

# Corporate and Construction Update

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Our firm's corporate and construction clients are dealing with the challenging events of the recession. In an effort to assist our clients, analyze strategic issues and manage daily operations, we address various topics in our newsletters. If you have questions about these or other topics, then please let us know.

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## Community Dollars For Infrastructure Costs

There are a number of publicly available resources that can assist you with your quest to survive in these tight economic times. Taking advantage of these mechanisms can help you use capital otherwise tied up in certain areas for other projects.

## Tax Incremental Financing Districts ("TIFs")

In Illinois, TIFs have typically been used for the redevelopment of blighted industrial and commercial corridors. TIFs are redevelopment project areas created by a municipality in accordance with the requirements of the Illinois Tax Incremental Allocation Redevelopment Act. The purpose of TIFs is to use the incremental real estate taxes produced by new development in the project area to attract private investment. TIFs have recently been used to reclaim properties that do not fit the typical blighted area image, including unusual stormwater or wetlands areas that cannot successfully be developed with traditional financing. The eligible wetland mitigation costs in the TIF are either financed through the issuance of tax-exempt bonds by the municipality, or the developer will front the redevelopment costs by receiving developer notes from the municipality. The TIF increment is then used to pay off the debt, and the wetlands cost issues are solved.

## Special Service Areas ("SSA")/Special Assessment Areas ("SAA")

SSAs and SAAs are allowed by state statute (in Illinois, at least) and some developers are using them to fund the cost of construction of roads, sidewalks, detention facilities, sanitary sewer mains and on-site lift stations, water mains, storm sewers, and other infrastructure improvements within newly developed subdivisions. Although traditionally used in residential settings, they are now being considered to finance public infrastructure where there is an insufficient tax base to attract and support commercial and industrial projects.

Special assessment bonds are issued to pay for the public improvements, and then special tax assessments are collected against the record owners. By using assessment financing provided by the municipality, developers can then use their funds elsewhere in the project.

As a normal rule, the amount of bond issuance is tied into the property's market value as finished lots. Eligible public improvements are usually limited to on-site improvements and are specifically spelled out in the statute.

### **Enterprise Zones**

An Enterprise Zone is a specific geographic area targeted for economic revitalizing and is authorized under the Illinois Enterprise Zone Act. They encourage growth and investment in distressed areas by offering tax advantages and incentives to businesses located within the zone boundaries. As of last year, there were at least 89 designated enterprise zones in Illinois. Sales tax exemptions, tax credits, and income tax deductions are all available for projects in these areas.

### **Industrial Revenue Bonds ("IRBs")**

IRBs can be structured as tax-exempt revenue bonds issued for traditional manufacturing companies to finance the acquisition of assets such as land, buildings, and equipment or to construct new or renovate existing facilities. Taxable bonds have also been used to finance government related construction activities for otherwise unqualified commercial activities. Interest rates are generally lower on tax-free bonds than private financing, but the disadvantage of tax-exempt IRBs comes with their technical eligibility restrictions.

If you have any questions regarding these concepts and their application to your situation, please feel free to contact:

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## **Are You Worried About Your Loan?**

You have just ended another difficult quarter, and your accountant has provided you with your financial statements. What do you say to your banker about your loan covenants? These days, bankers are asking themselves similar questions with respect to their financial statements and the bank auditors.

### **Bankers Want To Reduce Exposure**

A key goal is to make certain that your loan is performing. If payments are being made and there has been no breach of a loan covenant, you should be in good shape to talk with your banker about restructuring the loan. Today, bankers want to reduce their credit exposure.

### **Reduce the Amount Due**

There are several ways to reduce the amount due on the loan. The first way is for you to make an additional payment. In today's economy, **Cash Is King**, so many borrowers want to hang on to every last dime. If you have an out parcel, then consider selling it to another investor or a potential user. The bank may be willing to finance the sale because you have reduced your loan by the amount of the sales price or a portion thereof and the bank has another borrower to look to for payment. You may be giving up some potential future gains by selling now, but you may be avoiding a more immediate problem with the bank.

If you are in the middle of drawing down on your construction loan and the bank has committed for the end loan, then consider scaling back on the scope of the project. The end loan will be less than the original amount the bank committed.

### **Loan Covenants**

If you are going to reduce the amount due on your loan, then use this as an opportunity to re-negotiate the various loan covenants. Today, bankers are focused on the **Debt Service Coverage Ratio** ("DSCR"). In commercial real estate finance, DSCR is the primary measure to determine if a property will be able to sustain its debt based on cash flow. The general formula for commercial real estate is:  $DSCR = \frac{\text{Annual Net Income} + \text{Amortization} + \text{Depreciation}}{\text{Principal Repayment} + \text{Interest payments}}$ . Up until the mid-2000s, many lenders would require a DSCR of at least 1.2; however, as we entered into 2006 and 2007, lenders were willing to accept DSCRs of less than that amount since the lenders took comfort in the rising prices of commercial real estate and the financial strength of the borrowers. Today, the lenders are discounting lease payments of all tenants, except for those with excellent credit.

