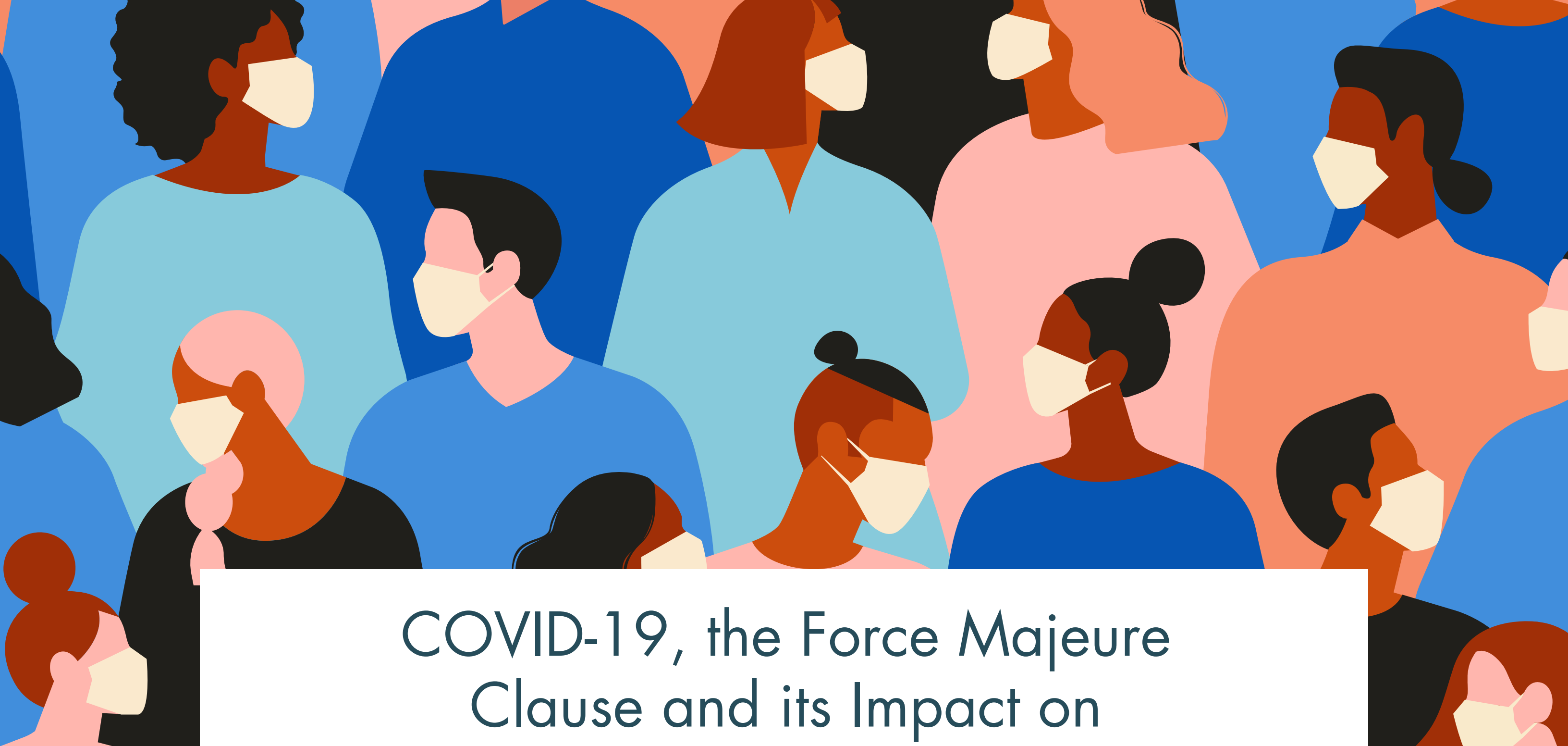

COVID-19, the Force Majeure Clause and its Impact on Real Estate Owners and Developers

Part 2: COVID-19 and Construction Loans

As discussed in Part 1, the COVID-19 pandemic, and the resulting federal, state and local government restrictions, have put great stress on commercial tenants and landlords. For Part 2 of the series, we focus on another major component of commercial real estate—the financing of real estate development. This alert analyzes issues relating to construction loans that may arise mid-construction as a result of construction delays caused by government-imposed restrictions. Additionally, this alert provides a checklist of some issues that developers and other construction loan borrowers should keep in mind when negotiating and finalizing new construction loans in this atmosphere.

