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Client Alert: Loan Documentation: Force Majeure and the Implications of COVID-19

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In the wake of governmental responses, including "shelter in place" or "safer at home" mandates (collectively, "**Shelter Mandates**") of various U.S. state and local government units, to, as well as other effects of, the current coronavirus disease ("**COVID-19**") global pandemic, many construction loan borrowers and/or their contractors have been delivering notices of the occurrence of "force majeure" events ("**Force Majeure Notices**") and attempting to invoke the force majeure provisions of their governing loan documents and/or the underlying general construction contracts.

This Client Alert provides an analysis of the issues involved in evaluating such Force Majeure Notices, whether the same are appropriately given, and potential responses that lenders might give in response to receipt of same.

"Force majeure" is a French legal term meaning "superior force" and is generally implicated in certain clauses in contracts that excuse a party's performance as a result of an event that is defined as, or deemed to be, "force majeure." Such things as acts of God, war, labor strike, extreme weather, terrorism, disruption of supply chains, declared national emergencies, and certain other declared governmental actions are often events that would be classified as "force majeure." However, force majeure is not a common law concept, since it derives from the French civil law system. As such, it is primarily in the U.S. a creature of contract law,[1] which must be specifically set forth in the contract between the parties and is not something that a court would generally infer.[2] It should also be noted that our analysis herein would, for the most part, pertain to any claimed force majeure event. COVID-19 and governmental and private responses to same, while themselves unique, are otherwise undifferentiated from any other matter that might be covered under a force majeure clause and the application of such a clause.

In the commercial loan context, force majeure generally arises only in construction loans.[3] Construction loan agreements typically contain a number of covenants regarding the commencement, prosecution, and final completion (generally as evidenced by issuance of a certificate of occupancy or other jurisdictional equivalent) of the improvements that are to be constructed using the proceeds of the construction loan. Construction loan agreements generally provide that an event of default will have occurred under the loan

agreement if construction is not either timely commenced or finally completed, in either case, by dates certain or otherwise readily ascertainable. Further, most construction loan agreements provide that a work stoppage beyond a certain specified number of days, generally ranging from 15 to 30 days, also constitutes an event of default. The object is that the project is to be timely completed without material delay. Construction loan agreements, however, recognize that certain events, such as those that would be deemed to be force majeure, are beyond the control of the borrower (or for that matter the contractor) and thus will be tolerated, at least for a period of time. Note, that it is extremely rare that a force majeure event would, in and of itself, ever be considered an event of default under a construction loan; instead, use of a force majeure clause excuses certain covenant compliances, failure of which would otherwise ordinarily be deemed events of default under the loan agreement, and which are not under the control of the borrower.

Given that force majeure is largely a matter of contract law, the express language of the definition as to the specified events within its ambit and the context in which such defined term is used within a loan agreement are critically important, as courts generally strictly construe such definitions and clauses. In the current context, it is important to first determine whether and how COVID-19 and its repercussions fit into a force majeure definition. Some force majeure definitions do in fact specifically provide for or contemplate "epidemics," "pandemics," "contagious diseases," and other public health-related events. However, many do not. Other definitions may be generally broad and provide for open-ended definitions that capture the general spirit that a party is not responsible for events outside of its control and provide "including without limitation" laundry lists of items that would be covered, but which are not exclusive. If the definition does not clearly cover pandemics, etc., such as COVID-19, then an analysis must be done to determine whether COVID-19 or any of the potential results caused by COVID-19 may otherwise fall within the force majeure definition. Examples, depending on the express language of the definition, might be items, such as "national emergencies," "material shortages," "interruptions to financial markets," "disruptions to domestic or international transportation," "government prohibitions or regulations," or similar terms. COVID-19 is itself a declared "national emergency"[4] and thus would be covered in a definition that included national emergencies. Further, to the extent that there are or have been supply chain disruptions (including delivery of materials) as a result of COVID-19, or governmental responses to same, such disruption might create a "material shortage" or be construed as a disruption to transportation which would give rise to a force majeure event. Thus, in order to assert force majeure, a baseline determination has to be made that the particular event or condition (COVID-19 and its results in the current situation) claimed actually falls into the express contractual definition or applicable clause of the loan agreement. Absent this, there is not a valid claim of force majeure.

