.bobotek@pillsburylaw.com.

Attention: New Foreign Tax Withholding Forms

by Dana P. Newman

The Internal Revenue Service (IRS) recently announced that it is modifying certain of its tax forms, known generally as Form W-8s, used by foreign individuals and entities ("Foreign Parties") to claim a reduction or exemption of withholding taxes on payments from U.S. sources ("U.S. Payors"). Payments subject to withholding include interest, rents, dividends and partnership distributions, all of which are extremely relevant to U.S. real estate activities. These new Form W-8s are scheduled to be finalized in December 2012 and available for use starting in 2013. If you are a U.S. Payor making payments to any Foreign Party in connection with your business activities, or if you are a Foreign Party receiving U.S.-sourced income, it is important that you are aware of the revisions to the Form W-8s to avoid any unintended tax withholding liabilities.



Background on Foreign Tax Withholdings

U.S. tax laws impose withholding tax obligations on any individual or entity making certain payments from U.S. sources to any Foreign Party, including payments of interest, dividends, rents, royalties and partnership distributions. Unless there is an exemption or reduction in the withholding tax rate, the withholding tax rate on these payments is generally a flat 30% of the payment (except in the case of partnership distributions, where the withholding tax rate is the highest rate applicable to the type of income allocated by the partnership). A Foreign Party may be eligible to claim a reduced rate of withholding under one of several exemptions, and, as discussed below, such exemptions are claimed by filing the Form W-8 for the applicable exemption.

Compliance with the U.S. withholding tax rules is critical for both U.S. Payors and Foreign Parties. If a U.S. Payor fails to make the proper withholding, the U.S. Payor is personally liable to the U.S. Treasury for any taxes not withheld from the payments to the Foreign Party. This liability can be particularly costly to the U.S. Payor if there is a longstanding payment history between the parties. However, receipt by a U.S. Payor of a Form W-8 from a Foreign Party that reduces or eliminates the applicable withholding taxes protects the U.S. Payor from any liability for not withholding taxes in excess of the reduced rate. Similarly, if a Foreign Party fails to provide the proper documentation to claim a reduction or exemption from the withholding tax, the Foreign Party is required to pay the 30% withholding tax rate. This mistake can be costly, because once withholding tax is paid, it is difficult to obtain a refund.

Changes to the Form W-8

Currently, there are four basic categories of Form W-8: (1) Form W-8BEN (Certificate of Foreign Status), (2) Form W-8ECI (Certificate of Claim that Income is Effectively Connected with Conduct of U.S. Trade or Business), (3) W-8EXP (Certificate of Foreign Government), and (4) Form W-8IMY (Certificate of Foreign Intermediary). The IRS last published these forms in 2006.

Attention: New Foreign Tax Withholding Forms (continued)

In May 2012, the IRS began publishing revised drafts for all of the Form W-8s. Based on the published drafts, the proposed changes to Form W-8ECI and Form W-8EXP are not substantive. However, the proposed changes to the Form W-8BEN and Form W-8IMY are significant. These changes are described below.

Revised Form W-8BEN

A foreign entity filling out this form will now be required to categorize itself by selecting only one of the over 20 possible categories for its type of entity.

The 2006 Form W-8BEN is widely used in connection with real estate transactions, and it is the form used by Foreign Parties who can claim the benefit of a tax treaty between their country of residence and the U.S. to reduce the applicable withholding tax on their U.S.-sourced income. The U.S. has many tax treaties in place with other countries, which reduce the withholding tax rate in general to 15-20% depending on the type of income and, in many cases, even eliminate the withholding tax entirely. The 2006 Form W-8BEN is a single-page form in which the Foreign Party provides certain identification information (e.g., name, type of entity, address) and certifies that it is a resident of a particular country. The proposed 2012 Form W-8BEN is now split into two separate forms, a W-8BEN and a W-8BEN-E. The 2012 W-8BEN is similar in content to the 2006 Form W-8BEN, except only foreign individuals can use this form. All foreign entities, including corporations, partnerships, trusts, tax-exempt organizations and financial institutions, now must use the new Form W-8BEN-E.

