

Virus Relief Bill Could Harm Lending, Collections Landscape

By David Dormont, Gregory Donilon and Maura Russell (September 8, 2020)

As the COVID-19 pandemic continues to impact the U.S., Congress may potentially alter the legal landscape for creditors and debtors.

The U.S. House of Representatives recently passed H.R. 6800 — the Health and Economic Recovery Omnibus Emergency Solutions, or HEROES, Act. This \$3 trillion, 1,852-page bill contains provisions that would significantly affect the extension of credit to and the collection of debts from individuals, small businesses and nonprofit organizations.

In short, most legal collection and enforcement efforts against covered entities and individuals would likely be stayed nationwide for the foreseeable future.

Since the pandemic began, creditors attempting to collect debts and/or enforce judgments and security interests have faced a hodgepodge of state and local procedures restricting such measures. Under the HEROES Act, those collection actions that have been allowed to proceed may actually grind to an indefinite halt.

Highlighted below are several important provisions of the act that, if passed, would abruptly shift the playing field for creditors and debtors. These provisions also raise a host of questions and potential pitfalls. As detailed further, this well-intended legislation may actually be fraught with unintended consequences for both creditors and debtors — unintended consequences that could exacerbate already-distressed economic conditions.

The Bill

As a proposed amendment to the Fair Debt Collection Practices Act, the HEROES Act would prohibit most collection actions against small businesses and nonprofits from the date of the law's enactment until 120 days after the end of the president's national emergency declaration. This covered period figures to be a long pause, which may continue well into 2021.

The upshot of this legislative moratorium is that creditors may be saddled with large receivables that they cannot legally attempt to collect for at least a year. Once the act's moratorium ends, it is likely that creditors attempting to seek relief through the court system could still encounter an unprecedented backlog of cases.

Additionally, the act would expand the FDCPA's definition of a "debt collector" to include essentially any person or entity that engages in the collection of a debt and may require such person or entity to follow the requirements that the FDCPA places on debt collectors.

There are two important exceptions to the foregoing. First, a mortgage loan is not covered in the definition of a debt. Second, the restrictions do not apply to "an obligation arising out of a credit agreement entered into after the effective date" of the act.



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Thus, if after the act becomes effective, (1) the debtor signs a new credit agreement, and (2) the creditor lends new money or tenders new goods based on that new credit agreement, then the creditor will not be restricted by the provisions of the act in collecting that new accumulated debt.

Prohibited Collection Activity

The HEROES Act would bar various collection measures, including:

- Enforcing a security interest;
- Collecting any debt;
- Commencing or continuing an action to evict a small business or nonprofit organization for nonpayment; and
- Threatening to take any of the foregoing actions.

As proposed, the act would effectively stop the enforcement of any judgment against a covered business, even if the judgment was obtained before the act's effective date. Arguably under The HEROES Act, creditors may also be prevented from asserting mechanic's liens against covered businesses and nonprofits. Further, creditors may be forbidden from renewing existing liens as they expire due to state time limits.

The HEROES Act's prohibition on threats to take certain action raises the important question of whether a creditor would be prohibited from even filing a lawsuit against a debtor. In many jurisdictions, the entry of a judgment results in an attachment of the debtor's real property, which the act would explicitly prohibit.

A lawsuit may therefore be deemed a threat to attach or foreclose on real property. While the act is silent about whether obtaining a judgment would violate the law, it does explicitly prohibit commencing or continuing an action to evict a small business or nonprofit.

As such, there is a potential statutory counterargument that, if Congress had intended to bar a creditor from commencing or continuing a suit for a debt owed, it knew how to do so and determined not to impose such a prohibition.

Protected Businesses

The HEROES Act would protect a wide array of businesses from collections, including small businesses and almost all nonprofits organizations, including most universities, schools, hospitals, religious organizations and charities.

With respect to small businesses, the act defines the term as having the same definition as the term "small business concern" in Section 3 of the Small Business Act. In addition to certain criteria enumerated in the SBA, classification as a small business concern under the SBA is dependent upon the definition of "small" under industry size standards categorized using North American Industry Classification System codes.

The industry size standards are generally based on the average number of employees over the previous year or average annual receipts over the past three years.

Creditors should take note that these standards vary from industry to industry and some businesses may still qualify as a small business concern and, thus, a small business under the HEROES Act, despite having as many as 1,500 employees or up to approximately \$40 million in average annual receipts depending upon the applicable industry.

Indeed, the SBA definition of a "small business concern" encompasses more than just the typical mom-and-pop shop and includes a large segment of U.S. businesses. Given the complexities of identifying a small business under the HEROES Act, and before pursuing any collection activity against another business, creditors should seek assistance from legal counsel to determine whether a particular business is a small business protected by the act.

Tolling

The HEROES Act would toll "[a]ny applicable time limitations for exercising an action" against a small business or nonprofit for the duration of the covered period. Accordingly, the act attempts to protect creditors who are unable to timely pursue claims as a result of the act's restrictions

This provision of the act, however, raises the constitutional question of whether this federal act can modify a state's statute of limitations period. This question may need to be addressed by the courts in coming years.

Penalties

Violations of the collection provisions of the proposed HEROES Act are subject to the penalties set forth in Section 813 of the FDCPA. Along with those potential damages specified under the FDCPA, in any successful action to enforce the foregoing liability, the costs of the action and reasonable attorney fees may be awarded.

