

The Banking Law Journal

Established 1889

An A.S. Pratt™ PUBLICATION

MARCH 2022

EDITOR'S NOTE: BANKING HISTORY IN THE MAKING

Victoria Prussen Spears

OFAC ISSUES SANCTIONS GUIDANCE TO VIRTUAL CURRENCY INDUSTRY

Abena Mainoo, Chase D. Kaniecki, Michael G. Sanders, John Lightbourne and William S. Dawley

FEDERAL BANK REGULATORS SET OUT REGULATORY ROADMAP FOR CRYPTO-ASSETS

Clifford S. Stanford, Brian D. Frey, Brendan Clegg and Jessica Garcia Keenum

U.S. FEDERAL BANKING AGENCIES ISSUE RULE REQUIRING BANKS TO NOTIFY REGULATORS OF CYBER INCIDENTS WITHIN 36 HOURS

Daniel Silver, Megan Gordon, Celeste Koeleveld, Philip Angeloff, Brian Yin and Shannon O'Brien

FINANCIAL INSTITUTIONS NEED TO KEEP UP WITH THE CHANGING BUSINESS OF RANSOMWARE

Michael A. Mancusi, Kevin M. Toomey, Nancy L. Perkins, Anthony Raglani, Daniel E. Raymond and Kara Ramsey

OCC ADVISES BANKS TO CAREFULLY EVALUATE VENTURE CAPITAL FUND INVESTMENTS

David F. Freeman, Jr., Kevin M. Toomey and Anthony Raglani

U.S. BANK REPORTING HANDBOOK UPDATED BY OCC

Jeffrey P. Taft and Matthew Bisanz

NAVIGATING FAIR LENDING AND REDLINING CONSIDERATIONS UNDER THE BIDEN ADMINISTRATION

Abigail M. Lyle and Nicole Skolnekovich

NEW YORK IMPOSES COMMUNITY REINVESTMENT ACT REQUIREMENTS ON MORTGAGE BANKERS

Bob Jaworski

FIFTH CIRCUIT HOLDS DIFFICULT ECONOMIC CIRCUMSTANCES INSUFFICIENT TO CLAIM DURESS; LENDERS ENTITLED TO THREATEN TO EXERCISE CONTRACTUAL RIGHTS AS NEGOTIATING LEVERAGE

Gregory G. Hesse and Jennifer E. Wuebker

CURRENT DEVELOPMENTS

Steven A. Meyerowitz

THE BANKING LAW JOURNAL

VOLUME 139

NUMBER 3

March 2022

Editor's Note: Banking History in the Making Victoria Prussen Spears	109
OFAC Issues Sanctions Guidance to Virtual Currency Industry Abena Mainoo, Chase D. Kaniecki, Michael G. Sanders, John Lightbourne and William S. Dawley	112
Federal Bank Regulators Set Out Regulatory Roadmap for Crypto-Assets Clifford S. Stanford, Brian D. Frey, Brendan Clegg and Jessica Garcia Keenum	118
U.S. Federal Banking Agencies Issue Rule Requiring Banks to Notify Regulators of Cyber Incidents Within 36 Hours Daniel Silver, Megan Gordon, Celeste Koeleveld, Philip Angeloff, Brian Yin and Shannon O'Brien	122
Financial Institutions Need to Keep Up with the Changing Business of Ransomware Michael A. Mancusi, Kevin M. Toomey, Nancy L. Perkins, Anthony Raglani, Daniel E. Raymond and Kara Ramsey	126
OCC Advises Banks to Carefully Evaluate Venture Capital Fund Investments David F. Freeman, Jr., Kevin M. Toomey and Anthony Raglani	130
U.S. Bank Reporting Handbook Updated By OCC Jeffrey P. Taft and Matthew Bisanz	134
Navigating Fair Lending and Redlining Considerations Under the Biden Administration Abigail M. Lyle and Nicole Skolnekovich	138
New York Imposes Community Reinvestment Act Requirements on Mortgage Bankers Bob Jaworski	143
Fifth Circuit Holds Difficult Economic Circumstances Insufficient to Claim Duress; Lenders Entitled to Threaten to Exercise Contractual Rights as Negotiating Leverage Gregory G. Hesse and Jennifer E. Wuebker	148
Current Developments Steven A. Meyerowitz	152