Since the nature of force majeure is as an excuse from performance or compliance with certain time-conditioned covenants, then, in addition to the occurrence of an event that would be included within a force majeure definition, there must also be actual delay (or inability to perform) caused by the claimed event. The occurrence of the event by itself without any resulting delay or inability to perform does not provide reason for an excuse for performance. The occurrence of the event coupled with either actual delay in performance of or the inability to perform the covenant would be construed as a force majeure event, for which the borrower would have whatever remedy or excused performance is provided in the loan agreement. Normally, force majeure clauses will excuse (i) cessation of work for a period longer than that permitted in the loan agreement (as noted above, normally from 15 to 30 continuous days) or (ii) failure to complete before the required completion or delivery date for the project. Often construction loan agreements will provide for a day for day extension of the final completion date for the project for each day of delay actually caused by the force majeure event, normally with a maximum number of days of delay permitted, often 120 or 180 days, such that in any event, and notwithstanding the applicable force majeure event, the project must be completed within 120 or 180 days after the defined completion date.

In addition to evaluating whether or not a force majeure event has in fact occurred under the applicable construction loan agreement, it is also important to consider whether an instance of force majeure has occurred under the general contract for the project as well. Often, the respective force majeure provisions of construction loan agreement and provisions of general contracts relating to delay do not necessarily align. For instance, the AIA Document A201™-2017 General Conditions of the Contract for Construction (the "AIA General Conditions") published by the American Institute of Architects, which are often used in large construction projects, do not use the term "force majeure" but instead, as set forth in §8.3 thereof, provide a list of items which might entitle the contractor to an extension of time for performance. These items which may be the basis for the contractor's delay include (i) an act or neglect of the owner, architect, or another contractor; (ii) change orders; (iii) documented labor disputes, fire, unusual delay in delivery, or unavoidable casualties, or other causes beyond the contractor's control;[5] (iv) authorized delays pending mediating and binding dispute resolution; or (v) other causes asserted by the contractor, if the architect so determines, that justify delay. It should be noted that §8.3 of the AIA General Conditions does not specifically contemplate a pandemic or epidemic such as COVID-19. Instead, it is necessary to focus on "unusual delay in delivery" or "other causes beyond the contractor's control." Certainly, the resulting effects of COVID-19 or Shelter Mandates likely would fall within the applicable section of the AIA General Conditions.

One peculiar issue in the current environment is the issuance by various governmental authorities of Shelter Mandates, which generally require that individuals must largely stay at home and that only certain "essential businesses" are entitled to continue to operate provided that in any event, appropriate "social distancing" protocols are maintained. Construction sites and projects are often included within the definitions of "essential businesses," generally as long as the project is properly permitted (i.e., the appropriate building permit has been issued by the applicable jurisdiction) and, depending upon the particular Shelter Mandate, certain other guidelines or requirements, such as "social distancing," use of personal protective equipment (where appropriate), maximum number of persons in enclosed spaces, maintenance of water, soap, and/or disinfectants are in effect. While true in many jurisdictions, others, such as New York, have halted non-essential construction but have allowed construction to continue for roads, bridges, transit facilities, utilities, hospitals/health care facilities, affordable housing, homeless shelters, and emergency construction (necessary to protect health and safety of occupants or if it would be unsafe to remain undone until the project is safe to shutdown).[6] In the early stages of development or construction, particularly during infrastructure and/or other horizontal construction, such Shelter Mandates may have little impact given that the work is in the open and distances may be maintained, however, as a project moves to vertical construction, particularly internal construction, delays may become much more likely due to requirements limiting the number of workers that may be in a particular space or which impose other "social distancing."

Most construction loan documents contain certain notice provisions, which require the borrower to provide written notice to its lender of the occurrence of certain events, including the existence of a force majeure event. In the last few weeks, many construction lenders have received Force Majeure Notices from their borrowers using as a basis the circumstances surrounding COVID-19. Some borrowers have gone as far as asking for the lender's standard form of "pre-negotiation" letter.[7] Many of these notices appear to have been delivered by borrowers on a somewhat "preemptive basis." Borrowers and their counsel should carefully consider whether they are being premature in giving Force Majeure Notices or in requesting pre-negotiation letters. To the extent that the construction loan agreement definition of force majeure event requires both the occurrence of the claimed event and an actual delay or prevention in performance, including a delay in timely project completion (i.e., completion by the defined completion date in the construction loan agreement), it is not likely that the Force Majeure Notice has been properly given if both prongs of the definition have not been met. If given prematurely in such situations, the borrower then has to consider providing another Force Majeure Notice upon the occurrence of an actual delay in order to properly comply with the terms of the construction loan agreement. Further, since force majeure is, in and of itself, not an

event of default under most loan documents, but is instead an excuse for performance, a request for a pre-negotiation letter is often misplaced. In any event, such letters may contain overbroad and overbearing waivers and protections that any borrower should be cautious about.