As compared to the single-page 2006 Form W-8BEN, the 2012 Form W-8BEN-E is expanded to six pages. The reason for this increased complexity is that this new form is expanded to accommodate foreign financial institutions that are subject to the Foreign Account Tax Compliance Act (FATCA). Under FATCA, foreign financial institutions are subject to a 30% withholding tax on certain U.S.-sourced income unless the foreign financial institutions are registered with the IRS. It appears that the IRS created the new W-8BEN-E form with the purpose of having a single form applicable to all foreign entities subject to U.S. tax withholdings, including foreign financial institutions. A foreign entity completing this form will now be required to categorize itself by selecting only one of the over 20 possible categories for its type of entity. Fortunately, once this categorization is made, only the portions of the form that are applicable to the selected type of entity need to be completed.

Revised Form W-8IMY

The 2006 Form W-8IMY is the form used by Foreign Parties who are foreign intermediaries (including foreign banks, partnerships and trusts) to evidence that they are not acting for their own account and that they are taking responsibility for withholding and collecting the withholding certificates from the ultimate Foreign Party beneficiaries. The 2006 Form W-8IMY is a two-page form in which the Foreign Party provides certain identification information (e.g., name, type of entity, address) and certifies that it is either a qualified intermediary, nonqualified intermediary, U.S. branch or foreign partnership or trust.

As compared to the 2006 Form W-8IMY, the proposed 2012 Form W-8IMY is lengthened to seven pages. The reason for this increased complexity again is that the 2012 form is expanded to deal with foreign financial institutions that are subject to FATCA. As with the 2012 W-8BEN-E, a foreign entity filling out Form W-8IMY is required to categorize itself by selecting only one of the over 20 possible categories for its type of entity. Similarly, once this categorization is made, only the portions of the form applicable to the specific type of entity need to be completed.

Challenges of the New W-8 Forms

The increased complexity of the new 2012 Form W-8BEN-E and the new 2012 Form W-8IMY create a number of challenges for U.S. Payors and Foreign Parties completing these forms. Notably, a Foreign Party will be required to make a number of additional determinations before it can properly complete the form. In addition, the new complexities of the 2012 W-8 Forms likely will make it more difficult for U.S. Payors and Foreign Parties to determine the applicable withholding tax rate that applies to any payments to Foreign Parties. To avoid any unintended tax withholding liabilities on payments to Foreign Parties, U.S. Payors and Foreign Parties should carefully review the documents governing U.S.-sourced payments (e.g., loan agreements, leases, partnership agreements) to make sure that the parties are adequately protected against any inadvertent liability resulting from improper withholdings.

Dana P. Newman is a partner in Pillsbury's Los Angeles office. She can be reached at 213.488.7334 or at dana.newman@pillsburylaw.com.

Resolving Municipal Distress: Chapter 9 and Public-Private Partnerships

by Deryck A. Palmer and Samuel S. Cavior

The effects of the recent financial crisis and the ensuing recession continue to take their toll on municipalities in the United States, which are struggling with reduced revenues at the same time their residents have an increased need for government services. It has been reported that Atwater, California is considering Chapter 9 bankruptcy, and Atwater is not likely to be the last municipality to be faced with such a decision.[1] Many cities and counties will have to address extraordinary budgetary shortfalls as they face increasing operating and legacy costs (and in some cases, the consequences of bad investment decisions) in the distressed economic environment left by the real estate boom and bust, deteriorating local industries, declining tax revenues and reduced state aid.