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ISBN: 978-0-7698-7878-2 (print)

ISSN: 0005-5506 (Print)

Cite this publication as:

The Banking Law Journal (LexisNexis A.S. Pratt)

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POSTMASTER: Send address changes to THE BANKING LAW JOURNAL, A.S. Pratt & Sons, 805 Fifteenth Street, NW, Third Floor, Washington, DC 20005-2207.

Fifth Circuit Holds Difficult Economic Circumstances Insufficient to Claim Duress; Lenders Entitled to Threaten to Exercise Contractual Rights as Negotiating Leverage

*By Gregory G. Hesse and Jennifer E. Wuebker**

A ruling by the U.S. Court of Appeals for the Fifth Circuit that an individual guarantor remained liable for more than \$58 million in commercial debt, despite the individual's claims that the lenders induced him to provide the guaranty under duress, provides meaningful guidance, particularly for lenders in distressed situations. The authors of this article discuss the decision and the court's reasoning.

The U.S. Court of Appeals for the Fifth Circuit has held that an individual guarantor remained liable for more than \$58 million in commercial debt, despite the individual's claims that the lenders induced him to provide the guaranty under duress.¹ The Fifth Circuit concluded that threats and actions by lenders to exercise rights and remedies authorized in the loan documents can be used as leverage in workout negotiations to extract concessions from a borrower, including concessions such as the appointment of a chief restructuring officer ("CRO") with authority to operate the borrower's business.

BACKGROUND

In September 2015, Michael Lockwood's companies—Lockwood International, Inc. and its affiliates Lockwood Enterprises, Inc., LMG Manufacturing, Inc., and Piping Components Inc.—entered into two revolving credit loan facilities, from each of Wells Fargo (for \$70 million) and Trustmark National Bank (for \$20 million). By the following year, Lockwood's companies already had breached certain of their loan obligations, and to avoid acceleration of the debts, the parties entered into a loan amendment that reduced the total debt to \$72 million. As a condition to the loan amendment, on the same day the amendment was signed, Lockwood executed a personal guaranty of the debts.

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¹ See *Lockwood International, Inc. v. Wells Fargo, NA, et al.*, Case No. 20-40324 (5th Cir. Aug. 16, 2021).

The lenders required this guaranty to ensure that Lockwood retained “skin in the game.” The lenders also recommended (or required, according to Lockwood) that Lockwood’s companies—the borrowers—bring on a CRO to manage the companies and help turn them around.

Despite bringing on the CRO, the situation at Lockwood’s companies did not improve, and further loan defaults occurred. To avoid acceleration of the debt, Lockwood and his companies executed a forbearance agreement with the lenders. Importantly, the forbearance agreement acknowledged and ratified the underlying debt, including the guaranty, and that there were “no valid defense[s] to the enforcement of such [o]bligations.” The forbearance agreement also included a waiver and release of all claims and defenses, of any nature, against the lenders.

As the forbearance agreement neared expiration, and the threat of acceleration presented itself once again, Lockwood and his companies executed a second forbearance agreement, and again acknowledged and ratified the underlying debt and guaranty and waived all claims and defenses.

When the second forbearance agreement expired, and the lenders finally accelerated the debt, litigation immediately followed. Lockwood International brought claims against the lenders for negligence, fraud, conversion, and numerous other business torts. The lenders counterclaimed and impleaded Lockwood, alleging breach of contract and breach of guaranty. The borrowers’ tort claims were dismissed, but the lenders’ breach of guaranty claim against Lockwood survived, and the lenders moved for summary judgment in the district court.