Once you get by the DSCR, the bankers are looking at the **Loan to Value Ratio** very critically. Appraisers are continuing to lower values due to the glut of distressed commercial real estate on the market. Many community banks are being told by regulators that they have too much commercial real estate in their loan portfolio, so even solid projects are being rejected until lenders clear out some of their non-performing loans.

Bankers are also tightening their ratio requirements for loans to businesses. They will loan you however much cash you have in your accounts; however, they are reducing the amount that they will loan based on accounts receivable and inventory. They are finding that many receivables aren't collectible and the market for unsold inventory is plummeting.

### **Timing of Measuring Ratios**

No matter what ratios are imposed by the lender, it is imperative that you look at the timing of the measurements of these ratios. Many businesses are cyclical, so you want to negotiate the right part of the business cycle to calculate the ratios. Also, many banks are requiring that the covenants are measured on a more frequently than in the past.

### **Have Regular Meetings**

Keep your banker up to date on your business performance. When you meet with the banker, have a plan as to how you will deal with your current situation. If you go into the meeting with no plan and your loan is not performing or you are having difficulty meeting a covenant, then the banker will be more likely to transfer the loan to the workout group. If you have a plan to address the situation, then the baker may have flexibility to re-structure the loan in a manner that will be acceptable to both parties.

### **Carefully Review and Negotiate**

When you are entering into loan agreements, be certain to carefully review each provision with your advisors. Whether you have been a long time customer of the bank or you are a new customer, many provisions of loan agreements can be negotiated to meet current conditions.

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## **Owners - Don't Pay Twice! Lesson from the *Weather-Tite* Case**

Owners should pay subcontractors directly or by a check payable to both the contractor and subcontractor. This is the lesson learned from the recent Illinois Supreme Court case of *Weather-Tite v. University of St. Francis*, 233 Ill.2d 385, 909 N.E.2d 830 (Ill. 2009). In *Weather-Tite*, the owner (University of St. Francis) hired a contractor (Stonitsch Construction, Inc.) to renovate a residence hall. Stonitsch thereafter hired various subcontractors to perform certain of the work associated with the renovation. Throughout the project, Stonitsch submitted sworn statements, identifying subcontractors and amounts due, and requesting payment from the University. The University paid Stonitsch and Stonitsch thereafter made payments to its subcontractors. This is a common method of processing payment in the construction industry and served the parties well for the first four payments. On the fifth payment, Stonitsch again submitted a sworn statement with its subcontractors' information requesting payment. The University again provided payment to Stonitsch but, before Stonitsch could process payments to its subcontractors, Stonitsch's bank exercised its right to a set off of the amounts in Stonitsch's account, leaving insufficient amounts to pay subcontractors. When the subcontractors did not get paid, they recorded mechanics liens on the project and commenced litigation.

In response to the lawsuit, the University argued that it had met its requirements under the Illinois Mechanics Lien Act (the "Act") and should not be subject to double payment, stressing that because it had demanded and received the sworn statement, it could make payments to the contractor for funds due to subcontractors without further liability. The Court disagreed with this argument, stating that the purpose of Section 5 of the Act was not to provide a method for orderly payment but to put the owner on notice of subcontractor claims. The Court held that once the owner was on notice that amounts were due to the subcontractor pursuant to the Section 5 sworn statement, the owner was under a duty to retain those funds and pay those funds to the subcontractors. The Court specified the process owners should use to ensure subcontractors are paid and do not assert liens, as follows:

What is clear from our reading of the Act is that the legislature intended the following orderly method of conducting construction transactions to protect subcontractor claims: (1) the owner and generalcontractor enter into a contract for the construction work; (2) as the work is completed, the general contractor submits a section 5 sworn affidavit that must list all subcontractors and the amounts due, to become due, or advanced; (3) when the section 5 sworn affidavit lists an amount due or to become due to a subcontractor, section 24 requires the owner retain sufficient funds to pay the subcontractor; and (4) section 27 requires the owner to make subcontractor payments upon receiving notice of a subcontractor claim pursuant to a section 5 sworn statement.

The *Weather-Tite* court made it clear that the burden was on the owner to ensure that subcontractors are paid so that the owner can avoid subcontractor liens. A prudent owner will change payment procedures to provide for direct payment to subcontractors, or a check made payable to both the general contractor and subcontractor, to avoid subcontractor liens.

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## **I've Been Sued! Do I Have to Produce all my E-Mails?**

Over the last decade, the use of electronic messaging ("e-mails") in corporate America has exploded. Conservatively, more than 15-billion e-mail messages are sent and received each day in corporate America. For most companies, the vast majority of the information and documents they rely upon to conduct their business exist purely in electronic format. Once a company becomes involved in litigation, it must review and analyze its electronically stored information to determine the information and documents that are relevant. Companies are legally required to protect and preserve relevant electronically stored information as soon as it becomes aware of a lawsuit or that one is imminent. The inadvertent deletion of relevant data can have severe consequences.

