MANAGING THE COVID-19 PANDEMIC IN AMERICA

HKA COMMERCIAL DAMAGES TASK FORCE, AMERICAS

We are in unprecedented times. Much of the U.S. population are being urged to stay at home, states have issued shelter in place orders and all "nonessential" businesses in many states closed their physical workplaces. Many banks are still getting up to speed on the application process for the Small Business Administration Paycheck Protection Program and nearly 10 million Americans filed for unemployment in the last two weeks of March. The initial economic impacts of COVID-19 surpassed the Great Recession, although many hope that the economic downturn is short-lived, since the cause was a "Black Swan" or unpredictable event.

Companies are seeking advice on how to best document and assess the actual, ongoing, and potential damage impacts of the COVID-19 pandemic. While the economic consequences are still unfolding, the team at HKA is continuously working to evaluate the information related to the pandemic to create plans and analyses to assist our clients. Although the full scale of economic ramifications is unknown, there are factors that will impact our clients that can be anticipated. Timely strategic action may be a deciding factor in how businesses fare.

Some near-term factors to prepare for include:

- supply chain disruption - materials may be unavailable, delayed or subject to price escalation for various reasons including, for example, manufacturers making labor and production changes, ports imposing import and export restrictions, and retail outlets remaining closed;
- labor shortages – workforces are affected by illness or the need to care for loved ones, causing shortages in vital skilled labor; and
- spending decreases – even for those businesses considered essential and allowed to remain open, consumers' disposable income and confidence will be impacted. Businesses may struggle to collect on accounts receivable, as cash preservation efforts are enacted.

In the longer term, consumers', businesses' and governments' elective spending may decline as the focus turns to saving and repaying debt. As the value of any business interest is based on forward-looking expectations of cash flow to investors, many businesses will suffer from decreased asset and equity valuation.

While some clients may not be able to immediately identify specific impacts, they can work to protect their financial and contractual positions. Clients are advised to work with their accounting, procurement, and risk management teams to assess impacts and determine anticipated cash flow. Some firms are instituting furloughs, layoffs, capital expenditure deferrals, and other cost-cutting measures to stay afloat. Businesses that historically never had to borrow money may need to consider adding leverage to their balance sheet. Unlike the Great Recession, the current economic downturn is not expected to be accompanied by a credit freeze, and access to loans at historically low rates are currently available.

Firms or parties to contracts that are highly leveraged may not be able to withstand the impacts, and ultimately face liquidation. Companies need to prepare for business interruptions, government mandated shutdowns, pre- and post- COVID-19 delays, and cost overruns in the near term and reduced capital spending in the longer term.

Despite being considered an essential business in many states, many construction projects are experiencing significant impacts from the COVID-19 pandemic. The impacts include project delays or complete shutdowns, reduced labor productivity, deferred construction starts, procurement issues, and labor shortages, among others. As contractors and owners implement safety measures and other best practices to address COVID-19, the impacts are widespread. For example, on some project sites, workers are filling out daily health questionnaires upon arrival at the job site, having their temperatures taken twice daily, and being required to perform social distancing on the job. These measures can have an impact on labor productivity by reducing the number of available working hours per day. Further, managing and prioritizing critical path work can be challenging due to social distancing. Social distancing could result in fewer critical path craft laborers allowed to perform work in the jobsite confines, thus resulting in delays to project completion. Social

distancing may also lead to out-of-sequence or inefficient work. Labor shortages due to illness, childcare or caring for an ill family member could also result in project delays or productivity impacts.

Parties to ongoing construction projects are encouraged to review the contract and work with counsel to address legal requirements such as addressing notice provisions. Documenting the discrete impacts resulting from COVID-19 (or any impacting event) will be useful in later quantifying cost overruns or project delays. For example, recording the status of the project through a project schedule update, progress reporting tools, photographs, or other means could be very helpful in a claims environment – especially to the extent progress is recorded as close to the start of the impacting event as possible. Documenting the additional requirements resulting from the impact (e.g., added safety and security measures), including the incremental costs, productivity and schedule impacts associated with them, is encouraged and useful for later analysis.

