

FUND FINANCE FRIDAY

Forbearance Agreements: Bringing the Deal Parties Together

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During times of market disruption and economic uncertainty, the representations and covenants set forth in a credit agreement play an even more important role in the ongoing relationship among the loan parties and lenders. While many credit agreements typically provide fund borrowers with flexibility and certain allowances to permit the fund borrowers to operate and grow their business in the normal course and to avoid unintentional “foot faults” under one or more interrelated provisions, even the most carefully negotiated provisions will not be able to anticipate every future event to impact a fund borrower’s business. When a lender is faced with an actual default or even an anticipatory default under a credit facility, a fund borrower will typically request a default waiver from the lender (previously covered by [FFF here](#)). Another approach that a lender may pursue instead of an outright waiver is to forbear taking action with respect to the default, thus providing the fund borrower additional time to cure the default or comply with a new covenant or performance milestone within a certain period of time. A forbearance agreement can be an effective means of providing the loan parties and the lender with an opportunity to resolve the pending default in a timely manner while at the same time restructuring one or more covenants, obtaining additional credit enhancements, such as supplementary collateral, and resetting expectations going forward.

To Forbear

To forbear is the act of refraining from taking action against another party. Under a forbearance arrangement, the lender agrees to forbear from taking any enforcement action against the loan parties as a result of the specifically described events of default. In exchange for such deferral, the loan parties will agree to cure the specific defaults to extent curable, modifications of deal terms, restructure financial covenants, comply with new obligations, provide additional collateral, and incur a forbearance fee as part of the consideration. These modifications strengthen the lender’s credit position while providing the loan parties with some breathing room to work through the issues caused by the default. Any modified terms must be strictly adhered to by the loan parties so as not to trigger any additional defaults that could terminate the lender’s forbearance. Restructuring one or more of the financial covenants may provide

additional headroom to the loan parties while simultaneously providing an acceptable risk rating for credit partners. It is important to note that the act of refraining by the lender doesn't constitute a waiver by the lender or a cure by the loan parties of the specific events of default but instead preserves the lender's rights and remedies to take further actions under the credit documents.

Forbearance Period

The forbearance period is the period of time in which the lender has agreed to refrain from filing any legal action or instituting or enforcing any rights and remedies it may have against the fund borrower. A lender should carefully consider the length of the forbearance period so as to provide a fund borrower with a realistic opportunity to cure the existing defaults and to comply with any required covenants or performance milestones while at the same time protecting against further downside risk and potential deterioration of the collateral. The forbearance period may also be terminated by the fund borrower's failure to comply with any of the terms or undertakings of the forbearance agreement or the occurrence of any other event of default. Upon the expiration or termination of the forbearance period, a lender shall be permitted to exercise any and all of its rights and remedies against a fund borrower as it deems appropriate.

Forbearance Terms

The terms of a forbearance agreement can vary depending on the particular facts and circumstances of the default and the credit profile of the loan party. However, there are a few best-practice provisions that should be included in any forbearance agreement that clearly set forth the forbearance terms agreed to by the loan parties and reserves the rights of the lender.

The forbearance agreement should include factual recitals that provide a basis for entering into the forbearance arrangement and to prevent the loan parties from disputing such facts in a future legal proceeding. It is important for the parties to clearly and accurately identify all existing defaults to be covered by the forbearance agreement. Any other defaults not specifically identified or that may occur after the execution of the forbearance agreement will not be part of the forbearance agreement. The lender would then have the ability to terminate the forbearance agreement and immediately exercise all rights under the credit documents. Lenders will sometimes include anticipatory defaults in the forbearance agreement if the loan parties have preemptively disclosed to the lender that they will not be in compliance with a covenant, such as a financial or reporting covenant that isn't actually due until after the closing of the forbearance agreement. This approach is helpful to avoid triggering a subsequent default that is known to the loan parties prior to entering into the forbearance agreement. There should be an acknowledgment of the current loan balance, including the unpaid principal and interest, and any other amounts due and owing to the lender. If applicable, there should also be an acknowledgment that the lender issued a reservation of rights letter and/or notice of default letter.

The fund borrower should make certain acknowledgments to the lender, including but not limited to, that (a) each of the credit documents remain in full force and effect, (b) the liens granted by the fund borrower shall remain effective and unimpaired by the transactions contemplated by the forbearance agreement, and shall continue to secure all obligations under the credit documents, (c) ratifies and reaffirms all of its representations, warranties, covenants, and agreements made under the credit documents, (d) the existing events of default are

ongoing and continuing, (e) any actions it takes or fails to take is voluntary, informed and taken at its own risk, and (f) it consents to all of the terms and conditions of the forbearance agreement.

In consideration for the forbearance, a lender may decide to modify existing or include new affirmative and negative covenants, that a fund Borrower must comply with during the forbearance period and sometimes after, as an ongoing covenant requirement. Covenants may include a full or partial repayment of the outstanding loan balance, no additional advances during the forbearance period, maintenance of depository accounts with the lender in a minimum amount or percentage of global cash, modified financial covenants, and performance milestones, such as future closes of additional equity commitments, which if achieved may be a condition precedent to a conditional default waiver. The grant or pledge of additional collateral by a loan party to further secure the obligations under the credit documents may provide additional credit enhancement to the lender, but such additional collateral may be invalidated in a subsequent bankruptcy proceeding as a preferential transfer.

Forbearance Release and Reservation of Rights

It is imperative that a forbearance agreement contains a broad and general release of all claims by the loan parties. At a minimum, the release by the loan parties should include all possible known and unknown claims, demands, actions, losses and liabilities in any case arising on or before the effective date of the forbearance agreement under any of the credit documents and forbearance agreement. The release may be pleaded as a full and complete defense against any legal proceeding that may be instituted in breach of the release. In addition, the loan parties should acknowledge that the release constitutes a material inducement to the lender to enter into the forbearance agreement.

Another important provision that should be included in any forbearance agreement is a reservation of all legal rights and remedies of the lender under the credit documents and forbearance documents. These rights and remedies include the right upon the expiration of the forbearance period to immediately foreclose on any collateral and exercise any and all other remedies available under the credit documents or applicable law.

A forbearance agreement can be a very useful and effective tool to bring the deal parties together to collaboratively work on a resolution of an existing default. It provides a fund borrower with the opportunity to remedy the breach, increase covenant flexibility, or unlock a conditional default waiver upon the achievement of a performance milestone. Moreover, it strengthens a lender's credit position by implementing new covenants, obtaining additional collateral, and receiving a full release of all claims.