FEATURE STORY

Aftershocks Coming? Anticipating Borrower Defaults and Defenses When Stimulus Ends

BY BRYAN E. BATES AND ERIC W. ANDERSON

When the world turned upside-down a year ago, many predicted that the severity of the damage to the U.S. economy would usher in a period of borrower defaults, business failures and bank foreclosures. Rapid government intervention, including bank regulatory easing, has prevented that series of events, for now. Those policy measures will surely come to an end before long, at which point lender-enforcement activity will likely increase.

Takeaways

1. **Courts will focus first on the contract terms, but may take a holistic view in fashioning relief in light of the sweeping and unexpected nature of the pandemic.**
2. **Consider amending force majeure and similar contract clauses to expressly contemplate the pandemic to ensure which performance obligations are not excused.**
3. **Review your forbearance agreements for language suggesting any continued obligation to modify the loan, consider borrower proposals, or otherwise work with the borrower.**
4. **Update and formalize forbearance agreements with borrowers whose distress is continuing or worsening.**
5. **Consider written demand to return to strict compliance if the borrower's performance has deviated from forbearance terms.**

Due to the severity and novelty of the pandemic's effects on many businesses, lenders can expect that borrowers will assert myriad defenses to their defaults, claiming that their failures should be blamed on the unprecedented public health crisis. This article will examine both the current regulatory posture that is helping calm the waters and early court interpretation of several defenses raised by borrowers so far in the pandemic.

ERIC W. ANDERSON
Parker, Hudson,
Rainer & Dobbs LLP

BRYAN E. BATES
Parker, Hudson,
Rainer & Dobbs LLP

Congressional Relief Bills

At the outset of the COVID-19 pandemic in March 2020, the Coronavirus Aid, Relief, and Economic Security Act (the "CARES Act") was signed into law in an effort to address public health and economic impacts of COVID-19. Nine months later, in late December 2020—on the precipice of the sunset of certain provisions of the CARES Act protecting defaulted borrowers and tenants from remedial actions—the Coronavirus Response and Relief Supplemental Appropriations Act became law as part of the Consolidated Appropriations Act, 2021 (together with the CARES Act, the "Relief Bills"). The Relief Bills have injected unprecedented levels of economic stimulus into the U.S. economy, helping thus far avoid widespread financial calamity that many expected at the outset of the pandemic and its resultant business closures and restrictions across the country.

The Relief Bills, along with related regulatory guidance, also contain less-noticed, but very important, provisions that change how regulated lenders are permitted to account for and disclose troubled debt restructurings ("TDRs"). Generally, and at the risk of oversimplification, if a borrower is experiencing financial difficulty and the lender has granted a non-immaterial concession, then that credit is treated as a TDR, resulting in an impairment designation and certain impacts on the valuation and reserve requirements with respect to the credit. The Relief Bills temporarily relieve lenders from certain accounting requirements under GAAP applicable to TDRs. Specifically, the bills temporarily suspend the accounting treatment that would typically apply to a TDR, provided that the loan modifications stemmed from the effects of the COVID-19 pandemic on the borrower (as determined by detailed requirements in the bills).

As a result of this relief measure, and related regulatory guidance, lenders generally have been willing to enter forbearance agreements with borrowers, particularly those borrowers whose distress is clearly linked to the COVID-19 pandemic. Currently, the rules pertaining to TDRs will remain in place until January 1, 2022, unless the COVID-19 national emergency ends sooner, in which case they will expire 60 days thereafter.

Early indications from President Biden's administration suggest continued relief measures may be implemented, but at some point the relief measures will no longer be required, and the manner in which TDRs are treated will likely revert to traditional requirements. At that point, lenders will be more likely to exercise remedial rights on a broader scale against distressed borrowers.

When that occurs, lenders can expect resistance from borrowers, who may bristle at a seemingly sudden change in course. Since the outset of the pandemic, it was widely predicted that defaulting contract counterparties would assert defenses to performance on theories of *force majeure*, impossibility/impracticability of performance, and frustration of purpose due to the impact of the pandemic. Post-pandemic, defaulting borrowers are likely to assert those same defenses, and others, against remedial actions. Three decisions discussed below, rendered during the pandemic on certain of these

defensive arguments, provide an instructive look into how courts may address these sorts of arguments as they continue to arise post-pandemic. These decisions involved commercial leases in retail settings, which predictably produced some of the earliest reported cases, given the impact of COVID on the retail sector, but the legal principles at issue extend to all contracts, including loan agreements.

