

Drafting Considerations: Forbearance Agreements

Michael Hamilton (DLA Piper LLP (US)) and John Nolan (Wintead PC)

Exhibit A attached hereto contains a sample forbearance agreement. In addition to the essential elements of any forbearance agreement, the sample agreement includes alternative and optional provisions to address particular needs. The optional provisions also afford the reader a menu of sorts, the particulars of which the reader may advise his or her client to consider even if the provisions do not ultimately appear in a final agreement. In addition, we have included in bracketed italics certain negotiated inserts/modifications to the form language, most of which are derived from commonly encountered borrower requests.

Essential to the drafting and negotiation of any forbearance agreement is a reflective understanding of the primary purpose and essential elements of such an agreement and the law underlying the provisions therein. We have provided a capsule summary of these matters below.

Primary Purpose and Essential Elements of a Forbearance Agreement

The primary purpose of a forbearance agreement is to prevent the lender from exercising remedies during the pendency of a settlement with the borrower. The removal of the threat of foreclosure, or other exercise of remedies, puts the parties on more equal footing, thereby improving the chances for a mutually satisfactory settlement. The borrower, of course, is the primary beneficiary of a written forbearance agreement. However, the lender also benefits by specifying the terms and conditions to its continuing forbearance, which absent a written agreement may be unpredictably and unfavorably implied by a court.

The essential elements of a forbearance agreement are, in simple terms: (1) a promise by the lender to refrain from exercising remedies for a specified period; (2) a description of the events that will result in the forbearance agreement terminating (such as (a) another default, (b) failure of the borrower to perform the obligations under the forbearance agreement or (c) borrower filing for bankruptcy); (3) agreement regarding any new/modified obligations (for example, will borrower be excused from debt service during the forbearance period); and (4) confirmation that the loan documents remain in full force with reservation of all of lender's rights. A forbearance agreement often includes more than these four elements (see Exhibit A), but the foregoing should suffice to achieve the primary purpose.

Capsule Summary of the Law Underlying Certain Provisions of a Forbearance Agreement

The following is a capsule summary of the law that underlies certain of the provisions in a forbearance agreement. It is important to remember that the forbearance agreement is typically drafted by the lender, and lender's form documents are often prepared not only to comply with the law in a majority of jurisdictions, but also to address outlier judicial conclusions which, if applied, could be detrimental to the lender.¹ As such, certain of the following statements are not representative of the majority rules, but reflect findings that have been issued by courts which

¹ From the borrower's perspective, this is essentially a race to the bottom and the proverbial kitchen sink.

were alarming enough to the lending community to prompt attention in the lender-oriented form of forbearance agreement.

- Written Agreement is not Necessary. It is not necessary for a forbearance agreement to be in writing; a court may imply an agreement under theories of implied agreement or equitable concepts of estoppel and waiver. The court will look to the conduct of the parties and the facts and circumstances of the particular case. For example, the act of forbearance (without an agreement), coupled with the contemporaneous acceptance of some other benefit by the lender (e.g., a modified promissory note, a new guaranty), would support in many cases a finding of implied agreement.
- Delay Does Not Imply Agreement to Forbear. Mere delay in the exercise of remedies, even for relatively long periods of time (9 years in one case), has not generally been the basis for implying an agreement to forbear, so long as the borrower is not prejudiced thereby. In order for a borrower (or other affected party) to prove that it was prejudiced by such a delay, it would need to show that it changed its position to its detriment in reasonable reliance upon the actions/inactions of the lender (promissory estoppel).
- No Forbearance as to Other or Subsequent Defaults. A lender will not typically be prohibited from enforcing remedies as to defaults about which it was unaware at the time it entered into a forbearance agreement, or which occur thereafter. However, in certain cases, courts have imposed a course of conduct on the lender, such that its response to a subsequent default must be consistent with its prior responses. If, for example, it did not exercise remedies immediately as to one default, it may not be able to do so upon the occurrence of a similar default.
- Illusory Indefinite Forbearance Periods. Where forbearance agreements have been written to be indefinite (without a specified forbearance period), courts have tended to imply a “reasonable” forbearance period. Certain courts, however, have construed indefinite forbearance agreements as agreements where the lender agrees to forbear for so long as the lender so desires. Indefinite forbearance periods may also be interpreted as perpetual forbearance -- essentially covenants not to sue until the claim is discharged. If the facts and circumstances support a finding that the forbearance period was intended only to be for so long as the lender desired, the agreement may be illusory and unenforceable. As such, lenders should exercise caution in this regard, and such caution applies to various aspects of the agreement. If, for example, the “termination events” (events that give rise to an early termination of the forbearance period) include open-ended clauses that give the lender full discretion, essentially, to terminate the forbearance agreement (such as “material adverse change” or “insecurity” provisions), such provisions may render the entire agreement (and contemporaneous agreements, such as new guaranties) unenforceable. Perpetual forbearance would also be detrimental to a lender if not so intended.
- Valid Consideration for Other Obligors. An agreement to forbear is valid consideration for a third party’s (e.g., guarantor’s) promise with respect to the debt of the borrower.

