LEGAL INSIGHTS

The Top 5 Legal Issues Lenders Should Look Out For In 2021

BY BRETT GARVER AND DANIELLE J. MARLOW

The year 2020 has been a wild ride for secured lenders, particularly in light of the COVID-19 pandemic. The coming year promises to be full of plenty of twists and turns as well. Attorneys from Moritt Hock & Hamroff provide analysis of the top five issues secured lenders should be aware of in 2021.

The CARES Act, the Future of Legislative and Regulatory Support and the Aftermath of the COVID-19 Pandemic

In the early weeks and months of the COVID-19 pandemic, there was an extraordinary legislative and regulatory effort to support the entire economy in the unprecedented wake of complete and almost instantaneous economic standstill. The CARES Act, with extensive emergency programs, including the Paycheck Protection Program ("PPP") and the Main Street Lending Facility, sprang up quickly, aimed at bridging businesses (and to some extent their credit providers) to the other side of the crisis. In addition, regulated financial institutions were afforded broad deference in working with borrowers and granting loan modifications and payment deferrals that otherwise would have triggered capital reserves (on the lender's balance sheet), increased risk ratings and lender-side balance sheet issues.

We are at a critical juncture. Vaccine distribution is beginning, but we are still facing the potential of widespread lockdowns as numbers rise. At the same time, some of the key CARES Act programs are ending. The initial funding phase of PPP has concluded and the forgiveness phase will stretch into 2021. While the initial funding phase of PPP moved with great speed, the forgiveness process will stretch into 2021 as lenders are faced with collecting a daunting amount of information to obtain forgiveness (effectively underwriting loans after they were made). Unlike the seemingly bipartisan race to get the CARES Act adopted and even amended to provide supplemental PPP funding, the election cycle and traditional political battles put further legislative relief out of reach for most of the second half of the year. In 2021, the finance industry will have to adjust to the legislative relief adopted, including a revamped PPP program.

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Documenting a Return to "Normal"

Much like the race to get regulatory support in place, in the early days of the COVID-19 pandemic, credit providers similarly moved quickly to support borrowers and their own balance sheets by crafting sweeping deferral programs affording relief to businesses forced to adapt to a very different business model virtually instantaneously (e.g., retail sales) or whose industries ground to a complete halt (e.g., hospitality) or who were secondarily impacted, such as commercial and residential landlords faced with tenants who simply could not pay. Many lenders moved quickly to adopt streamlined loan modifications or deferrals that in some cases simply reflected the reality that the COVID-19 problems were simply transient and at the end of the lockdowns, borrowers' ability to pay should reset back to their pre-pandemic norms. That worked in many cases and at the end of a three, six or even nine-month deferral, borrowers are able to get back on normal terms. However, this will not be universally true. Secured creditors are faced with a new reality for some industries that may never be the same (such as hospitality and public venue entertainment) or industries that were already in jeopardy before the pandemic (brick and mortar retail). These creditors face the daunting task of turning what were well meaning and prudent emergency extensions into true negotiated forbearance agreements or into adversarial workouts for borrowers who are now almost one year behind and unable to return to normal. Creditors will face decisions about whether to impose tighter conditions,

or demand additional collateral or guarantees. Further documentation of deferral and extensions will have to focus on permanent solutions and move away from putting off the borrower's troubles for another day.

Extreme Limitations Upon Foreclosures

Mortgage foreclosure is one of the most powerful tools available to secured lenders. But in the wake of the COVID-19 pandemic, the availability of mortgage foreclosure has been extremely limited. For example, in New York, initiation of foreclosure proceedings was prohibited altogether from March 2020 until October 2020. Beginning in October 2020, residential foreclosure actions were permitted to proceed (with numerous limitations), but residential evictions are still prohibited through at least January 1, 2021, and commercial foreclosures and evictions are also still prohibited. Several other states have likewise prohibited residential and commercial foreclosures. Thus, in many areas, secured lenders have no practical ability to realize upon the value of the mortgage collateral securing their loans.

While, during the fall, it appeared that these restrictions may be lifted, in light of the uptick in COVID-19 cases and resulting resumption of shut downs in many areas, the extreme limitations upon foreclosures are likely to continue into 2021.

Stricter Scrutiny of UCC Article 9 Sales and "Commercial Reasonableness"

Mezzanine lenders have likewise seen their fair share of defaults in the wake of COVID-19. As a result, mezzanine lenders have and will likely need to continue to invoke their right to sell the equity collateral securing their loans in a Uniform Commercial Code ("UCC") Article 9 sale. In light of the limitations of mortgage foreclosures, UCC Article 9 sales – which in most cases have not been held to be subject to the foreclosure ban – are an important tool. However, mezzanine lenders need to be cognizant of the commercial reasonableness requirements of UCC §9-610(b), which courts have strictly construed, in the COVID-19 environment.