Chuck E. Cheese

In the Chuck E. Cheese bankruptcy cases in the Southern District of Texas, the Bankruptcy Court rejected arguments that the debtors were excused from contractual performance obligations under their leases due to the pandemic. *In re CEC Entertainment, Inc.,* 2020 WL 7356380 (Bankr. S.D.Tex. Dec. 14, 2020). Unquestionably, as an operator of indoor venues featuring arcade games, entertainment, and dining for family gatherings and groups of children, Chuck E. Cheese suffered unprecedented, unforeseen, and devasting impacts from the pandemic and related restrictions. The Court recognized that impact, and the Court agreed that certain government-mandated restrictions qualified as *force majeure* events. That notwithstanding, the Court held that the specific force majeure language of the contracts, most notably the exceptions, did not provide the debtors with a defense to their contractual performance obligations.

The leases at issue contained typical *force majeure* language, such as:

> if either party shall be prevented or delayed from punctually performing any obligations or satisfying any condition under this Lease by any … act of God, unusual governmental restriction, regulation or control … or any other condition beyond the reasonable control of such party, … then the time to perform such obligation or to satisfy such condition shall be extended on a day-for-day basis for the period of the delay caused by such event. **This Section shall not apply to the inability to pay any sum of money due hereunder or the failure to perform any other obligation due to the lack of money or inability to raise capital or borrow for any purpose.**

Because the exception precluded application of the *force majeure* defense to excuse payment obligations due purely to financial distress, the Court ruled that the debtors were not excused from performance, even if the occurrence of the global pandemic and related government regulations qualified as *force majeure* events.

The Court also examined the debtors' arguments under the alternative theories of frustration of purpose and impossibility of performance, under applicable state law. Principally, the Court reasoned that where parties affirmatively allocate risk of unforeseen events amongst the contract parties, such as through a *force majeure* clause, then the existence of such contract provision supersedes common law theories of frustration of purpose and impossibility of performance. But even considering the merits of such theories, the Court overruled the debtors' arguments because the *force majeure* events did not operate either to entirely frustrate the purpose of the contracts or render performance impossible.

Pier 1 Imports

By contrast, the Bankruptcy Court for the Eastern District of Virginia took a more flexible approach in the very early days of the pandemic in the Pier 1 Imports case, and permitted the debtors to delay making contract payments, noting the unforeseeability of the pandemic and related restrictions. *In re Pier 1 Imports, Inc.,* 2020 Bankr. LEXIS 1242 (Bankr. E.D. Va. May 10, 2020). The primary issue was the mandate of § 365(d)(3) of the Bankruptcy Code that debtors must continue to "timely" perform under their commercial real property leases while operating in bankruptcy.

The debtors had implemented other cost reduction measures, but sought authority to delay rent payment obligations while they pursued a sale. The Court explained that the pandemic effected a "temporary, unforeseen, and unforeseeable glitch" in the debtors' operations and restructuring efforts, and perhaps in the vein of an impossibility theory, noted that the debtors "cannot operate … because they have been ordered to close their business," "cannot effectively liquidate the inventory while their stores remain closed," and were "unable to open their stores to conduct the sales."

The Court reasoned that the performance requirements of § 365(d)(3) did not compel payment, just the incurrence of an administrative claim to be paid in accordance with other requirements of the Bankruptcy Code. The Court noted the existence of numerous other creditor constituencies in the case, and the scarce resources available to satisfy all claims. On the whole, amidst the highly uncertain early days of the pandemic, the Court fashioned relief designed to preserve value for the benefit of all stakeholders, rather than just the direct counterparties to the contracts in question.

Hitz Restaurant Group

The Bankruptcy Court in the Hitz Restaurant Group bankruptcy took somewhat of a middle-ground approach. *In re Hitz Restaurant Group,* 616 B.R. 374 (Bankr. N.D. Ill. 2020). That Court disagreed with the analysis in *Pier 1* that § 365(d)(3) did not compel payment, reasoning that the requirement of "timely" performance compels rent payments ahead of other administrative expenses (which, incidentally, comports with the Court's analysis in *Chuck E. Cheese*). The debtor argued that its force majeure clause excused performance. Noting that the existence of a *force majeure* clause in a contract supersedes the common law doctrine of impossibility, the Court examined the *force majeure* clause in the Hitz lease. That clause excused performance if prevented by governmental laws/orders/actions, but excepted lack of money as a ground to excuse performance.

The Court explained that the *force majeure* clause was triggered by a government order restricting restaurant operations, which order proximately caused the debtor's inability to generate funds sufficient to pay its contract obligations. Despite the exception that the lack of money was not grounds to

excuse performance, the Court allowed the debtor to reduce its payment obligations in proportion to the debtor's reduced ability to generate revenue due to the government order.