Municipal credit ratings face reviews and downgrades, as demonstrated most recently by Moody's largely negative statewide action in California.[2] Many bond insurers have left the market since the 2008 financial crisis. Amid all this, states and municipalities facing fiscal discipline are understandably leery of adding to their debt burdens at increasing costs. In states where municipalities are permitted to use Chapter 9 of the U.S. Bankruptcy Code, they may elect to undertake a Chapter 9 restructuring. But for all municipalities, even those not specifically authorized by state law to pursue Chapter 9 restructurings, public-private partnerships may offer untapped revenue streams and alleviate municipal distress.

Chapter 9 Municipal Bankruptcies

Chapter 9 of the U.S. Bankruptcy Code was designed specifically to assist insolvent municipalities. A Chapter 9 bankruptcy is generally similar to a bankruptcy under Chapter 11, commonly used for corporate reorganizations. As Chapter 11 does for business debtors, Chapter 9 permits municipal debtors to continue operating, protected from creditors' debt-collection efforts, while in bankruptcy. With court approval, the municipality can "reject" burdensome contracts, replacing them (if necessary) with new contracts at market terms. With respect to rejection of labor contracts in particular, the municipal debtor may use the normal standard that is applicable to all other kinds of contracts, rather than the heightened standard for labor contracts required in Chapter 11 cases. To replace ordinary debt-collection mechanisms, Chapter 9 provides for the formulation, court approval and implementation of a "plan of adjustment" that specifies the classification and treatment of creditors' claims.

A Chapter 9 plan of adjustment can provide for the discharge of debt and rejection of certain contracts, allowing the municipality to effect a financial restructuring that reduces its past and going-forward obligations. Of course, uneconomical labor contracts and unmanageable debt burdens sometimes may be addressed outside of court with the consent of the affected unions and creditors, but Chapter 9 provides a mechanism for relief when consensual renegotiation of such contracts and obligations is not possible. As a result, in states permitting Chapter 9 restructurings, the mere threat of a Chapter 9 filing may make unions and unsecured creditors more willing to negotiate.

Resolving Municipal Distress: Chapter 9 and Public-Private Partnerships (continued)

Statutory and Credit Risk Limitations

While some municipalities may effectively wield Chapter 9 to restructure their financial affairs, either by threatening to file or actually filing a bankruptcy case, Chapter 9 is not a magic bullet. First, constitutional and statutory limitations prevent Chapter 9 from being as powerful, and hence as useful, as it might otherwise be. In particular, a bankruptcy court cannot require a municipality to take certain actions that may be critical to addressing a municipality's insolvency, such as raising taxes, cutting services, selling assets or changing municipal organizational structures, so unless the municipality elects to take these politically difficult revenue-generating or cost-saving measures on its own, a Chapter 9 proceeding may not effect a full restructuring of the municipality's finances. Municipalities that can benefit from taking such actions, however, might pursue them under state law while concurrently using Chapter 9 to restructure unsecured debts and labor contracts. Indeed some states, including Massachusetts, North Carolina, New York, Connecticut and New Jersey, have enacted legislation or taken case-by-case measures to facilitate this complementary use of state and federal law.

A second limitation on Chapter 9's usefulness is the perception that it may result in further damage to a municipality's credit rating, thereby making it harder and more expensive for that municipality to access the bond market for years. In part because of this perception, nearly half of all states currently do not authorize municipalities to use the federal bankruptcy statute.[3] Fear of a potential downgrade, not just for the debtor but for similarly situated municipalities (and possibly the state), can delay a municipality's decision to file for Chapter 9 and generally has the effect of forcing state intervention. Ironically, this delay can result in a deeper fiscal crisis for the municipality to address in Chapter 9.

Asset Privatization With or Without Chapter 9

The restructuring of troubled municipalities, with or without Chapter 9, is not an overnight process.

