LAW360

Portfolio Media. Inc. | 111 West 19th Street, 5th Floor | New York, NY 10011 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

Coronavirus Will Transform Project Development And Finance

By **Nathan Galer and Jeffrey Davis** (March 12, 2020, 3:39 PM EDT)

The emergence of COVID-19 is already disrupting the project development and finance market in profound ways. Supply chains have been interrupted as workforces are furloughed, leading to cascading series of delays.

Nathan Galer

This has been most immediately felt in early- and intermediate-stage manufacturing processes of components that are eventually integrated into a wide range of energy, infrastructure and industrial projects.

Disputes will inevitably arise surrounding the interpretation of existing contractual provisions and applicable statutory and equitable principles of law in light of the current outbreak.

Jeffrey Davis

The more lasting impact of COVID-19, however, will be a fundamental rethinking of how project development and finance documents deal with future outbreaks. Indeed, even if the emergence of a coronavirus strain of this severity ends up only being a once-in-a-generation-type event, there are early indications that COVID-19 may be a new type of seasonal malady; the flu and cold season may become the flu and cold and COVID-19 season.

If so, the disruptions we are witnessing now may, on some level, become a new normal. This has understandably injected concern throughout the project development and finance market. This article provides an overview of some of the key contractual considerations in project development and finance documents that are potentially ripe for rethinking in light of COVID-19.

Current Contractual Tools in Project Development

Project development documents are the full suite of agreements signed between an owner of a project and its counterparties with respect to, inter alia, the design, procurement and equipment supply, construction and operation of a project.

Many of these documents do not typically contain detailed provisions relating to pandemics, epidemics, or other disease-related outbreaks. This is particularly true of equipment supply contracts, which are precisely those that are being hardest hit by COVID-19.

The most relevant provisions in such contracts are usually those which relate to force majeure and/or excusable events. These types of clauses generally allow the affected party relief from the performance of its obligations to the extent a specified event occurs and hinders such performance.

There are several key considerations in how these clauses work, including (1) what constitutes an excusable event, (2) what impact such event must have on the affected party, (3) what steps the affected party must take to claim such event, (4) what types of relief are offered to the affected party, and (5) the extent to which a party may terminate a contract for an extended occurrence of such event. COVID-19 has the potential to impact each of these areas in fundamental ways.

Definitions

As mentioned, many project documents contain no express reference to disease-related outbreaks, and those that do often use generic terms like "epidemic" and/or "quarantine" without defining these terms with any specificity.

This leaves open several key questions: What defines the occurrence of an epidemic vs. a mere outbreak? Do quarantines need to be mandatory declarations by government authorities or do they cover voluntary actions by private parties (or something in between)? Affected parties whose contracts do not expressly reference disease-related outbreaks (or only do so in vague terms) can face a difficult path to making a claim.

The same is true for parties with generic force majeure standards relating to any unforeseeable event outside of the control of the affected party. COVID-19 is likely to lead to some level of claim under such generic standards, but it is not clear exactly what related impacts are seen as direct and material versus incidental. Common law-type doctrines such as frustration of purpose or impossibility offer little additional clarity, as these can often carry very high burdens of proof.

The result is that many owners and counterparties alike are struggling in the current environment to understand the contractual impact of COVID-19. We expect that, going forward, both sides may expect and demand that disease-related outbreaks and related actions like quarantine be expressly included and defined in detail.

Impact

Negotiations on excusable event provisions often focus on the concepts of materiality and direct vs. incidental impact, which we do not expect to change as a result of COVID-19. However, one fundamental feature of current excusable event provisions is that they are overwhelmingly granted to counterparties (e.g., contractors, engineers, consultants, service providers, etc.) and not the owner itself. Owner obligations are typically those of payment, which are usually not excusable for force majeure-type events.

As a result, depending on a contract's payment structure, some owner payments may become due during a shutdown caused by COVID-19 even though the counterparty's work may be at a standstill. As outbreaks become their own specified category of excused event, some owner obligations, such as fixed-date payment obligations, may be eliminated or subjected to potential excuse/delay. This type of change may, in turn, have long-term pricing implications for projects.

