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Exploring Forbearance Issues in the Context of COVID-19

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Overview

The lightning-fast spread of COVID-19 around the world has quickly transformed our commercial and financial outlook, ending one of the longest economic expansions in U.S. history and throwing future prosperity into doubt. As conditions deteriorate from here, the likelihood that lenders will need to consider a forbearance is high, and as such, now is a good time to identify at-risk credit facilities and perform any necessary due diligence.

Generally speaking, there are a number of circumstances where reviewing credit exposures is appropriate—for instance, in the context of leveraged M&A, massive changes in the regulatory or legal environment, or a turnover in presiding loan officers; however, the single-most relevant circumstance is rather obvious: the emergence of a big, new, risky, complex problem. Most people would agree that the coronavirus pandemic qualifies.

This is a tumultuous time and there will be bumpy roads ahead, including a number of credit defaults. Under most agreements a default gives the creditor rights to accelerate a borrower's obligations, take enforcement action against collateral, and charge default interest. Further, upon a default, the creditor generally will not be obligated to make any further advances to the borrower. Thus, the creditor has to make serious decisions regarding its ongoing relationship with the borrower. At this time it is unclear if legislation contemplated by federal and state authorities will modify these typical contractual rights for a period of time while the coronavirus pandemic is ongoing. Perhaps now more than at any other time in current memory, it is important to consider every aspect of an at-risk credit facility.

A note on loan documentation practices

A good place to begin in analyzing credit exposures in light of the coronavirus outbreak is subjecting loan documentation practices to close scrutiny, and chief among these practices is the way collateral is described in security agreements. Best practice dictates that security agreements must unambiguously identify the property in which the secured creditor holds an interest and must reasonably identify what is described. UCC Article 9 prohibits super-generic descriptions in security agreements.

Lenders should also take a look at their UCC-1 Financing Statement descriptions, which are intended to put subsequent lenders on notice of prior collateral interest. The description in the financing statement may be less specific than in security agreement. For instance, stating "All of debtor's assets" is acceptable, but should be used only if a creditor is certain that the collateral descriptions in the security agreement really do comprise all assets of the debtor.

Key issues for review

There a host of other important questions that form the basis of a sound review. A short list of questions to begin the exercise would comprise the following:

Are the key transactional documents signed and authorized?

Are any relevant assignments documented?

Are corporate financial statements up to date?

Are financial covenants being met?

Have tax returns been filed?

Are there relevant opinion letters and are requirements being met?

Have default notices been appropriately sent?

Have acceleration/default interest rates been triggered?

Are the guaranty agreements in place and executed by the guarantors intended?

Did the correct guarantors sign in the first instance?

Any changes in corporate structure—e.g., corporate restructuring, individual transitions, etc.—necessitating consideration of adjustment to/expansion of guarantors?

Have any subsequent loan modifications occurred requiring update of guaranty agreement(s)?

Have liens/judgments been properly recorded & renewed

Entering workout mode

As set forth above, a creditor must evaluate any issues relative to competing creditors and/or any threats from third parties (taxing authorities, IRS, landlords). Further, it is important to understand what type of collateral is available and whether the value of the collateral is likely to decrease (or disappear) if left in the hands of the borrower.

The terms of a workout can differ greatly depending on the circumstances of the particular situation. Workouts are not standard. There is no obligation for the creditor to waive a default and restructure the loan agreements—to the contrary, the loan documents specifically provide the creditor with rights and remedies upon default; however, the creditor is in the business of maximizing its recovery, and depending on the answers to some of the issues raised above, that may mean continuing to do business with the borrower in some manner. The decision to go forward—and the way that will look—are largely at the discretion of the creditor. In some situations, the creditor may extend payment options and increase interest rates; other situations may require additional capital, reorganization of the business, reduction of overall debt, new management or receivership. In a workout the borrower will want existing defaults waived, continued access to credit, restructuring of financial covenants to workable levels, etc. All of these issues (and possibly others) will be the subject of negotiation.

Typically, no matter how much a borrower wishes it were so, a creditor will not completely waive existing defaults. With a little convincing, a creditor may agree to forebear from exercising its rights upon default until the earlier of a date certain or the occurrence of a new default. Often, in this situation a forbearance agreement is executed to define the rights of the parties during this limited period.

Conclusion

It is important not to be cavalier in your approach to a default. A default can be a great opportunity for both parties to take a fresh look at the deal and salvage that which can be salvaged. It is also a chance for the creditor to address issues that might have created some exposure if default remedies had been exercised immediately; however, forbearance doesn’t always make sense. There must be at least some minimal alignment of a creditor’s goals and a borrower’s ability to perform. Only then does forbearance become a viable option.

Contact us

Husch Blackwell continues to monitor the evolving situation and its implications for our clients. Should you have any questions, please do not hesitate to contact Buffey Klein or your Husch Blackwell attorney.

Husch Blackwell has launched a COVID-19 response team providing insight to businesses as they address challenges related to the coronavirus outbreak. The page contains programming and content to assist clients and other interested parties across multiple areas of operations, including labor and employment, retailing, and supply chain management, among others.