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Forbearance Agreements: A Refuge for Creditors and Lenders During the Pandemic

Many businesses in Alberta had been facing difficult financial circumstances prior to the onset of the COVID-19 pandemic. Over the past few weeks, the business environment has deteriorated, and remains uncertain at best. All aspects of business, including operational expenses, completion of contracts, cash flow requirements and business/asset valuations are likely affected. As a result, the ability of many to make required payments, meet margin or other financial covenants, and satisfy other contractual obligations has likely been compromised to some degree. Creditors' businesses are being equally affected

Where a customer or debtor has defaulted under a contract, it may be in the best interests of all parties to work together and come to some form of understanding that manages the situation, at least in the short term, A "Forbearance Agreement" is one possible, and commonly utilized, option.

A Forbearance Agreement is an agreement between the creditor and debtor. In reaching an agreement, the debtor's default is acknowledged, and the creditor agrees to not commence, or not to continue with, enforcement or recovery steps against the debtor for a certain period of time and upon certain terms and conditions.

Whether the parties are willing to enter into such an agreement, and under what terms, depends on a variety of factors. Generally, the creditor will be more likely to consider forbearance if the debtor can establish that the cash flow problem or default is short-term, and/or there is a likelihood that timely payments will resume or otherwise be made, if certain steps are taken or refinancing is obtained within an acceptable time frame. Conversely, forbearance is unlikely if it appears that the debtor's financial situation, and/or the creditor's security and recovery position, will only worsen with added time. For both parties, having a practical appreciation for the debtor's short-term financial position and his/her/its plan to demonstrate the future stabilization and the ability to make good on repayment is critical.

Forbearance Agreements are generally different than standard modification or amendment agreements. Those types of agreements often eliminate any prior default and tend to indicate the parties' intention to continue the business relationship. Forbearance Agreements generally (but not necessarily) preserve the debtor's default for later enforcement and are considered an "exit" agreement, where the creditor is looking to end the business relationship with the debtor.

In Alberta there are relatively "standard" forbearance terms utilized by the majority of institutional creditors, including banks, credit unions, equipment lessors and other private lenders. Forbearance terms are nonetheless generally negotiable and flexible so that they can be crafted in a manner that is practical and workable for all parties. When considering a Forbearance Agreement, each party should think about their goals and needs in entering into such an agreement, and then bring some benefit to the negotiating table that the other party desires in exchange for getting something that it wants as part of the agreement.

Goals of a Forbearance Agreement

The Creditor's Perspective

As part of a Forbearance Agreement, the creditor may seek one or more of the following, in no particular order, from the debtor in order to meet its goals:

(a) structured permanent paydowns of the indebtedness and/or permanent reductions of credit limits of certain accounts;

(b) equity cash infusions into a corporate debtor;

(c) additional security and/or collateral secured in favour of the creditor;

(d) additional guarantees and/or guarantors;

(e) lump sum fees to be paid to the creditor for agreeing to a forbearance;

(f) revisions to the interest rate and/or amortization or maturity periods;

(g) revisions to the reporting requirements of the debtor;

(i) appointment of a “monitor” or other outside consultant at the expense of the debtor in order to monitor the business activity of the debtor, assist the debtor in completing their forbearance obligations and report back to the creditor;

(j) certain acknowledgments and agreements favorable to the creditor in respect of the validity and enforceability of the underlying debt, loan agreements, guarantees and security;

(k) certain Consent Orders (e.g. judgments, receivership orders, redemption orders, and preservation orders) to be held and used in the event of a default;

(l) reductions or eliminations of certain debtor’s rights (such as waivers of offsets and defences) and releases in favour of the creditor;

(m) correction or rectification of any legal weaknesses/deficiencies in the existing any documents;

(n) asset sales for the benefit of the creditor at the cost of the debtor; and

(o) installation of new, or modification of existing, margin or financial covenants.

The overarching consideration for the creditor in deciding to enter into a Forbearance Agreement or not is whether the terms and conditions of the proposed Agreement are likely to result in a better net recovery than simply proceeding to immediate enforcement.

The Debtor’s Perspective

As part of a Forbearance Agreement, the debtor may wish for and seek one or more of the following, in no particular order, from the creditor in order to meet its goals:

(a) as much time without creditor enforcement as possible in order to restructure financial affairs, obtain refinancing and/or take other necessary steps to be able to pay down/off the indebtedness;

(b) continued access to and operation of any credit (particularly operating lines) provided by the creditor;

(c) write down or compromise of the principal and/or other indebtedness;

(d) modification or suspension of principal and/or interest repayment terms;

(e) waiver or modification of margin or financial covenants;

(f) modification of asset sale terms;

(g) new credit or other amounts from the creditor; and

(h) flexibility for new equity partners and/or to obtain subordinate debt.

The overarching consideration for the debtor in deciding to enter into a Forbearance Agreement or not is whether the terms and conditions of the proposed Agreement provide a meaningful, and practically achievable, opportunity to restructure, refinance and/ or otherwise complete such steps as are necessary to effect significant or complete a pay down of the indebtedness.

Final Remarks

Whether you are a creditor or a debtor, the impact of COVID-19 has the potential to be profound. The various governments' responses to COVID-19, and the short and long-term financial impact of the pandemic, are fluid situations, resulting in significant uncertainties going forward. A Forbearance Agreement may help both parties navigate this difficult business environment.

Forbearance Agreements can take simple or complex forms, and often involve significant legal rights and obligations being compromised or granted. Parties need to be careful and cautious to ensure that the bargain being struck is beneficial and practically feasible from their perspectives. However, Forbearance Agreements represent a common and useful tool in managing economic difficulties, defaults, and structured payouts of debts. In many circumstances, they are preferable to immediate enforcement by creditors.