Procedures

One early takeaway from the COVID-19 outbreak is that there is a lack of clarity about how to handle related claims. In particular, when should such claims be made and what supporting documentation is valid? Under most current contractual formulations, affected parties typically do not notify others of claims until actual material delay or cost increase has been felt; for many owners and lenders in the COVID-19 outbreak, this has come later than desired. Early-notice provisions may be required in future contracts, particularly where outbreaks are known to exist and likely to spread to the affected party.

Regarding supporting documentation, COVID-19 has shown that outbreaks may be pervasive but (ironically) difficult to document. This may be especially true where impact is anticipated to occur, or has resulted, from soft shutdowns by companies or institutions, generic governmental or quasigovernmental declarations or recommendations, or simple unavailability of needed goods.

A related issue is the duty to mitigate: To the extent there are regional differences in the severity of an outbreak, it is unclear how stringently an affected party must seek alternative equipment sourcing, for example. We expect that, in the future, project documents may contain a much more significant amount of detail on what such supporting documentation should look like and how the duty to mitigate should be exercised and evidenced.

Relief

With some exceptions, most project documents take a very simplistic view of relief for parties affected by excusable events. The traditional approach for force majeure, by and large, has been binary: owners bear schedule risk stemming from such events, and contractors bear the associated costs of delay. For other specified (non-force majeure) excusable events, owners often bear both schedule and cost risk.

As COVID-19 spreads and becomes a potential annual occurrence, we expect parties to take a more sophisticated approach to relief. This could be done many ways, such as through sharing of schedule and cost risk. For example, contractors may be able to get relief for only a specified percentage of certain cost and/or schedule claims.

Alternatively, the concept of deductibles may become more widely used, whereby owners would bear X days and/or Y dollars' worth of documented delay above a certain threshold minimum, with contractors bearing the remainder (or vice versa). A desire for greater certainty and limitations on such claims may be driven not only by owners, but by their lenders and investors as well.

Termination

Voluntary or automatic termination for extended force majeure is often, but not always, included in project documents. While the terms of such termination can vary greatly, the middle of the market for large projects is usually that either party may terminate if there has been an excusable event occurring for six consecutive months. This type of historical precedent is not often tailored for the specifics of a project and is usually an afterthought in most negotiations.

In light of COVID-19, these provisions may receive much more scrutiny. Contractors and other counterparties may seek adjustments to these provisions to account for the new reality of outbreaks. Owners (and their project lenders and investors) may want the ability to quickly move to different suppliers/service providers quickly if the contracted counterparty is unable to perform.

COVID-19 and Project Finance Documentation

Project finance documentation is also typically silent on the issue of disease-related outbreaks. Lenders and investors are typically reliant on overall deal structure to capture any residual or unknown risks to the project being financed. However, there are a few key areas in these documents that are likely to receive increased scrutiny.

Schedule Analysis, Insurance and Financial Force Majeure Provisions

A major risk element for any project is the time it takes to achieve completion. As such, schedule risk is a key area of focus of lenders, investors, and their advisers (particularly in the financial, legal, tax, technical and insurance areas). While a certain amount of float is always built into project schedules, analyses will need to account for the potential of lingering and recurring COVID-19 impacts and similar outbreaks.

Some project finance documents contain force majeure provisions that are relevant in connection with long-stop completion deadlines that can trigger enforcement actions. For markets that use these types of provisions, many of the same considerations discussed above for project document force majeure may also be relevant in finance documents.

A related point for lenders and investors is whether any insurance products can play a role in addressing these schedule risks. While delay in start-up and business interruption insurance policies do not typically extend coverage to disease-based outbreaks, there may be a rise in specialty insurance-like products that cover related types of delay.

Whether such new insurance products play a role in future project financings or not, lenders and investors are likely to require modifications to overall deal structure to account for this new type of schedule risk.

Renewables and U.S. Tax Incentives

Concern over schedule is likely to be particularly salient for not only owners but also lenders and investors to U.S. renewables projects that rely on federal tax incentives, including tax credits. Such tax incentives are a critical component of the economics of the project, and they support tax equity financing that may provide the take-out for construction lenders and or early-stage investors. The full effect of COVID-19 is in some respects uncharted territory, but there are two primary issues with which project participants are already grappling.

The first relates to the Internal Revenue Service requirements that renewables projects start construction by the applicable statutory deadlines. Many projects seek to meet these start-of-construction deadlines under so-called 5% safe harbor rule, which treats an owner as having started construction of a project if it has paid or incurred at least 5% of the total project costs.