### **What is Spoliation?**

Spoliation of evidence is defined as "the intentional mutilation, alteration or concealment of evidence." While not all spoliation of evidence is intentional, parties can still be found liable for inadvertently destroying relevant electronically stored information. Though Illinois courts have refused to recognize "negligent spoliation of evidence" as an independent cause of action, Illinois courts have allowed such claims to be brought under existing negligence law. *Boyd v. Travelers Ins. Co.*, 652 N.E.2d 267 (1995). The general rule is that there is no duty to preserve evidence; however, a duty to preserve evidence may arise through an agreement, a contract, a statute. In any of the foregoing instances, a party owes a duty of due care to preserve evidence if a reasonable person in the party's position should have foreseen that the evidence was material to a potential civil action.

### **Consequences of Spoliation – Sanctions & Inferences**

Failure to preserve relevant documents may lead to a wide variety of sanctions. Among some of the sanctions a trial court may impose are: 1) a stay of the proceedings pending compliance; 2) a bar for further pleading relating to that issue; 3) dismissal of a claim or counterclaim relating to that issue; 4) the exclusion of evidence relating to that issue; or 5) a default judgment or dismissal against the offending party. In addition to the procedural sanctions a court may impose, Rule 219(c) also allows a court to impose attorneys' fees and costs.

Also, the destruction of evidence may warrant an adverse jury inference. The Illinois Pattern Jury Instructions provide that if a party fails to offer evidence within his/her power to produce, the jury may infer that the evidence would be adverse to that party if they believe that: 1) the evidence was under the control of the party and could have been produced by the exercise of reasonable diligence; 2) the evidence was not equally available to an adverse party; 3) a reasonably prudent person under the same or similar circumstances would have offered the evidence if he believed it to be favorable to him; and 4) no reasonable excuse for the failure is shown.

### **Avoiding Spoliation**

The best way to manage a crisis is to take steps in advance to prevent it from happening in the first place. A company that has spent the time and effort into developing a well-crafted and well-defined electronically stored information management and litigation plan will be ready to timely respond to e-discovery requests with minimal disruption to its business when, and if, the time should arise. As the saying goes, "an ounce of prevention is worth a pound of cure."

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## **Protecting Your Business Information from "Hackers"**

The Computer Fraud and Abuse Act ("CFAA") was enacted in 1984 to enhance the government's ability to prosecute computer crimes. The CFAA prohibits a number of computer crimes which involve (1) accessing computers "without authorization" or "in excess of authorization", and (2) obtaining information or damaging a computer or computer data. While Congress' primary intent in promulgating the CFAA was to enact a criminal statute that would target computer hackers who steal information or simply disrupt or destroy computer functionality, the CFAA also provides a civil right of action for private persons and entities who are injured by such activity. "Any person who suffers damage or loss by reason of [the CFAA violation] may maintain a civil action against the violator to obtain compensatory damages and injunctive relief or other equitable relief." 18 U.S.C. §1030(g) (1984).

The CFAA provides both criminal and civil remedies against outside "hackers" who access your computer system, but what about insiders who depart from the company taking information, such as customer lists or other proprietary business and financial information, with the intent to use the information for competition or to otherwise harm your business? The issue before the court in the recent case of *NCMIC Finance Corporation v. Artino*, 2009 WL 2244617 (S.D. Iowa, July 28, 2009), was whether an employee "may act without authorization" or "exceeds authorized access" when he accesses confidential and proprietary business information from his employer's computer that he has permission to access, but then uses that information in a manner inconsistent with the employer's interests or in

violation of other contractual obligations, and where the employee intended to use the information in that manner at the time of access. The *NCMIC Finance Corp.* court and others who have recently addressed this or related issues have found that the FCAA may apply and be utilized in this manner.

Since officers and employees of a company typically are authorized to access company computers and computer data, the question posed is when do they become "unauthorized", or act in a manner that is "in excess" of their authorization? *NCMIC Finance Corp.* involved an employee who resigned from his employment and set up a competing business. The employee obtained the customer lists and information prior to his resignation and while he was still "employed" by the company, and thus, had been authorized to access the company's computers and data. The court found that even though an employee has permission to access the company's proprietary business information from the company's computer during his employment, when he accesses *it with the intent* to use the information in a manner inconsistent with the company's interests, he may be considered as having been stripped of the authority to access the information, and engages in conduct prohibited by the CFAA.

Companies protect their business and proprietary information by having employees sign confidentiality or non-compete agreements. Protecting your business by restricting access to information outside of and even within the company so that such "trade secrets" are protected from misappropriation is also important. The CFAA should not be viewed as a replacement for these means for protecting your business, but it may supply an additional remedy, or could be your sole avenue of recourse when other preemptive methods have not been put in place.

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*The attorneys at Bryce Downey & Lenkov LLC constantly strive to keep you updated regarding the latest developments in Workers' Compensation law in Illinois and Indiana. If you have any questions regarding Illinois and Indiana Workers' Compensation law, please contact Richard Lenkov at 312.377.1501 or rlenkov@brycedowney.com, or any member of our Workers' Compensation team.*

*The firm also strives to keep you updated regarding the latest developments in Insurance and Tort law in Illinois, Indiana and other states. If you have any questions regarding these issues, please contact Storrs W. Downey sdowney@brycedowney.com or Terrence J. Madden tmadden@brycedowney.com or at 312.377-1501 or any member of our General Liability Team.*

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