In the event of a project shutdown or significantly reduced workforce, again, documentation is key. In order to prepare for potential claim analyses, it is recommended to record project status (or lack thereof), communicate with other parties (e.g., owner, general contractor, vendors, suppliers, and subcontractors), and record daily headcounts, installation quantities, labor and equipment hours. Ideally, this documentation was ongoing prior to the COVID-19 impact and is continued throughout the life of the project to facilitate quantifying cost and schedule impacts.

HKA professionals are well positioned to assist with impacts resulting from COVID-19. We can help document issues along the way, and can facilitate communications between owners, construction managers, general contractors, and subcontractors. We can also assist in analyzing data to quantify cost overruns, productivity impacts and delays resulting from COVID-19.

HKA is helping construction-focused and other clients assess these issues, as well as identifying the type and recoverability of economic damages that may arise. One avenue of potential recovery available to firms includes business interruption insurance policies. While many policies consider the COVID-19 pandemic an exclusion, we are seeing states propose legislation to “backstop”

coverage, or otherwise utilize insurance companies as a vehicle to make business owners whole. In addition, litigation surrounding lost profits and diminution in assets or business values often spike following a financial downturn. In order to prevail in these proceedings, it is critical to know how to document the losses.

Most business interruption insurance policies provide for loss of business income for a covered loss during a specified period of restoration. Business income is the net profit before income taxes that would have been earned in the ordinary course of business. This measure is similar to the incremental lost profits that are recoverable in certain legal proceedings. Lost profits are computed as lost revenue less the cost of producing that revenue. The cost to produce the revenue consists of variable expenses directly linked to the sale, including for example, materials costs, transportation costs, commissions, or other items typically classified as cost of goods sold. To the extent savings are achieved by cost cutting measures or rent abatements, for example, these savings will also be considered. In litigation proceedings as well as through business interruption insurance claims, parties that seek recovery for lost profits are also required to mitigate or reduce the damage to the extent possible. In addition, if the recovery is sought in the context of a legal proceeding, the injured party must establish a causal link between the event or act and the economic damage.

We encourage our clients to consider evaluating and documenting the impacts of COVID-19 to their business and profits including:

- assembling documentation including business plans or projections to indicate the profits that were anticipated, historical profit and loss statements and tax returns to substantiate those expectations, and bank statements, payroll records, occupancy expenses, etc. to compute the profits actually achieved;
- tracking and documenting increases in operating costs during the pandemic, such as precautionary maintenance and cleaning measures, increased cost to obtain supplies from alternative suppliers, increased delivery expenses, etc.;

- identifying and documenting all reasonable actions taken to mitigate the impacts of the pandemic; and
- capturing and documenting causation triggers, preferably with contemporaneous records such as emails from suppliers and vendors, cancelled contracts, and state and local executive orders.

COVID-19 presents a litany of complications for business owners and insurers. In the case where the insured challenges the insurer's denial of COVID-19 business interruption coverage and pursues the claim through the legal system, insurers should consider:

- performing forensic accounting, period of interruption, and building consultant analyses;
- identifying pre-pandemic factors that materially affect causation and lost profits; and
- the need for expert witness services.

Insurers and business owners should remain abreast of legislation changes, as states (such as New York and New Jersey) may require the insurance companies to pay business interruption losses, regardless of policy exclusions.

Many businesses facing decreases in revenue and cash flow may soon find themselves unable to meet existing debt covenants and credit obligations. In the current environment, clients are advised to consider the solvency of the parties with whom they are doing business and consider creating contingency plans. In the wake of the Great Recession, many of our construction industry clients became interested parties when owners, contractors, and subcontractors filed for bankruptcy protection. Businesses and individuals who never considered the implications of avoidable transactions and fraudulent conveyance soon had material vested interests in the outcomes of such transactions. It is vital to understand the financial position of the parties to a contract and anticipate how they may be affected by the COVID-19 pandemic. Contractors may be unable to collect from owners that file for bankruptcy protection. Likewise, owners could be unable to complete projects as a result of subcontractors filing for bankruptcy protection. As a result, identifying and managing risk across the contractual chain will be crucial.

The financial impact of COVID-19 is a fluid situation and the scale of disruption to businesses and industries is unknown. Rest assured that HKA is here to anticipate, investigate and resolve these issues, and as part of that support HKA is offering a complimentary advice clinic to assist businesses worldwide.

The intent of this commentary is not to provide legal advice and we strongly encourage readers needing such advice to connect with legal counsel.