Forbearance Agreements: What Lenders Need to Know

Banking Brief: Financial Services Insights

By Keith Mundrick on May 15, 2024

After an Event of Default occurs, it is important to understand the options available to the Lender other than demanding repayment or simply waiving the default. A Forbearance Agreement allows the Lender to *preserve*, rather than waive, the default, while also obtaining key releases from the Borrower and allowing for strategic and customized modifications to the relationship.

Lenders must always use caution once a default has occurred; renewing the credit facility or amending the Loan Documents will act as a legal waiver of the Borrower's default. Furthermore, inaction in the face of a default can give rise to an argument that the lender has established a course of conduct that it will not enforce certain defaults. This is why intended waivers should be clearly and specifically documented.

A Forbearance Agreement can be a versatile tool after a default has occurred. In a Forbearance Agreement, the Lender specifically preserves the Borrower's default, but agrees to forbear on collection for a specified period in exchange for certain accommodations from the Borrower.

A Forbearance Agreement is highly customizable and can be tailored to the situation and the specific goals of the Bank; the Bank may wish to give the Borrower an opportunity to remedy the situation so the relationship can be continued, or the Bank may wish to encourage the Borrower to seek financing elsewhere by imposing more stringent controls and penalties. The terms of the forbearance can be uniquely customized for each situation.

Any forbearance process should begin with a comprehensive file review and collateral audit. This provides the Bank with an opportunity to fix any errors or oversight in the Loan Documents.

In crafting the Forbearance Agreement, the Bank may elect to impose new requirements on the Borrower. Examples include charging a forbearance fee, imposing new reporting requirements or financial covenants, adding collateral or guarantors, establishing a lockbox into which all accounts receivable are deposited, requiring the reduction of certain fixed expenses, delivering a business plan, maintaining all Borrower accounts with the Lender, or other modifications to the credit relationship as may be appropriate.

The Lender should also require the Borrower to release the Lender from any and all potential claims the Borrower may have against the Lender. Competent counsel should be engaged, and all costs and legal fees resulting from an Event of Default should be passed on to the Borrower.