SMITH ANDERSON
expectexcellence®

IMPACT OF COVID-19 ON REAL ESTATE, CONSTRUCTION AND SUPPLY CONTRACTS

03.17.2020
By Wayne Maiorano, Scott Miskimon and Pat Wilson

As coronavirus (COVID-19) continues to disrupt lives and businesses, it is important to consider how it may affect your real estate, construction, and supply businesses. Every situation and contract will be different, so it is important to consider your exposure and know how to respond.

It Could Happen to You . . .

The duration and extent to which COVID-19 will affect the real estate and construction sectors is unclear, but it will have an impact.

- **Project owners** may suspend or try to terminate construction contracts due to funding or other concerns.
- **Construction projects** may experience labor and material shortages, crews may be restricted in onsite activities or barred from entering a site, or there may be payment disruptions.
- **Tenant upfits** may be delayed, disrupting access to new office space and causing problems exiting prior rental space. Tenants may be late with rent, or percentage rental income may drop due to decreased economic activity. Tenants may seek to exercise break clauses due to being denied access to rental space.
- **Suppliers** may experience supply chain disruptions, material shortages or shipping restrictions affecting their ability to fill orders, particularly those originating in overseas markets.
- **Owner-developers** may be delayed in delivering projects, impacting access to rental space.
- **Lenders** may become slower to approve new loans or draws on existing lines of credit, restrict access to such funds or seek further security before extending credit.
- **Government owners** may experience slow-downs in project letting, or order project suspensions as agencies redirect attention and resources elsewhere or experience operational disruptions.
- **Municipalities** may cease all in-person activities and reduce meetings related to plan review and approval proceedings or limit onsite inspections.

While these are just a few examples of how COVID-19 may impact the development and construction process, it is important to review your contracts in order to be prepared for whatever may arise. Before taking action under an existing contract or entering into a new one, it is imperative that you know your rights and remedies, and those of the other contracting parties.

What is *Force Majeure*? – and Does it Apply to COVID-19?

A contract's *force majeure* clause may provide one or both parties with some relief when certain extraordinary events delay or prevent performance by a party (including a time extension, suspension, termination, or compensation). Generally, a *force majeure* clause can excuse a party from performing its contractual obligations if certain events occur beyond the party's control that prevented or hindered it from performing under the contract. As a result, a *force majeure* clause can be helpful to the party seeking relief, but can have severe consequences for the other party to the contract.

Commonly referred to as "Acts of God," the extraordinary events that constitute a *force majeure* event are rare and are not reasonably foreseeable. They typically involve matters such as war, natural disasters, governmental directives preventing performance, and, potentially, global pandemics. It is possible that a *force majeure* clause lists specific events constituting a *force majeure* event, or it may simply reference events outside the parties' control.

Force majeure clauses are found in all types of contracts, including construction contracts, leases, supply contracts, and commercial loan agreements. While these clauses are frequently captioned "*Force Majeure*," or the term itself is used within the body text, that is not always the case. For example, in the AIA 201™ – 2017, a form construction document often used between owners and general contractors, the term *force majeure* never appears. Instead, this AIA form addresses *force majeure* by listing a number of events which, if they occur, could give rise to a party to seek an extension of time. Other industry form contracts take a similar approach. Instead of seeing a *force majeure* clause, your contract may have a clause that simply lists a number of extraordinary events. This is where to look to determine whether your contract addresses events like a pandemic.

A party's ability to seek relief on grounds of *force majeure* is contract and fact specific. If the contract contains such a clause, you must next determine whether COVID-19 falls within the definition of a *force majeure* event. For example, does the *force majeure* provision refer to an epidemic or disease, such that COVID-19 may fall within the definition?

A party should not simply stop performing based on its belief that a *force majeure* event occurred. If there is a *force majeure* clause, it is critical that the parties fully comply with all aspects of it, including notice obligations, documentation, mitigation requirements, and providing proof that the event actually and meaningfully impacted a party's ability to perform.

Looking to your contract for a *force majeure* provision is the first step in the analysis. Understanding how the courts may interpret a specific *force majeure* clause will be important. Alternatively, in the absence of a *force majeure* provision, there may be other legal grounds for suspending performance or terminating the contract.