For example, Justice Masley of the New York Supreme Court issued a decision on June 23, 2020, holding that a UCC Article 9 sale on thirty-six (36) days' notice, which required the winning bidder to make a non-refundable deposit of 10% of the purchase price, pay the remaining balance within 24 hours, and precluded the borrower from submitting a bid, was commercially unreasonable. Similarly, on August 3, 2020, Justice Schecter of the New York State Supreme Court enjoined a lender from conducting a UCC Article 9 sale, holding that: "Severe turmoil in the real estate market due to the pandemic makes the notion of a sale resulting in payment of fair market value highly uncertain." Taken out of context, this decision could be read to preclude UCC Article 9 sales during the pandemic altogether.

Takeaways

1 **Temporary COVID-19 related regulatory and statutory upheavals will continue through 2021. Credit providers will have to actively monitor regulatory development in real-time.**

2 **Creditors will have to focus their efforts on restoring outstanding credit facilities to good standing and distinguishing between credit facilities that were disrupted by the pandemic and those that the pandemic revealed were already in trouble.**

3 **Creditors will continue to face challenges imposed by extreme restrictions on foreclosures and evictions.**

4 **Careful consideration will need to be given to the commercial reasonableness of the process by which UCC Article 9 sales are conducted while the marketplace is still restricted by the limitations imposed by COVID-19.**

5 **Creditors will have to focus on whether debtors gain traction asserting defenses to payment such as force majeure, impracticability, and frustration of purpose which prior to the pandemic had only limited success.**

However, recent decisions reflect a significant change in the tide. For example, in the very same case, in a decision dated October 27, 2020, Justice Schecter reversed herself and allowed the UCC Article 9 sale to proceed. Her decision this time had a decidedly different tone:

> *Forcing defendant to continue funding the costs that plaintiff failed to pay would be commercially unreasonable given the state of the property and the debt to the senior lender . . . Given the circumstances of this case and the current state of the pandemic, further enjoining this sale would be highly inequitable.*

Other courts have similarly demonstrated an increased willingness to allow UCC Article 9 sales to proceed. However, in light of the recent spike in COVID-19 cases and the prospect of potential additional shutdowns, mezzanine lenders should be careful to insure that Article 9 sales are "commercially reasonable," including by providing ample notice, advertising the sale in widely distributed periodicals, and conducting the sale by virtual means.

Force Majeure, Impracticability, Frustration of Purpose, and Other Defenses

The increase in loan defaults in the wake of the COVID-19 have also brought to the forefront numerous legal defenses put forward by borrowers – such as force majeure, impracticability, and frustration of purpose. Decisions by the courts during 2020 provided some insights as to how judges will view these defenses, but these cases are likely to more fully develop during 2021.

Force majeure allows a party to suspend or terminate their obligations when certain circumstances beyond their control arise. Impracticability may be invoked if it is still theoretically possible to perform a contract, but the costs necessary to complete it render the contract uneconomical. Frustration

of purpose applies when a change in circumstances makes one party's performance virtually worthless to the other. The decision whether to permit these defenses boils down to the allocation of risk, specifically (i) who should bear the risk of unforeseen circumstances, such as the pandemic, and (ii) does the lending agreement or other governing contract address the allocation of risk?

The lease context provides colorful examples as to how these issues may play out. Several prominent lessees, such as The Gap, which leases space in Times Square, Victoria's Secret, which leases space in Herald Square, and Hugo Boss, which leases space in Time Warner Center, have all tried to get out of their pricey leases, invoking force majeure, impracticability, and similar defenses. They argue that the exorbitant rent they pay was based upon the expected foot traffic at these renowned locations, which has almost ceased in the wake of the COVID-19 pandemic. To date, it appears that judges only have limited sympathy for these arguments. For example, in the case of The Gap, while the presiding judge enjoined the landlord from terminating The Gap's lease, The Gap was required to post a bond in the amount of 90% of the rent due as a condition of this relief. Lenders should keep a close watch on these and similar cases as they are decided throughout 2021, and the lessons these decisions provide, both for the interpretation of present lending agreements, and the drafting of new ones.

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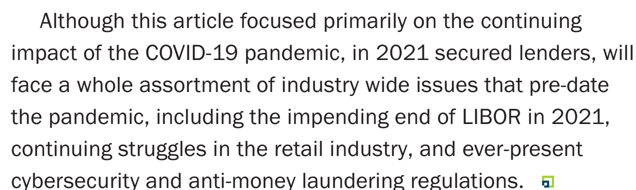

Although this article focused primarily on the continuing impact of the COVID-19 pandemic, in 2021 secured lenders, will face a whole assortment of industry wide issues that pre-date the pandemic, including the impending end of LIBOR in 2021, continuing struggles in the retail industry, and ever-present cybersecurity and anti-money laundering regulations.

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