

# Global Finance and Debt Products **ADVISORY**

June 5, 2009

## Key Provisions of an Effective Forbearance Agreement

As the economic downturn continues to affect our economy, a growing number of borrowers are having difficulty meeting the obligations under their financing arrangements. While a lender faced with a default has the right to accelerate the debt, foreclose on collateral, if any, and exercise its other remedies, a lender may opt to agree to forbear from suing, foreclosing or otherwise enforcing its rights against the borrower for a limited period of time. Such forbearance gives the borrower time to implement solutions to address its distressed condition, which may include refinancing the defaulted debt, raising additional capital or implementing business measures to strengthen its financial condition. The additional time also allows a lender time to evaluate its options and, if appropriate, arrange for an orderly “wind down” of the borrower’s business, which may mean a greater realization than would occur under distressed sale conditions.

A forbearance agreement is not a comprehensive solution to a borrower’s problems but, instead, an important, integral part of a comprehensive workout plan that addresses the intermediate needs of the borrower, preserves the rights of the lender, clarifies any possible disputes between the parties and accurately reflects the expectations of the parties going forward. For a forbearance agreement to effectively accomplish these goals, it should include the following provisions.

### 1. Description of Defaults.

A forbearance agreement should include a description of the specific defaults that exist. While a borrower will want this list to be as broad and general as possible, a lender typically will agree to forbear only with respect to specific defaults, with any omitted defaults not being subject to the lender’s agreement to forbear.

To balance the lender’s desire to have a specific list of defaults with the borrower’s desire for the protections of a broader list, the forbearance agreement can include an acknowledgement by the lender that it is not aware of any defaults other than those specified (commonly referred to as an “anti-sandbagging clause”).

### 2. Acknowledgment of Debt.

A lender will generally require that a forbearance agreement include an acknowledgment by the borrower of the outstanding principal balance, and accrued and unpaid interest, fees and expenses owed under the loan documents. The borrower may also be required to acknowledge that the loan documents are enforceable and that any liens securing the debt are valid, perfected and of the appropriate priority. These types of acknowledgments serve to avoid disputes between a lender and the borrower regarding the amount of the debt.

This advisory is published by Alston & Bird LLP to provide a summary of significant developments to our clients and friends. It is intended to be informational and does not constitute legal advice regarding any specific situation. This material may also be considered attorney advertising under court rules of certain jurisdictions.

### 3. The Forbearance Period.

A forbearance agreement should specify the period during which the lender agrees not to exercise any of its rights with respect to the specified defaults. Unless the parties intend a different result, care should be taken to assure that the agreement to forbear is not characterized as a waiver of any of the specified defaults, because a waiver would result in the permanent relinquishment of the lender's right to enforce its remedies with respect to such specific default. At the end of the forbearance period, the lender's agreement to forbear is terminated and the lender may take enforcement action on the basis of the specified defaults.

In addition to the scheduled termination of the forbearance period, the forbearance period may also terminate early upon the occurrence of certain events set forth in the forbearance agreement. Examples of events typically resulting in the early termination of the forbearance period include the occurrence of any additional defaults and breach of any additional covenants imposed by the lender as a condition to the forbearance.

### 4. Continued Financing, Pricing and Compensation.

A borrower often needs additional financing during the forbearance period. While under no obligation to do so, a lender may determine that providing additional financing is in the lender's best interest. If the lender is willing to provide additional financing, the forbearance agreement should specify the pricing and other terms and conditions of such financing.

Regardless of whether a lender agrees to extend additional financing during the forbearance period, the parties should address any adjustments in the terms and pricing of the existing debt. Since a default has occurred, the lender already has the right to impose a default interest rate under the loan documents and may opt to decrease or increase that rate and/or impose additional fees as a condition to its agreement to forbear. To take pressure off the borrower's cash flow, the parties can agree that all or a portion of accrued interest otherwise payable in cash be added to the principal balance of the loan (so-called "payment in kind" or "PIK" interest). Where a borrower is in particular financial duress, the lender may also be willing to forego a portion of accruing interest, provided that the "foregone" interest becomes payable if the lender is not paid off or paid down by some agreed upon amount at the end of the forbearance period. In addition to interest rate adjustments, a lender may seek additional compensation for the forbearance in the form of a forbearance or restructuring fee, which may be paid in cash or some other form of payment, such as a warrant.

### 5. Covenant Adjustments.

As a condition for its forbearance, a lender may require that existing covenants be tightened, additional covenants be imposed or both. For example, a lender may impose additional financial covenants, such as minimum EBITDA, minimum fixed charge coverage or minimum cash flow covenants, to closely monitor the financial condition of the borrower. A lender may also tighten existing covenants by decreasing (or increasing, as applicable) thresholds or ratios, or even demand the elimination of exceptions to covenants by removing baskets for permitted debt, distributions or asset sales or any other provision in the loan documents that would allow for the flow of assets out of the business. A forbearance agreement should address any covenants of the loan documents that the borrower has already breached and, if necessary, modify such provisions to avoid foreseeable defaults during the forbearance period.

## 6. Budget During Forbearance Period.

Because cash is tight, and the enterprise may likely be in a negative cash flow position, the lender will typically require the development of a budget that will be in effect during the forbearance period. The forbearance agreement will typically provide that revolving borrowings may only fund budgeted expenses. Further, the forbearance agreement will typically provide that, in the event expenses exceed a specified percentage of the budget, the forbearance period will terminate.