While pursuing such claims may seem like a bonanza for plaintiff's firms, under the unique Catch-22 of the HEROES Act, any judgment obtained against a small business could not be enforced and, arguably, may not even be commenced.

Protections for Consumer Debts

The HEROES Act also offers a variety of protections to individuals that parallel those offered to small businesses and nonprofits, including a proposed eviction moratorium, and prohibitions of the same broad array of collection efforts. The HEROES Act also clarifies that, after the covered period ends and debt-collection protections expire, individuals will not be forced to repay those debts at an accelerated rate.

The HEROES Act creates a credit facility for creditors and debt collectors who suffer losses caused by loan forbearance to consumers.

But companies seeking these loans will be subject to extra restrictions, including (1) the companies must grant automatic forbearance "upon the request of a consumer," and (2) they may not charge "fees, penalties, or interest (beyond the amounts scheduled or calculated as if the borrower made all contractual payments on time and in full under the terms of the loan contract) ... to the borrower in connection with the forbearance."

The exact requirements for obtaining these credit facilities and how such facilities will be rolled out are not spelled out in the act and will require significant regulatory input and clarification.

Impact on Creditors

At first blush, the proposed restrictions on collection efforts under the HEROES Act appear to give struggling businesses and nonprofits the needed breathing room to stabilize their operations and cash flow, and get back on their feet.

In practice, due to the act's expansive effect, imprecise definitions and indefinite duration, the act's long-term impact on small businesses and nonprofits may have the opposite effect. In particular, other businesses large and small may hesitate doing business with such entities due to the increased credit risk posed by such transactions.

During the covered period, lenders, vendors and suppliers looking to do business with small businesses and/or nonprofits would no longer be able to rely on the ordinary business terms and relationships that existed prior to the effective date of the HEROES Act.

In order for post-effective date lending, extensions of credit, and delivery of goods to fall outside the restrictions of the act, new credit agreements would need to be entered into before the extension of credit or other business transaction with the small business or nonprofit.

Vendors and suppliers without a new credit agreement may consider providing goods or services to a small business or nonprofit on a cash in advance or a cash on delivery basis to protect themselves from being unable to collect from a small businesses or nonprofit that fails to timely perform or satisfy even post-HEROES Act debt obligations.

This will make an already bad credit situation even worse. As the term "credit agreement" is not defined under the HEROES Act, lenders, vendors and suppliers, even if unsure as to whether or not a business is considered a small business or nonprofit organization under the act, would be well served to memorialize further lending and extensions of credit in a new master credit agreement, evidencing the timing and the credit terms.

It is important to note that, under the act, pre-HEROES Act debt is not being forgiven. It is merely being postponed. As many lenders, vendors and suppliers will continue to do business with many small businesses and nonprofits, the act's standstill could lead to financial difficulties for these creditors themselves. Moreover, these same creditor entities may or may not be protected from their own creditors by the HEROES Act.

If they are not protected, these lenders, vendors and suppliers could be faced with creditor workouts or bankruptcy scenarios of their own. Lenders, vendors and suppliers will be faced with important decisions of whether they want to continue to do business with business entities under these circumstances.

The HEROES Act will most certainly influence — and in many instances negatively — key components of the bankruptcy system. Indeed, without the need to file for bankruptcy protection, the act serves as a massive, unsupervised automatic stay for tens of millions of individuals and businesses.

Not only would collection efforts be stayed under the act, but creditors — now all classified as debt collectors — are likely prohibited from, among other things, commencing an involuntary bankruptcy proceeding against a small business or nonprofit organization that is in default on its payment obligations to such creditor on account of a pre-HEROES Act covered debt.

Instead, the creditor must stand by and wait until the covered period expires, in the hopes that the small business or nonprofit organization has stabilized itself and has the necessary cash flow to resume payments under the payment plans imposed by the HEROES Act.

Preferring Creditors

The HEROES Act expressly does not prohibit a small business or nonprofit "from voluntarily paying, in whole or in part, a debt," thereby allowing small businesses and nonprofits to prefer one creditor over another during the covered period. In a bankruptcy proceeding, a trustee is vested with avoidance powers to recover such preferential payments and redistribute them among the debtor's creditors.

Given the duration of the covered period, many payments made to preferred creditors during the covered period would no longer be avoidable in a subsequent bankruptcy case or state court insolvency proceeding because the applicable look back period (usually 90 days) under the U.S. Bankruptcy Code and certain state laws will have expired.

Thus, unless the lookback period is extended, preferential payments made by a small business or nonprofit to certain of their creditors during the covered period may ultimately be unrecoverable to the detriment of other creditors that were not paid and were faced with the restrictions of the HEROES Act.

Furthermore, given the broad definition of a "debt collector," the act might even prevent a trustee in a pending bankruptcy case from commencing or continuing any preference avoidance action against a small business or nonprofit organization until such time as the covered period is over.

While affording small businesses and nonprofits with the necessary breathing room for the near future, the HEROES Act may do little more than delay the inevitable rush to the bankruptcy court that may still occur after the covered period.

Unsecured lenders, vendors and suppliers who continue to do business with these small businesses and nonprofits may find that, even with a new credit agreement as discussed above, once the covered period is over, they stand in a very long line for payment with all of the other creditors of such small business or nonprofit.

Absent a perfected lien or security interest, such unsecured lender, vendor or supplier will have no preferred status over other pre-HEROES Act creditors.

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