The Pandemic's Impact On Construction Projects

Since late-March, shelter-in-place orders implemented by state and local governments have stopped or delayed construction projects across the board. These orders designated limited types of construction as "essential" and broadly prohibited all other "non-essential" construction. For example, in New Jersey, Executive Order 122 halted all construction other than "essential" projects—defined as those necessary for healthcare, transportation, utilities, affordable housing, and schools, among other delineated categories—and work on non-essential projects necessary to maintain the safety and integrity of the project sites.[1] In New York, revised Executive Order 202.6 defined "essential" projects even more narrowly, limiting work to roads, bridges, transit facilities, utilities, hospitals or health care facilities, affordable housing, and homeless shelters.

In recent weeks, the list of permitted construction work has grown as restrictions began to ease. Under a revision of its original shutdown guidance, New York has expanded "essential" construction work to include hotels, restaurants, convenience stores, banks, among other businesses that have already broken ground.[2] New Jersey just issued Executive Order 142, which permitted "non-essential" construction in New Jersey to begin again as of May 18, 2020.[3] However, even as New Jersey, New York and other states ease

1. https://nj.gov/infobank/eo/056murphy/pdf/EO-122.pdf
2. https://esd.ny.gov/guidance-executive-order-2026
3. https://nj.gov/infobank/eo/056murphy/pdf/EO-142.pdf

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governmental restrictions on construction, the ability for developers to maintain construction schedules will continue to be inhibited due to requirements for implementing policies and protocols to enforce social distancing. For example, in New Jersey, all construction projects must adopt the following policies:

- Prohibit non-essential visitors from entering the worksite;
- Engage in appropriate social distancing measures when picking up or delivering equipment or materials;
- Limit worksite meetings, inductions, and workgroups to groups of fewer than 10 individuals;
- Require individuals to maintain six feet or more distance between them wherever possible;
- Stagger work start and stop times where practicable to limit the number of individuals entering and leaving the worksite concurrently;
- Identify congested and "high-risk areas," including but not limited to lunchrooms, breakrooms, portable rest rooms, and elevators, and limit the number of individuals at those sites concurrently where practicable;
- Stagger lunch breaks and work times where practicable to enable operations to safely continue while utilizing the least number of individuals possible at the site;
- Require workers and visitors to wear cloth face coverings, in accordance with CDC recommendations, while on the premises, except where doing so would inhibit the individual's health or the individual is under two years of age, and require workers to wear gloves while on the premises. Businesses must provide, at their expense, such face coverings and gloves for their employees. If a visitor refuses to wear a cloth face covering for non-medical reasons and if such covering cannot be provided to the individual by the business at the point of entry, then the business must decline entry to the individual. Nothing in the stated policy should prevent workers or visitors from wearing a surgical-grade mask or other more protective face covering if the individual is already in possession of such equipment, or if the businesses is otherwise required to provide such worker with more protective equipment due to the nature of the work involved. Where an individual declines to wear a face covering on the premises due to a medical condition that inhibits such usage, neither the business nor its staff shall require the individual to produce medical documentation verifying the stated condition;
- Require infection control practices, such as regular hand washing, coughing and sneezing etiquette, and proper tissue usage and disposal;
- Limit sharing of tools, equipment, and machinery;
- Where running water is not available, provide portable washing stations with soap and/or alcohol-based hand sanitizers that have greater than 60% ethanol or 70% isopropanol;
- Require frequent sanitization of high-touch areas like restrooms, breakrooms, equipment, and machinery;
- When the worksite is an occupied residence, require workers to sanitize work areas and keep a distance of at least six feet from the occupants; and
- Place conspicuous signage at entrances and throughout the worksite detailing the above mandates.

Thus, while construction restarts on a limited basis, these requirements will likely cause further delays, particularly with projects in the vertical or internal construction phases.

There is also a litany of other issues, such as supply chain disruptions, the inevitable delays in obtaining timely inspections and approvals, and labor shortages, that will continue to impact construction schedules. Moreover, there is no guarantee that shutdowns or shelter-in-place orders will not happen again if there is, as some experts predict, a second wave in the fall.

The ability to access project financing is critical to the success of any construction project, and staying in compliance with all obligations set forth in a construction loan agreement is necessary to ensure access. As such, it is important that developers and construction loan borrowers understand how the COVID-19 pandemic and construction delays may impact their rights under their loan agreements, and what relief, if any, is available to them.

What to Expect Mid-Construction

Construction loans require developers to stay on tight schedules, meet set performance obligations, and maintain a variety of performance and financial covenants in order to draw upon loan proceeds. Construction stoppages and delays can severely impact a developer's ability to satisfy or meet a variety of requirements set forth in their loan agreements, thereby resulting in the inability to access additional funding or financing, or default under the loan agreement.

