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"Take This Pill, It's Good for You": Fifth Circuit Concludes That Forced Change of Control Was Not the Product of Duress

By Arthur J. Steinberg, Jonathan W. Jordan, and Sarah L. Primrose*

The U.S. Court of Appeals for the Fifth Circuit recently affirmed a lower court's rejection of a guarantor's duress defense in the face of a $58 million personal guarantee. The authors of this article discuss the decision and its implications.

Distressed businesses are often their own worst physicians. Faced with an operational or financial crisis, established management frequently resists outside ideas, lives in denial, or simply lacks the tools to fix the business. Without effective (and sometimes bitter) medicine, lenders would be forced to sit back and watch their collateral free-fall while management flails about.

In today's over-leveraged world, when a formal legal proceeding such as bankruptcy, foreclosure, or receivership can cause collateral values to plummet, change of control has become a favored arrow in a lender's quiver. Where loan documents permit, a lender may exercise corporate managerial rights by proxy to vote in new management—which may mean putting a turnaround or restructuring expert at the company's helm. In other cases, where a lender has not secured proxy rights in its loan documents, a lender may have to force the debtor to retain more effective management by making, á la Vito Corleone, "an offer [debtor] can't refuse."

Can lenders do that? The U.S. Court of Appeals for the Fifth Circuit recently affirmed a lower court's rejection of a guarantor's duress defense in the face of a $58 million personal guarantee. Concluding that duress requires more than a willingness to use economic leverage, the Fifth Circuit held that under Texas law, lenders did not commit a "bad act" when they issued an ultimatum to a defaulting borrower: Transfer control of the company to a chief restructuring officer ("CRO") in 48 hours or face the full wrath of the lenders' remedies. The

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Fifth Circuit also rejected the defaulting borrowers' other attempts to undo the concessions made by them in negotiated forbearance agreements.

TOUGH LOVE OR DURESS?

The case, styled *Lockwood International, Inc. v. Wells Fargo, N.A.*, grew out of a lengthy legal battle over a $90 million revolving credit facility funded by Wells Fargo and Trustmark National Bank. When the borrower, Lockwood International, Inc., defaulted, Wells Fargo and Trustmark required its principal, Michael Lockwood ("Lockwood"), to sign a personal guaranty for the loan balance as a condition to amending the loan agreement.

The business did not turn around, and when the borrower continued to default, the lenders issued an ultimatum: Turn management authority over to the CRO in 48 hours, or the lenders would use their extensive arsenal of remedies against the borrower and Lockwood. Lockwood complied. When the borrower later missed a required loan payment, the lenders, Lockwood and the borrower entered into a forbearance agreement that, among other things, disclaimed any defenses and waived all setoffs or counterclaims. A second forbearance agreement confirmed those same borrower concessions. Ultimately, the forbearance expired, and the lenders accelerated and began exercising remedies.

Lawsuits flew in all directions. The borrower sued Wells Fargo and Trustmark for over $1.5 billion based on a slew of business torts, and the lenders counterclaimed and brought in Lockwood as a third-party defendant for his guarantee. The corporate borrower's claims against Wells Fargo and Trustmark were transferred to a bankruptcy trustee and settled, but the lenders' personal guaranty claims against Michael Lockwood survived. Lockwood asserted that the guaranty and forbearance agreements were the product of duress. The district court disagreed, finding that the lenders' pressure to sign forbearance agreements and transfer control to the CRO did not constitute duress under Texas law. Lockwood appealed.

WHAT GOOD IS LEVERAGE IF YOU DON'T USE IT?

The Fifth Circuit rejected Lockwood's duress claim—finding as a matter of law that using economic leverage in negotiations creates discomfort, but not duress. Writing for the court, Judge Gregg Costa observed that economic pressure is a natural element of the distressed business landscape:

> No doubt Lockwood feared the looming prospect of the banks' demanding the tens of millions of dollars that he and his companies owed. The banks used that leverage to seek something they wanted: a

> transfer of authority to the CRO. But using leverage is what negotiation is all about. And difficult circumstances alone do not give rise to duress. If they did, then many loans would be voidable. People and businesses often need loans because they are facing financial challenges. Borrowers who seek to modify their loan agreements after failing to make payments are even more likely to be feeling the squeeze.

Under Texas law, duress requires a "bad act" that the lender has no right to take. Because a lender may demand a change in management as a condition of loan modification, the Fifth Circuit found that the lender committed no "bad act" that would validate a duress defense.

WIDER IMPLICATIONS FOR LENDERS

Viewed on its face, the opinion in *Lockwood* stands for the proposition that the Texas law of duress offers no defense to a borrower who makes concessions in forbearance negotiations. But the "bad act" requirement under Texas law is mirrored in other states, such as New York, which requires an "unlawful threat" to establish duress. Where a borrower is in default, Lockwood offers comfort to lenders that a duress defense should not deter them from requiring a change of management as a condition to loan modification or forbearance.