- *Third Parties May Benefit.* Third parties, such as subordinate lenders or competing creditors, may benefit from an implied or express agreement by the lender to forbear. An implied agreement which benefits a third party may have unintended and adverse consequences for the lender. As such, notwithstanding that an agreement contains conventional “no third party beneficiary” language, a lender is well-advised to identify all potentially affected parties and obtain their agreement to the terms and conditions of the forbearance.

With the foregoing in mind, we refer you now to the attached sample agreement. We hope that this summary and the sample agreement will serve to inform your preparation and negotiation of forbearance agreements in the future.

Forbearance Agreement

(with annotations, alternative and optional provisions and negotiated inserts)

Prepared by Michael Hamilton (DLA Piper LLP (US)) and John Nolan (Winstead PC)

This FORBEARANCE AGREEMENT (this "Agreement") is made effective as of the _____th day of _____,

_____ (the "Effective Date"), by and between _____, a national banking association ("Lender"); _____, a _____ ("Borrower"); and _____, a _____ ("Guarantor").

RECITALS

- A. Lender made a loan (the "Loan") to Borrower on _____, in the maximum principal amount of _____ AND /100 DOLLARS (\$ _____), pursuant to that certain Loan Agreement dated as of _____, _____ by and between Borrower and Lender (the "Loan Agreement").
- B. In furtherance thereof, Borrower executed and delivered to Lender that certain Promissory Note, dated effective as of _____, _____ (the "Note"), payable to the order of Lender in the amount of and evidencing the Loan.
- C. As security for the performance of its obligations, Borrower executed and delivered that certain Deed of Trust (With Security Agreement and assignment of Rents and Leases) (the "Deed of Trust") dated of even date with the Note to _____ as trustee ("Trustee"), for the benefit of Lender, recorded on as Instrument No. of the Official Records of _____ County, _____, covering the real property described in Exhibit "A" attached hereto and incorporated herein for all purposes, together with all improvements, appurtenances, other properties (whether real or personal), rights and interests described in and encumbered by the Deed of Trust (the "Property"), to secure the payment of the Note and performance by Borrower of the other obligations set forth in the Loan Documents (as herein defined).
- D. Borrower caused Guarantor to execute and deliver to Lender that certain Guaranty Agreement (the "Guaranty") dated of even date with the Note guaranteeing [payment of the Note and all the other monetary obligations contained in the Loan Documents and performance by Borrower of the other obligations as set forth in the Loan Documents][certain obligations of the Borrower as set forth in Section ____ of the].
- E. Lender, Borrower and Guarantor entered into that certain Modification Agreement dated (the "Modification Agreement") which modified the terms of the Loan (the Loan Agreement, the Note, the Deed of Trust, the Guaranty, the Modification Agreement and the other related