In response, Lockwood asserted four affirmative defenses: fraudulent inducement, duress, unclean hands, and equitable estoppel. The district court granted the lenders’ motion for summary judgment and determined that:

- The waivers and releases Lockwood signed in connection with the forbearance agreements foreclosed any claim that he was fraudulently induced;
- Lockwood’s allegations of intense business pressure fell short of duress; and
- Lockwood’s other defenses failed because they related only to equitable relief no longer at issue.

Lockwood appealed the district court’s ruling, and the Fifth Circuit affirmed.

THE FIFTH CIRCUIT'S DECISION

As the Fifth Circuit pointed out, to avoid enforcement of the guaranty, Lockwood needed a “hat trick” showing that the guaranty, the first forbearance agreement, and the second forbearance agreement all were voidable. Lockwood achieved no such hat trick.

The court began its analysis with the guaranty, finding that Lockwood “cannot escape his promise to guarantee the debt” because, even if the guaranty itself was voidable, Lockwood ratified the guaranty and its terms through the first forbearance agreement. The court noted that, under Texas law, ratification occurs when “a party by its conduct recognizes a contract as valid, having knowledge of all relevant facts” and that, once ratified, “a guaranty otherwise voidable due to fraudulent inducement or duress cannot be avoided.”² The court concluded that the first forbearance agreement “ratified the guaranty in no uncertain terms.”

The court next turned to Lockwood’s defense of duress. The court understood that “[n]o doubt Lockwood feared the looming prospect of the banks’ demanding the tens of millions of dollars that he and his companies owed” and that the lenders used their leverage to get “something they wanted” in the form of a chief restructuring officer with control of the companies. However, the court cautioned that “using leverage is what negotiation is all about. And difficult economic circumstances do not alone give rise to duress.” If they did, the court postured, opportunities to modify and stave off financial disaster would be “few and far between if a borrower could later void the modification because of the economic pressure that prompted it in the first place.” The court concluded that “duress requires more.”

Specifically, the court held that duress exists only when a party can prove three things: “(1) a threat to do something a party has no legal right to do, (2) an illegal exaction or some fraud or deception, and (3) an imminent restraint that destroys the victim’s free agency and leaves him without a present means of protection.” Thus, Lockwood needed to prove all three.

The court found that Lockwood’s defense failed at the first requirement and that it need not consider the second and third requirements. Lockwood could not provide evidence of any threat by the lenders to do something it had no legal right to do. Rather, the court found that the lenders took actions—threatening to accelerate the debt—well within their contractual rights.

Because Lockwood could not establish any “bad acts” to obtain his signature on the first forbearance agreement, including the agreement to appoint a CRO,

² Citations omitted.

the duress defense failed. In addition, because the duress defense failed, the first forbearance agreement was not voidable and indeed ratified the underlying debt and guaranty. Thus, Lockwood was liable for the debt.

KEY CONSIDERATIONS

The Fifth Circuit's ruling in *Lockwood* provides meaningful guidance, particularly for lenders in distressed situations. One of the key threshold issues the court considered was the validity, and voidability, of the individual guaranty. However, because the first forbearance agreement expressly ratified the guaranty, the court's inquiry was brief. The ratification provided a total bar to the defenses of fraudulent inducement and duress with respect to the guaranty. The inclusion of a guaranty ratification in forbearance documentation is thus advisable to protect the lender.

Similarly, the district court focused much of its attention on the waiver and release contained in the two forbearance agreements. Indeed, while the circuit court did not reach this issue, the district court held that the waiver of all defenses and the releases in the forbearance agreements foreclosed any claim of fraudulent inducement relating to the earlier agreements. Each forbearance agreement, with its waiver and release provision, wiped the slate clean for the lender with respect to any alleged prior fraudulent inducement.

Finally, the Fifth Circuit gave lenders comfort that utilizing leverage, even in a distressed situation, does not alone rise to duress. There must be more. Thus, the lender may threaten, or take, any action it is permitted to take under the loan documents, and is not foreclosed from exercising any or all of its remedies, including acceleration. A threat to take a contractually permitted action as negotiating leverage does not constitute a bad act as required by the duress defense.