A special rule allows an accrual basis owner who pays costs in one year (even though the equipment will not be delivered until the following year) to treat the costs as having incurred if the owner reasonably expects delivery within three and one-half months of the payment.

Equipment supply disruptions from outbreaks such as COVID-19 threaten to delay deliveries beyond the

three–and-one-half month period. Whether those disruptions affect the reasonable expectation test is a fact-based inquiry, which may depend in part on what was known about COVID-19 at the time of payment.

The expectation of owners who paid costs in December of 2019 (pre-outbreak) was most likely not affected by COVID-19, but it is less clear how owners may be treated going forward in a post COVID-19 world (particularly if future annual outbreaks are anticipated).

A second issue relates to the so-called continuity requirement. Once construction has started, the IRS rules require that the owner maintain a continuous program of construction to completion. A safe harbor treats a project as satisfying the continuity requirement if the project is placed in service by the end of the fourth year after the year in which construction was started.

Stoppages in construction due to COVID-19 are likely to be seen as excusable disruptions beyond the owner's control for purposes of the continuity requirement. However, they will not (under current IRS rules) toll or extend the four-year safe harbor rule, and they will not extend any statutory deadline by when a project must be placed in service.

This may put significant pressure on the availability of tax credits for certain projects seeking to achieve completion near the end of the applicable deadlines. For example, a wind project that started construction in 2016 under the 5% safe harbor but has not demonstrated continuity must be placed in service by the end of 2020 to be within the safe harbor. As a result, work stoppages during 2020 could jeopardize the project's eligibility for production tax credits.

As a result of these issues, owners, lenders and investors of projects currently under construction are quite focused on the potential impact of COVID-19 on tax credits. However, it is also an open question as to how comfortable they may be taking risk on these issues in future deals, particularly in light of potential future outbreaks or annual recurrences of COVID-19. Deal structures, project documents and overall construction timelines may need to be adjusted as a result.

Project Covenants and Direct Agreements

By the very nature of project financings, lenders and investors are deeply involved in the details of the project documents underlying a project. Finance documents often contain customized, detailed covenants to account for project document risk areas identified during the diligence phase. In addition, security documents such as direct agreements or consents to collateral assignment often address particular areas of concern directly with the project counterparty.

As the new market for project document provisions emerges (including those on excusable events as mentioned above), these provisions will be analyzed by lenders and investors and will likely result in new covenants and direct agreement requirements. For example, lenders and investors may wish to have heightened reporting requirements relating to outbreaks and/or additional limitations on contractor remedies and termination rights in respect of such outbreaks.

They may also wish for owners to have greater flexibility to procure goods and services from alternative providers. Lenders and investors are likely to play a significant role in how project documents are structured in the future to provide clarity and cost and schedule certainty around disease-related events.

Secondary Effects and the Bottom Line

The net effect of all these considerations is that, absent significant reform to project documents to address outbreak-related issues, lenders and investors may price deals with more risk and/or for longer construction schedules than would have existed but for the COVID-19 outbreak. This is likely to have an impact on base case financial models and the required capital raise for some owners. In some cases, it may determine whether certain tightly scheduled projects, or projects relying on certain safe harbor exceptions under US law, are even viable in the marketplace.

Finally, aside from the documentary issues mentioned here, COVID-19 may cause a number of secondary effects in project finance markets. Over the short term, these can include general price suppression of traditional energy sources (such as oil) that may boost some sectors but make others (such as renewables) less competitive.

Labor shortages in certain markets may also impact price and schedule for completion of projects. Import or travel restrictions may hamper the free flow of goods and services. Over the medium term, COVID-19-caused recessions in major economies can also have profound impacts on the level and type of capital that is available to fund projects.

Conclusion

The global rise of COVID-19 is causing immediate repercussions throughout the project development and finance market. The full impact of this outbreak is currently unknown and is likely to vary greatly on a project-by-project and market-by-market basis. However, one thing is certain: the potential for future outbreaks (including potential recurrences of COVID-19) is likely to be a key risk factor for project owners, counterparties, lenders and investors for the foreseeable future.

Nathan Galer and Jeffrey Davis are partners at Mayer Brown LLP.

The opinions expressed are those of the author(s) and do not necessarily reflect the views of the firm, its clients, or Portfolio Media Inc., or any of its or their respective affiliates. This article is for general information purposes and is not intended to be and should not be taken as legal advice.