Why am I Thinking About Forbearance?

Our lender clients will be soon dealing with some of the likely economic impacts of the coronavirus. When quarterly financial statements are issued, many compliance certificates will reflect violations of financial covenants. When customers cancel orders or fail to pay outstanding accounts, overadvances will result. Borrowing bases will be negatively impacted by accounts receivable becoming ineligible due to delinquency. And canceled orders will shrink borrowing bases and negatively impact liquidity. In other words, lenders will soon be confirming what they have been suspecting. Events of default have occurred under many of their customers' loan and credit agreements.

Congress is trying to avoid an economic meltdown. Legislation such as the CARES Act will hopefully assist businesses in recovering from the effects of "stay at home" and "safer at home". Some businesses are doing fine (paper product vendors and food vendors that supply supermarkets and grocery stores). But many are struggling. Some will be able to bounce back quickly. Some will face a slow recovery. Some will fail.

When it comes to troubled loans, there is an old adage that "your first loss is your best loss". This is often true. But there will be a lot of pressure on lenders to be supportive of their ailing customers. Sometimes workouts and restructurings are successful. Given that the US economy has been performing well for a long time, do the lenders feel that they have sufficient workout experience? Do the borrowers have sufficient workout experience?

When thinking about a borrower's workout prospects, here are some things to consider. How are the fundamentals of the borrower's business? Are they in an industry that is likely to bounce back? For example, health care providers and vendors that sell to successful retailers will probably bounce back faster than cruise ship operators. Has the borrower applied for a PPP loan or some other form of financial support? If yes, what is the status? How strong is the management of the borrower? Are they experienced? Could they benefit from the advice of turnaround consultants? Does the borrower want to continue or do they want to throw in the towel?

Assuming a defaulted borrower wants to continue in business and the lender wants to be supportive, then a forbearance will be a likely alternative. Some things to know about forbearance arrangements:

- It is not a one size fits all arrangement. Forbearance is not the same as a waiver. To forbear means to delay. If a lender is forbearing in the face of an event of default, that means that the lender is delaying from exercising certain remedies. If the lender waives an event of default, then the lender is giving up all of it remedies that would arise from that event of default. There is a big difference between forbearance and waiver.
- There are two basic forbearance alternatives, day to day forbearance and a forbearance for specified period of time. Often a day to day forbearance is for a short period of time to enable the lender to assess the situation and determine the best course of action. A forbearance for a specified period of time is a common follow-up to a day to day forbearance.

- Historically, a center piece of a forbearance for a specified period of time is a "13 week budget". It is a short term business plan that is intended to demonstrate to the lender that it will be better off at the end of the 13 week period than at the start of it. The 13 week budget is based on certain assumptions and might well include "right sizing" adjustments. But the current market conditions probably cloud the value of a 13 week budget. After all, who can predict how long the market will be shut down and what the recovery will look like? That said, the 13 week budget will still have value with respect to "right sizing" and demonstrating creativity in finding new business alternatives. Examples of creativity are retailers offering curbside and delivery business and restaurants becoming local grocery stores.
- Common provisions in a forbearance agreement are acknowledgements from the borrower, and guarantor if applicable, as to the amount of the debt, the existence of the events of default, that the loan documents are valid and enforceable, and that the loan obligations are not subject to any defenses.
- The forbearance of rights and remedies should be specific, not general. This is because the lender may want to exercise some of its rights, for example imposing a default rate of interest, requiring additional appraisals at borrower's expense, and the exercise of cash dominion. Foreclosure on collateral is the remedy that is most likely to be subject to forbearance.
- The forbearance agreement should also include a general release by the borrower and guarantors. Push back is not unusual, but the lender should not give in. It is the price the borrower must pay for being given a chance to successfully workout its business issues.

We have assisted clients through several down markets. We have considerable experience with forbearance agreements. So if you are thinking about forbearance and want to discuss ideas, feel free to contact me.

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