If a Contract Does Not Have a Force Majeure Clause, Then What?

Impossibility or Impracticality

If your contract does not have a *force majeure* clause, certain legal principles under North Carolina law will apply in the event unforeseeable circumstances intervene and make it impossible or impractical to perform. General financial hardship will not excuse performance or justify terminating the contract. Instead, there must be an intervening event that could not reasonably have been foreseen. Even without a *force majeure* clause, the terms of the contract can control the outcome of a dispute over a rare event that makes performance impractical. If the parties explicitly contemplated a particular event might occur and agreed to put the risk of it on one of the parties, then the fact that the event actually happened would not relieve the party of its obligation to perform.

For example, assume that a party is obligated to deliver light fixtures made in China, but imports from China are halted due to a pandemic and it is not possible to purchase substitute fixtures from a third party (or it would be wastefully expensive to do so). If the contract does not put the risk of a pandemic or a government-ordered embargo of goods on the obligated party, then the obligated party may be excused from the contract due to the doctrine of impracticability.

Frustration of Purpose

In addition to impossibility or impracticability there is also the doctrine of "frustration of purpose." The two overlap to some degree: both involve events that were not reasonably foreseeable, and both come into play for contracts that do not have a *force majeure* clause or terms that put the risk of the rare event on one of the parties. The key difference is that impracticability means that it is impossible or nearly impossible to perform, while frustration of purpose assumes a party can still perform but it would be unreasonably burdensome to do so where the rare event has made the reason for entering into the contract irrelevant. For example, assume that a promoter rents a 20,000-person arena to hold a basketball tournament. If a tornado destroys the arena, the doctrine of impracticability applies and the promoter is excused from performing and can terminate the contract. But make a different assumption: if the arena is leased but the tournament is cancelled due to COVID-19 concerns, it is still possible to use the arena for basketball games, but the purpose of renting the building has been frustrated. Therefore, the promoter may be excused under the doctrine of frustration of purpose.

Steps You Can Take . . .

Every situation and every contract will be different. If you are currently operating under an existing contract, invoking a *force majeure* clause or relying on the doctrines of impracticability or frustration of purpose should only be considered in extreme circumstances and is not something that should be taken lightly. If a party believes a rare, unforeseeable event has intervened, then stopping performance or terminating the contract could be risky. If wrong, that party could be putting itself in breach.

Before finalizing negotiations and executing a new contract, taking action regarding an existing contract, or responding to another party who is seeking to take action, consider the following first:

- Review your existing contracts. Does your contract specifically include some reference to delay caused by illness, such as quarantine, outbreak of disease, epidemic, or pandemic? Or does it only generally reference events that are beyond the parties' control? In searching voluminous contract documents, it may be helpful to search for such terms as: "force majeure," "events," "frustration of purpose,"

"impossibility," or "impracticability."

- Re-read contracts you are about to enter into, including form or "boilerplate" contract language. Consider whether to add or revise a *force majeure clause.*
- In addition to reviewing your contracts, talk with the other parties to the contract, and learn about any potential barriers to performance they now have or may have in the future which could affect the value of their contract with you, or impact your ability to perform a contract that you have with someone else.
- Similarly, if you are a supplier or purchaser under a supply contract, learn about your supply chain and consider contingency plans to address potential disruptions.
- Review your insurance policies and talk with your insurance broker to determine if you have adequate business interruption insurance or other forms of applicable coverage, or if you need it.
- Talk with your lender to understand what actions it may take concerning loan closings, access to credit, or its business operations in a way that could affect you.

As the COVID-19 outbreak unfolds, we urge you to be safe and wish for the very best of health and outcomes for all. We also understand that protecting your business will be critical to you during this uncertain time. Accordingly, it's important to understand your legal rights and responsibilities before taking any action or responding to actions taken by others.

If you have any questions related to this alert, please do not hesitate to contact a member of the Real Estate Development group or your regular Smith Anderson lawyer.

Special thanks to **Pat Wilson**, contributing writer.

PROFESSIONALS

Wayne K. Maiorano

Scott A. Miskimon

Patrick D. Wilson

PRACTICE AREAS

Construction & Infrastructure

Real Estate Development

Real Estate Litigation