Borrowers Asserting Pandemic as Excuse

The lender flexibility spawned by this unprecedented pandemic may well lead borrowers to become accustomed to or expect continued forbearance and flexibility going forward, and borrowers may try to claim some entitlement to that treatment. Two decisions entered during the pandemic (both in the mortgage context) highlight some borrower arguments and judicial reasoning that lenders can expect in those circumstances.

In Reynolds v. Wells Fargo Home Mortgage, 2020 WL 3977934 (W.D. Va. July 14, 2020), the Court denied a borrower's claim that the lender breached its implied covenant of good faith and fair dealing in refusing to modify the loan under certain programs, including the CARES Act. The Court zeroed in on the key factor that no contractual provision between the lender and borrower required the lender to do so, and absent bad faith, a lender cannot be liable for breach of an implied covenant of good faith and fair dealing if it is merely exercising its contract rights.

In another pandemic-era decision, the Court in *Foster v. Reverse Mortgage Solutions, Inc.,* 2020 WL 4390374 (C.D. Cal. May 13, 2020), similarly denied a borrower's claim stemming from the lender's refusal to grant loan modifications. But the Foster court noted an earlier contrary court decision, *Lueras v. BAC Home Loans Servicing, LP,* 221 Cal. App. 4th 49 (2013), in which the subject forbearance agreement included language that incorporated regulatory guidance that lenders "should" work with borrowers and expressly required the lender to "review" the borrower's loan to determine if additional default resolution assistance could be offered. The agreement being construed in *Foster* did not have any such language, but if it had, then the outcome could well have been different.

Lender Guidance

For lenders, these rulings offer a look into the varied forms of legal analyses at issue and potential array of relief that may be fashioned if a defaulting borrower claims the entitlement to excuse performance by virtue of a *force majeure* provision in a loan agreement or any similar common-law theories. As shown in these decisions, courts, especially bankruptcy courts, will take a holistic view, but all courts will start by examining any express *force majeure* contractual provisions, as well as any contract provisions that operate similarly (regardless of whether denominated as a "*force majeure*" clause).

Review your contracts for any language addressing *force majeure* events, any other excuses for performance, and any potential obligations to continue working with borrowers. The benefit of having these provisions is that they are likely to supersede application of alternate common-law theories, because the parties have expressly contemplated the issue and determined how to allocate risk. Many loan contracts may not have *force majeure* clauses, which leaves open the possibility that common-law theories of impossibility, impracticability, and frustration of purpose may apply (exploration of which is beyond the scope of this article). In any event, before taking remedial action, lenders should consider documenting a demand to return to strict compliance, reasonably in advance of taking such action.

During this pandemic, lenders have entered into forbearance agreements on an extraordinary scale. The manner in which lenders documented those agreements spanned a broad spectrum, from the highly informal to painstakingly negotiated, comprehensive written agreements. Lenders should review those agreements and consider whether it may be necessary or advisable to revise or amend them to expressly contemplate the current pandemic and ensure that the language of any *force majeure* exception clearly delineates what performance obligations (e.g., payment obligations) are not excused upon the occurrence of a *force majeure* event. Lenders should also analyze their forbearance agreements regarding any terms governing continued obligations to modify loan obligations, or to even consider borrower proposals.

Taking these steps now could pay dividends in the post-pandemic return to a broader exercise of remedial rights.

Eric Anderson is a partner in the bankruptcy practice group of Parker, Hudson, Rainer & Dobbs LLP in Atlanta. His practice focuses on bankruptcy, workouts, financial restructuring and commercial finance, representing lenders and other parties in bankruptcy and financial restructuring matters in and out of bankruptcy, debtor-in-possession financing, purchase and sale of assets of distressed companies, and various related transactions. Eric is a frequent speaker and lecturer on bankruptcy and related topics, and a frequent author for the ABI Journal and other publications. Eric is a member of the Board of Directors of the American Bankruptcy Institute and the Southeastern Bankruptcy Law Institute and is a Fellow in the American College of Bankruptcy. He can be reached at eanderson@phrd.com.

Bryan Bates is also a partner in the bankruptcy practice group of Parker, Hudson, Rainer & Dobbs LLP in Atlanta. His practice focuses on business bankruptcy, creditors' rights, and commercial litigation. He represents secured and unsecured creditors, debtors, committees, trustees and other parties-in-interest in Chapter 11 reorganization proceedings, insolvency matters, and debtor/creditor litigation, both in and out of Court. Bryan also represents parties in business disputes and commercial litigation matters in state and federal courts. He is a member of the Turnaround Management Association, the Bankruptcy Section of the Atlanta Bar and the American Bankruptcy Institute. He can be reached at bbates@phrd.com.