## 7. Supplemental Reporting.

During this crisis period, the lender may request supplemental reporting information in addition to that required by the existing loan documentation. Supplemental documentation will typically include a weekly update of the borrower's 13-week cash flow status, expense variance to budget, weekly update reports on the business, copies of all reports prepared by the borrower's financial advisor and/or weekly conference calls with management and the advisor.

## 8. Consultants and Advisors.

As the motivation of a forbearance agreement is often to give a borrower time to recondition its business operations, a lender will often require a borrower to engage the services of a turnaround specialist, operational advisor or other similar business consultant to assist the borrower with running the business, developing a business plan, budgeting and other critical workout matters. While a lender will want to approve any such consultant, the borrower should be the party actually hiring such a consultant to avoid the lender being seen as exerting excessive control over the borrower and its business.

Alternatively (or in addition, in such cases where the complexity or severity of the situation warrants), a lender may engage its own consultant to examine special issues, such as unfunded pensions, pending litigations, management issues, cash flow and the potential sale of assets or businesses, or to otherwise assist in the administration of the loan. Such a consultant will provide more candid advice to the lender than would a consultant engaged by a borrower.

## 9. Security.

A secured lender should closely review its collateral package in connection with the negotiations of a forbearance agreement. A secured lender should review its security documents for any errors or items that can be improved and use the leverage provided by the borrower's need for forbearance to compel any desired changes. Such a review can also include updated audits, appraisals and lien searches. A lender may want to consider taking the steps necessary to obtain and/or perfect liens in assets that are not perfected by the filing of a UCC-1 financing statement, such as motor vehicles, aircraft and certain intellectual property. An unsecured lender may require the borrower to grant a lien on otherwise unencumbered assets as collateral for the outstanding debt.

A lender receiving a lien in new collateral, or perfecting an existing lien in collateral, will need to evaluate whether such grant or perfection can be avoided in bankruptcy as a preference or fraudulent transfer. Though there are often valid arguments as to why a grant of a security interest by the borrower in consideration

for forbearance does not constitute a preference, a trustee will seek to avoid any such grant or effort to perfect as a preference. Despite this risk, lenders often take such steps because, if they do not, there is no chance they will have the benefit of such collateral.

## 10. Mitigation of Bankruptcy Risks.

In the negotiations of some forbearance agreements, the lender may seek to include certain provisions to mitigate risks posed by the borrower's bankruptcy or to attempt to ensure certain procedural advantages in the event of a bankruptcy. These "bankruptcy proofing" devices are generally found in forbearance agreements with longer forbearance periods. While a meaningful discussion of all of the types of these provisions and their legal nuances is beyond the scope of this advisory, the following is a short list of some of the more common bankruptcy proofing devices:

- **Waiver of the Automatic Stay.** A borrower's agreement that, in the event of the imposition of the automatic stay in a bankruptcy proceeding, the borrower will consent to the entry of an order granting the lender relief from the automatic stay.
- **Stipulations Regarding Bad Faith Bankruptcy Filing.** A borrower's agreement that any subsequent voluntary bankruptcy proceeding by the borrower would be for the sole purpose of impeding the lender's exercise of its rights and remedies and, therefore, constitute a bad faith filing subject to dismissal.
- **Springing and/or "Exploding" Guarantees.** Guarantees by principals and/or sponsors of the borrower that only become enforceable upon the borrower's bankruptcy or certain other significant defaults by the borrower.

## 11. Release of Claims.

As stated previously, a forbearance agreement should clarify and/or address any possible disputes. Accordingly, most forbearance agreements include a release by the borrower of claims against the lender. This release may be coupled with a covenant not to sue or a confirmation that the borrower has no claims, offsets or defenses against the lender.

If you would like to receive future *Global Finance & Debt Products Advisories* electronically, please forward your contact information including email address to [globalfinance.advisory@alston.com](mailto:globalfinance.advisory@alston.com). Be sure to put “**subscribe**” in the subject line.

Paul M. Cushing  
404.881.7578  
[paul.cushing@alston.com](mailto:paul.cushing@alston.com)

Richard W. Grice  
404.881.7576  
[richard.grice@alston.com](mailto:richard.grice@alston.com)

D'Asia Morris Hailey  
404.881.7155  
[dasia.hailey@alston.com](mailto:dasia.hailey@alston.com)

#### ATLANTA

One Atlantic Center  
1201 West Peachtree Street  
Atlanta, GA 30309-3424  
404.881.7000

#### CHARLOTTE

Bank of America Plaza  
Suite 4000  
101 South Tryon Street  
Charlotte, NC 28280-4000  
704.444.1000

#### DALLAS

Chase Tower  
Suite 3601  
2200 Ross Avenue  
Dallas, TX 75201  
214.922.3400

#### LOS ANGELES

333 South Hope Street  
16th Floor  
Los Angeles, CA 90071-3004  
213.576.1000

#### NEW YORK

90 Park Avenue  
New York, NY 10016-1387  
212.210.9400

#### RESEARCH TRIANGLE

Suite 600  
3201 Beechleaf Court  
Raleigh, NC 27604-1062  
919.862.2200

#### SILICON VALLEY

Two Palo Alto Square  
Suite 400  
3000 El Camino Real  
Palo Alto, CA 94306-2112  
650.838.2000

#### VENTURA COUNTY

Suite 215  
2801 Townsgate Road  
Westlake Village, CA 91361  
805.497.9474

#### WASHINGTON, D.C.

The Atlantic Building  
950 F Street, NW  
Washington, DC 20004-1404  
202.756.3300

[www.alston.com](http://www.alston.com)

© Alston & Bird LLP 2009