A. Construction Deadlines and Other Performance Covenants

Construction loan agreements typically contain a number of covenants imposing deadlines for the draw-down of funds to be used for the commencement, prosecution, and completion of the construction. Builders and developers utilizing construction loans operate on strict schedules that only allow access to funds during defined time periods or after achieving certain milestones.

Even as construction stoppages are lifted, the backlog of pending permits and approvals facing local governmental agencies, as well as social distancing mandates that must be implemented on construction sites, will continue to impact construction schedules.

The inability to stay on schedule has serious consequences, including caps on the ability to further draw on the loan. Additionally, loan agreements requiring construction be substantially completed by certain dates may also prematurely cut off the borrowing period, causing further financial distress. Failing to meet completion dates may also trigger other consequences, such as the completion guarantor's contingent obligation to complete the project. Such guaranties also often require that the project be completed lien-free and require the guarantor to pay deficiency deposits in order to keep the construction loan in balance.[4]

B. Representations and Warranties, Covenants, and Other Reporting Requirements

In addition to requiring a developer to stay on a strict construction schedule, construction loan agreements also contain periodic financial reporting requirements, a variety of performance and financial covenants that must be maintained, as well as a litany of representations and warranties that must be affirmed and reaffirmed throughout the term of the loan, including each time a draw is taken.

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4. It is worth noting that there are very few cases that discuss the enforceability of completion guaranties, and, as a general matter, it will be a challenge for lenders to convince a court to grant specific performance compelling the guarantor to actually complete construction of the project, particularly where the lender has an adequate remedy at law in damages. See, e.g., Houseman v. Dare, 405 N.J. Super. 538, 542 (App. Div. 2009); Cho v. 401-403 57th St. Realty Corp., 300 A.D.2d 174, 175 (N.Y. App. Div. 1st Dep't 2002)

Loan agreements frequently, if not universally, require the borrowers and guarantors to provide financial reports on an annual or even quarterly basis. Financial statements must be provided by not only the borrower, but also any guarantors. Guarantors must also maintain certain liquidity and net worth thresholds and report that they are maintaining those thresholds. The failure to provide these reports or stay above the thresholds may constitute an event of default, thereby triggering a host of issues placing the developer, guarantor, and project in jeopardy.

Construction loan agreements also contain representations and warranties that a borrower must affirm prior to closing and reaffirm prior to any disbursement. Such representations include, for example: no default exists under the loan documents; the loan is in balance; there are no defaults under construction contracts; submitted financial statements are accurate and complete and fairly represent the financial condition of the borrower; and there has been no material adverse change in the financial condition of the borrower or guarantor or with respect to the project.

Depending on the nature of the project, borrowers may also be required to maintain a certain debt service coverage ratio ("DSCR"), *i.e.*, demonstrate sufficient cash flow. Loans for new projects involving previously undeveloped areas may not initially have such requirements, but usually will at some future designated date.

Such "testing" of these representations, warranties and covenants was not significantly impacted by the COVID-19 pandemic in the first quarter of 2020. However, with the second quarter of 2020 and onward, the financial condition of many borrowers and guarantors may be adversely impacted by construction delays caused by the pandemic, as well as the pandemic's impact on the economy as a whole—particularly the retail and restaurant industries—which could compromise borrowers' and guarantors' ability to maintain compliance with their various financial covenants.

C. Material Adverse Change or Effect Clauses

Many construction loan agreements contain material adverse change (MAC) or material adverse effect (MAE) clauses. These clauses, if triggered, typically provide that a lender will have no obligation to disburse additional loan proceeds or extend the term of a loan if there is a material adverse change to the condition of the property, or to the business, assets, financial condition or performance of the developer or loan guarantor. These clauses can vary significantly, and while such clauses in loan documents will not likely specifically address pandemics, the resulting effect of the COVID-19 pandemic on developers and borrowers, *i.e.*, material change in financial condition of borrower, ability to borrower to timely perform its obligation, *etc.*, may fall within the clause.[5]

It is imperative that developers and borrowers review their loan documents to determine if such a covenant is included, what the required time is to notify the lender and whether such an adverse event constitutes a default or otherwise imposes other limits on the borrower's rights. If a borrower believes that the COVID-19 pandemic (either directly or as a result of government orders) will result in a MAC event, then in order to avoid a default for failure to send timely notice of a MAC event, the borrower should consider sending a short letter to the lender alerting it to this potential MAC event. However, if a MAC event is itself a default or limits any right (e.g., the right to a loan advance or an extension of a maturity date), a borrower may want to defer sending such notice until it is able to assess the full effect of the MAC event on the borrower, guarantor or property.