Whether or not eligible to pursue a Chapter 9 restructuring, some municipalities may wish to pursue privatization of public assets and services as an alternative to filing Chapter 9. The concept of privatization may seem socially and politically untenable; nevertheless, finding creative ways to partner public and private interests in order to invest in the maintenance or redevelopment of municipal resources offers opportunities for both savvy investors and distressed municipalities (and their citizens). No doubt some municipalities have assets that may now be more efficiently utilized in private hands. Under the right circumstances and terms, underemployed assets and all but the most essential services (i.e., waste disposal, water treatment, utilities, hospitals, transportation, education, etc., but not police and fire) could be privatized, outsourced or entrusted to public-private partnerships, thereby relieving municipalities of financial burdens, stimulating the local economy and possibly even generating some positive cash flow for those municipalities. Unlike the restrictive statutes regarding Chapter 9, many states already have enabling legislation to permit or promote public-private partnerships.

Furthermore, for those municipalities that are legally permitted to pursue a Chapter 9 restructuring, doing so does not preclude also privatizing assets and services through public-private partnerships. If, however, a municipality intends to elect both Chapter 9 and infrastructure development and privatization, then the timing of each should be considered. On one hand, if the economic environment is sufficiently conducive to private investment at the time a municipality begins to consider its options, it may wish to pursue such investment prior to filing Chapter 9, in the hope that the investment will obviate the need for Chapter 9 or, at the very least, that the advantages of such investment may be realized prior to any chilling effect Chapter 9 may have on the local economic climate. On the other hand, if the investment climate is crippled, a municipality may wish to seek private investment after a Chapter 9 proceeding, so that such investors may be able to take advantage of the concessions and efficiencies that are realized through the restructuring process.

Resolving Municipal Distress: Chapter 9 and Public-Private Partnerships (continued)

The restructuring of troubled municipalities, with or without Chapter 9, is not an overnight process. Often, the absence or neglect of real estate and infrastructure development is symptomatic of the problem. In ordinary times, few municipalities would choose to leverage public assets and services, but challenging times call for unconventional and even speculative solutions. For some municipalities, public-private partnerships may be worth considering as an element in the plan for getting back to a stable, long-term footing.

Endnotes

1 See BloombergBusinessweek, "California Insolvencies Mount as Atwater Votes Emergency (Oct. 10, 2012), available at http://www.businessweek.com/news/2012-10-03/california-mayor-asks-for-prayers-as-bankruptcy-looms; Reuters, "Atwater, California Declares Fiscal Emergency" (Oct. 10, 2012), available at http://www.reuters.com/article/2012/10/04/us-atwater-bankruptcy-idUSBRE8930AS20121004; and NBCNews.com, "Fourth California City Faces Bankruptcy as Municipal 'Disease' Spreads" (Oct. 10, 2012), available at http://usnews.nbcnews.com/_news/2012/10/04/14218808-fourth-california-city-faces-bankruptcy-as-municipal-disease-spreads

2 Moody's Investors Service, "Rating Action: Moody's reviews ratings of 32 California cities; nine pension bonds downgraded" (Oct. 9, 2012), available at http://www.moodys.com/research/Moodys-reviews-ratings-of-32-California-cities-nine-pension-bonds-PR_257248.

3 In fairness, however, filing Chapter 9 does not necessarily lead to a permanent credit rating purgatory. Orange County, which filed in 1994, managed to recover an investment-grade rating within a few years after emerging.

Deryck A. Palmer is a partner in Pillsbury's New York office. He can be reached at 212.858.1100 or at deryck.palmer@pillsburylaw.com.

Samuel S. Cavior is an associate in Pillsbury's New York office. He can be reached at 212.858.1146 or at samuel.cavior@pillsburylaw.com.

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To learn more, visit us at www.pillsburylaw.com/realestate

Practice Section Leader
Robert C. Herr
415.983.1038
robert.herr@pillsburylaw.com

Editorial Staff
Laura E. Hannusch, Editor-in-Chief
Peter G. Freeman, Christine L. Roch and Noa L. Clark, Editors
Steven Gelfond, Production
For mailing list inquiries, please email real.estate@pillsburylawcom