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Tough Times Ahead – Loan Relief Through a Forbearance Agreement?

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The novel Coronavirus Disease 2019 (also referred to as COVID-19) has caused state and local governments to shut down non-essential businesses for weeks – and possibly months on end -and even going as far to order people to stay in their homes and shelter in place. Every business sector is affected. Businesses are suffering the woes of the economic turmoil resulting from being closed, customer and supplier shut downs, and thus facing existential challenges as a result of loss of revenue, loss of employees, loss of product, coupled with the need to pay expenses, while trying to avoid defaulting on lending and credit arrangements.

TDR Relief. A special assets banker I worked with used to remark that "a bank's first loss is its best loss." Most financial institutions are regulated entities and must maintain minimum capital requirements dictated by the federal government. If a loan is not performing – in default – the bank must "charge off" all or a part of loan or classify it as non-performing, thus adversely affecting the bank's balance sheet. A bank would have to justify to its regulators why a loan modification was not a trouble debt restructuring ("TDR").

On March 22, 2020, the Board of Governors of the Federal Reserve System (FRB), the Federal Deposit Insurance Corporation (FDIC), the National Credit Union Administration (NCUA), the Office of the Comptroller of the Currency (OCC), the Consumer Financial Protection Bureau (CFPB), and the State Banking Regulators (hereafter, the agencies), issued an interagency statement to provide guidance to financial institutions who are working with borrowers affected by COVID-19 and is encouraging financial institutions to "work prudently". The agencies encouraged lenders to provide short term (6 month) modifications including payment deferrals, fee waivers, extensions of repayment terms, or other delays in payment that are insignificant, to borrowers who are current (not more than 30 days overdue on any payment). Importantly, the agencies promise that "[w]orking with borrowers that are current on existing loans, either individually or as part of a program for creditworthy borrowers who are experiencing short-term financial or operational problems as a result of COVID-19, generally ***would not be considered TDRs***. Then, on March 27, 2020, the Coronavirus Aid, Relief and Economic Security Act" ("CARES Act") was enacted into law. Section 4013 of the Cares Act provides for optional suspension of TDRs under GAAP. Through December 30, 2020 a financial institution may elect to suspend the GAAP principles for loan modifications related to COVID-19 that would otherwise be categorized as a TDR. Lenders now have greater flexibility in restructuring loans. Lenders will not have to treat the TDR as an impaired loan when estimating loan or lease losses. Before the CARES Act was enacted, financial institutions had to classify a TDR as substandard and, if it is found to be impaired, the loan had to be written down. Now, lenders can more freely agree to loan modifications such as reducing interest rates, extending maturity dates at a rate lower than the current market rate of a new loan with similar risks or providing for interest only loans per ASC 310-40 (formerly FAS 114)

Temporary forbearance relief. Where a loan is not "current" or other material defaults exist, a financial institution is not going to be able to take advantage of the modified TDR guidance. It is improbable that a financial institution will agree to a simple deferral or amendment and the favored mechanism to preserve value until economic conditions return to a favorable climate is likely to be the "forbearance agreement". Indeed, many lenders are offering forbearance relief at this time. Freddie Mac announced a multifamily coronavirus forbearance program on March 24, 2020 whereby "multifamily landlords whose properties are financed with a Freddie Mac Multifamily fully performing loan can defer their loan payments for 90 days by showing hardship as a consequence of COVID-19 and by gaining lender approval". Quicken Loans is offering forbearance relief. Major car companies are advising customers that they will waive payments and fees. Major lenders are advising that they are now and will in the future work with customers experiencing financial difficulties as

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a result of coronavirus impact. PNC Bank is encouraging customers to call their business banker or a special number and advises that they are providing modification options with no late fee for small business lending products. Bank of America advises it will provide forbearances with certain fees.

So what terms can lenders and borrowers alike expect a forbearance agreement to contain? With a larger and more complicated the loan facility, the more complicated a forbearance agreement is likely to be. But for a smaller uncomplicated loan- especially an unsecured loan, a forbearance can be done in a simpler fashion, such as by letter agreement signed by the creditor with an acceptance signed by the borrower. A prudent borrower should consult with experienced workout counsel before executing any agreement. The lender certainly will have counsel involved; even if only to draft and help negotiate the agreement. Lenders need to be cautious where the borrower is an individual and review the applicable state contract, consumer and usury laws to assure the forbearance agreement does not run afoul of state provisions that may apply to an individual even if the debt in question is not a consumer obligation under federal laws.

Why is a forbearance better for a creditor than liquidating immediately? A forbearance agreement is often more attractive than obtaining judgment and liquidating for many reasons but the most common reason in a downturn is that the assets securing the indebtedness are relatively illiquid and enforcement of the loan through liquidation of the assets will create a loss so it is preferable to get cash payments for a period of time so the borrower can fix the defaults or perhaps refinance. If an agreement cannot be reached, the lender ultimately will proceed to litigation and liquidation and the borrower may "hand over the keys," liquidate or file a bankruptcy. Because the CARES Act has increased the debt limits for a small business debtor to $7,500,000 of total debt, a business borrower may opt to file a bankruptcy and repay the lender over three to five years, and a court can confirm that plan over the creditor's rejection if the business submits all of its earnings to fund the plan.

What are some standard terms in a Forbearance Agreement? While an agreement must be tailored to the specifics of the transaction, the following is a non-exhaustive template of the terms to include in the agreement. The agreement will usually have (1) recitals, (2) a stated standstill period, (3) a forbearance fee, (4) representations and warranties, (5) Confirmation of the Validity of Loan Documents, Collateralization and Fix Deficiencies, (6), the Scope of the Forbearance by Lender, (7) Interest Rates, (8) Payments During the Standstill Period, (9) Discount Payoff – Forgiveness of Debt, (9) Refinancing or Equity Infusion, (10) Payment of Professional Fees and other expenses, (11) Borrower's Retention of a Turnaround Professional, (12) Waiver of Defenses; Release; Covenant Not to Sue, (13) an Indemnity, (14) Forum Selection, (15) Jury Trial Waiver, (16) Performance of certain Covenants during Forbearance Period and suspension of others, (17) Forbearance Events of Default, (18) Bankruptcy Provisions, and Liquidation Remedies. Some of these terms are negotiable, some are not.

Note where there is a discount payoff, the tax impact caused by the forgiveness of debt is nominal if the business is insolvent. Under the CARES Act, a business can now carry back net operating losses ("NOLs") for up to five years in tax years beginning in 2018, 2019 or 2020. For pre-January 1, 2021 tax years, the CARES Act removes the TJCA limitation on NOLs that prevented taxpayers from offsetting in excess of 80 percent of a taxpayer's current taxable income, so a business can use its NOLs, so for the time being, a business can use NOLs to offset up to 100 percent of its current taxable income. The Tax Cuts and Jobs Act, Section 11012, Pub. L. 115-97. Amendments enacted in 26 U.S.C. §461.

Conclusion. A properly drafted forbearance agreement is an important and strategic tool for a lender and borrower to enable a borrower to cure defaults and return to a normal lending relationship, or in instances where an exit is desired, to put an exit plan in place, while preserving a lender's rights and defaults.

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