5. Since most agreements do not include objective benchmarks or a definition for "material" as used in the MAC or MAE clause, the determination of materiality will be left to the courts. As a general matter, any party invoking a MAC or MAE clause bears a heightened burden to show that the clause has been breached. See, e.g., In re Bank of Am. Corp. Sec., Derivative, & Employee Ret. Income Sec. Act (ERISA) Litig., 706 F. Supp. 23, 26-27 (D.D.C. 2009); Hexion Specialty Chemicals, Inc. v. Huntsman Corp., 965 A.2d 715, 738-39 (Del. Ch. 2008). Moreover, determining whether a MAC or MAE has occurred is highly fact- and contract-specific. See, e.g., Solutia Inc. v. FMC Corp., 456 F. Supp. 2d 429, 442 (S.D.N.Y. 2006) (determining whether a MAC has occurred "requires an assessment of all the facts and circumstances surrounding the situation").

D. Mini-Perm Loans

Another critical issue that may be affected by construction delays is the ability for a developer or borrower to exercise its right to access "mini-perm" loans. Like a bridge loan, mini-perm loans generally finance an income-generating commercial property that has recently been built, but does not yet have the income to qualify for traditional permanent financing. Such financing has become increasingly popular with developers and lenders because it is intended to cover the construction period and the follow-on period during which the project is expected to stabilize and ultimately achieve the anticipated level of normal post-construction operating revenue necessary to secure permanent loans. In essence, a mini-perm loan allows the borrower to extend the term of their construction loan, while giving the property time to generate more income to secure a longer-term loan on more favorable terms.

Qualifying for the mini-perm portion of the construction loan is usually predicated on the project meeting certain conditions. Typically, access to the mini-perm option is predicated upon timely completion of construction, and the supporting loan agreements frequently put the outside date to exercise the option as the construction completion date set in the loan agreement. Additionally, certain stabilization requirements, such as meeting or exceeding specified occupancy thresholds, and/or a minimum loan to value ("LTV") ratio and debt service coverage ratio ("DSCR"), are imposed. Additionally, the loan agreement will likely require that the developers and borrowers affirm that no actual or potential default exists and that the borrower and guarantors are satisfying their various liquidity or net worth covenants.

E. Can A Force Majeure Clause Provide Any Relief?

As discussed in Part I of this series, a force majeure clause is a "contractual provision allocating the risk of loss if performance becomes impossible or impracticable, especially as a result of an event or effect that the parties could not have anticipated or controlled."[6] Generally, the clause will delineate specific extraordinary events out of the control of the parties that will excuse, at least for a while, certain covenant compliances, failure of which would otherwise be deemed events of default under the loan agreement. Whether a force majeure clause in a loan agreement can provide relief to a developer or borrower facing difficulties presented by the COVID-19 pandemic turns on two issues: (1) whether the pandemic and governmental restrictions qualify as a force majeure event; and (2) whether the force majeure clause applies to the specific issue in the loan agreement.

Whether the COVID-19 pandemic qualifies as such an event requires an examination of the specific clause at issue. Here is an example of a typical force majeure clause found in many construction loan agreements:

> **"Force Majeure Event"** shall mean a delay, not to exceed a total of ninety (90) business days, caused by unusually adverse weather conditions which have not been taken into account in the construction schedule, fire, earthquake or other acts of God, strikes, lock-outs, acts of public enemy, riots or insurrections or any other unforeseen circumstances or events beyond the control of Borrower (except financial circumstances or events or matters which may be resolved by the payment of money), and as to which Borrower notifies Lender in writing within five (5) business days after such occurrence; provided, however, the occurrence of a Force Majeure Event shall not suspend or abate any obligation of Borrower or any Guarantor or any other person to pay any money.

6. *Force Majeure Clause*, Black's Law Dictionary (11th ed. 2019).

Courts generally will not hesitate to apply a force majeure clause to events specifically delineated in the clause, but like the above force majeure clause, many such clauses in loan agreements do not include "epidemics," "pandemics," or "governmental regulations or controls." Instead, developers and borrowers will have to argue that the COVID-19 pandemic and resulting shelter-in-place orders are covered by language like "unforeseen circumstances" or "acts of God."