When lenders receive Force Majeure Notices, including those based on COVID-19, they must first evaluate whether a circumstance that would be the basis for a borrower's claim of force majeure has in fact occurred, as well as whether or not a delay has occurred or is reasonably foreseeable as a result of such circumstance based on the specific language of the construction loan agreement. In the current COVID-19 environment, the pandemic, or one or more of its results, may likely fall within a force majeure definition; however, oftentimes, the second prong of required delay has not yet been met, since even in many jurisdictions in which Shelter Mandates have been issued, properly permitted construction projects are generally allowed to continue as essential businesses. Lenders should at least acknowledge that they have in fact received the Force Majeure Notice. They should also carefully consider, whether the claim of force majeure is in fact ripe. If not, they should so notify the borrower in writing of same. If the lender determines that both prongs of a force majeure have in fact occurred, they need to carefully consider the implications of such delay, and consult with the borrower to determine whether the project may be timely completed or whether any accommodation, not built into the construction loan agreement, should be considered.

This Client Alert is a supplement to our initial Client Alert of March 19, 2020 (*Commercial Loan Documentation: Effects of COVID-19*).[8] We are committed to keeping our clients informed of important issues that affect them, including as a result of the COVID-19 pandemic.

Shumaker's Financial Services practice group has extensive experience in representing both financial institutions and commercial borrowers in a variety of transactions and structures, in all areas of commercial lending. Please contact us if you have questions regarding this Client Alert or if we can be of assistance in reviewing loan documentation and advising of potential courses of action.

1Note that all U.S. states other than Louisiana, which has a civil law code, are common law states. Although Louisiana law is beyond the scope of this Client Alert, Louisiana Civil Code articles 1873 and 1878, which excuse contract performance for certain "fortuitous events", would likely have application to Louisiana transactions.

2 Note that there are other legal concepts such as impossibility or impracticability of performance or frustration of contract, which might have some application, but which are beyond the scope of this Client Alert.

3 However, it should be noted that sometimes events similar to what would typically be characterized as force majeure events, may excuse or mitigate (depending on how the loan documentation is drafted) certain material adverse effects or material adverse changes.

4 See, Proclamation on Declaring a National Emergency Concerning the Novel Coronavirus Disease (COVID-19) Outbreak, issued by President Donald J. Trump on March 13, 2020.

5 These listed items would normally be included within a definition of "force majeure".

6 See, Empire State Development Guidance for Determining Whether a Business Enterprise is Subject to a Workforce Reduction Under Recent Executive Orders, March 27, 2020 at 11:00 AM, https://esd.ny.gov/guidance-executive-order-2026.

7 A pre-negotiation letter is often entered into after the occurrence of a loan default and prior to the commencement of enforcement proceedings and sets forth the framework under which the lender and the borrower will discuss and potentially negotiate a loan workout or modification to address the default. They normally provide that the discussions are voluntary, that the parties may terminate the discussions, and that discussions, resulting negotiations, and exchange of drafts of documents to address the default are not binding, constitute settlement negotiations, and thus, not admissible in any proceeding among the parties. Additionally, certain pre-negotiation letters may attempt to reaffirm the loan documents including representations and warranties, or have borrowers or guarantors waive certain rights or release the lender from potential claims by the borrower or the guarantors.

8 https://www.shumaker.com/latest-thinking/publications/2020/03/client-alert-commercial-loan-documentation-ef¬fects-of-covid-19

For the most up-to-date legal and legislative information related to the coronavirus pandemic, please visit our Shumaker COVID-19 Client Resource Center at shumaker.com. We have also established a 24/7 Legal & Legislative Helpline at 1.800.427.1493 monitored by Shumaker lawyers around the clock.

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