Such catch-all language is typically construed narrowly by courts, viewed within the context of the events specifically enumerated.[7] Notwithstanding, courts interpret contracts based on the intent of the parties, the express terms of the contract, surrounding circumstances, and the underlying purpose of the contract,[8] and the clear intent of a force majeure clause in a construction loan agreement is to provide additional time to complete the project where unforeseen circumstances result in work stoppages or delays. The authors have not found any cases in New York and New Jersey involving a dispute over a force majeure clause in a construction loan agreement, but a lender that refuses to apply a force majeure clause to the present circumstances may find itself susceptible to an argument that such an interpretation would render the force majeure clause illusory, and therefore improper.[9]

If the force majeure clause is applicable, it must be determined whether the clause applies to the specific issue in the loan agreement and to what extent. For instance, while the force majeure clause will typically apply to completion dates and other deadlines tied to the completion date, many force majeure clauses (like the one above) have a cap on the total number of days the completion date can be extended. On the other hand, deadlines not tied to completion, such as requirements to submit financial reports, satisfy financial covenants, satisfy the conditions to required to exercise an option for a "mini perm" loan, and meet the various representations and warranties, may not be impacted by the force majeure clause.

Practical Steps and Checklist

As the above makes clear, the COVID-19 pandemic and the resulting governmental restrictions can impact developers' and borrowers' rights under a construction loan in number of ways. Developers and borrowers should consider the following:

- Review their loan agreements and all applicable terms in the agreement. Does the pandemic trigger any notice obligations pursuant to a MAC or MAE clause?
- Review the specific force majeure clause in the loan agreement. Does the force majeure clause clearly apply to the COVID-19 pandemic?
- Consider whether the pandemic or the resulting work stoppages and delays affect any financial or performance covenants in the loan agreement.
- Don't hesitate to ask questions or seek guidance. Each situation may be different or distinguishable so consult with legal counsel, as necessary.

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7. See Seitz v. Mark-O-Lite Sign Contractors, Inc., 210 N.J. Super. 646, 650 (Law. Div. 1986); see also Route 6 Outparcels, LLC v. Ruby Tuesday, Inc., 88 A.D.3d 1224 (N.Y. App. Div. 3d Dep't 2011) (economic recession not covered by force majeure clause because it did not explicitly include economic recession, and the vague catch-all parts of the clause could not be read to include economic recession).

8. See Matter of Cty. of Atl., 230 N.J. 237, 254 (2017); see also Kasowitz, Benson, Torres & Friedman, LLP v. Reade, 98 A.D.3d 403, 405–06 (N.Y. App. Div. 1st Dep't 2012), aff'd, 987 N.E.2d 631 (N.Y. 2013) ("The fundamental, neutral precept of contract interpretation is that agreements are construed in accord with the parties' intent . . . .").

9. See Jaworski v. Ernst & Young U.S. LLP, 441 N.J. Super. 464, 477 (App. Div. 2015); see also Credit Suisse First Bos. v. Utrecht-Am. Fin. Co., 80 A.D.3d 485, 488–89 (N.Y. App. Div. 1st Dep't 2011).

For developers currently negotiating or in the process of closing on a construction loan, it is important to keep in mind that the domino effect of the pandemic will likely continue and that a second wave may surface in the fall. Thus, the following should be considered and discussed with counsel:

- Negotiating a longer lead time to starting construction;
- Extending maturity dates (including allowing extensions if needed to due to COVID-19 delays);
- Extending construction completion dates (including allowing more generous extensions if needed to due to COVID-19 delays);
- Inclusion of pandemics, epidemics, and governmental restrictions in any force majeure clause;
- Extending time to exercise mini-perm loans (including allowing extensions if needed to due to COVID-19 delays);
- Modifying any MAC or MAE clauses to specific exclude the pandemic or governmental restrictions on construction work; and
- Ensuring that the respective force majeure provisions in any construction contracts align with the provisions in your construction loan agreement.

While it is still unclear what the full nature and impact the current pandemic will have on real estate construction, development and financing, the aforementioned thoughts, suggestions, and opinions are provided as a means of highlighting some important issues to consider for those who have or are contemplating procuring construction financing in this climate. They are not intended to be relied upon as legal advice or to create an attorney-client relationship with those to whom it is sent. Rather, this alert is being provided for informational purposes only and is not a substitute for a legal consultation based upon a thorough review of the specific facts under the law that may be applicable to your particular situation.

> To that end, should you wish to discuss these or other issues or concerns as they affect your business, please feel free to contact Marc Singer and Xiao Sun by phone 973-622-6200, or e-mail mcs@olss.com and xs@olss.com to discuss any potential issues or concerns. You may visit the OLSS website www.olss.com to review their practice areas and professional profiles for further information.