An Umbrella in the Rain: Protection Through Use of the Forbearance Agreement

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PRACTICES Finance

Most of us remember one of the lessons taught to us by our parents – always take an umbrella when rain is threatened. During a financial storm, such as the current oil and gas market downturn, many borrowers find themselves encountering financial stress and defaults. As a result, borrowers and lenders may reach for the forbearance agreement as a figurative umbrella to provide protection during such difficult times. This article will discuss the fundamentals of forbearance agreements and a few practical tips for the borrower and lender to consider when using them.

Because of the current downturn in the oil and gas industry, many exploration and production companies and service providers to the oil and gas industry are in financial stress as a result of the significant drop in commodity prices and resulting production cuts. The vast majority of these companies have entered into financing transactions over the past few years of increased U.S. oil and gas production as a result of improved and increased exploration and drilling activities. In some ways, these companies were, or have become, the victims of their own success. Those credit facilities were underwritten and based on a set of financial performance criteria widely accepted in the general marketplace. However, the tide turned, and as a result, many of these same companies have failed to comply with, or are projected in the very near term to have trouble complying with, the payment requirements or financial covenant requirements provided for in these agreements.

Forbearance agreements do not waive defaults, but rather maintain their existence while allowing the parties to continue the lending transaction under a set of specific terms and conditions – a sort of yellow-caution flag. In these cases, so long as no other or new defaults arise, the lender will agree to forbear (or pause) from the exercise of rights and remedies that would otherwise apply under such conditions for a period of time typically no more than 120 days or so (usually not too much longer than a quarterly reporting period) to allow the borrower to assess and address certain operational and situational issues with the business. In many circumstances, this will be a sufficient period of time for the borrower to refinance the credit or close a transaction that will involve a payoff of the troubled financing.

Forbearance agreements come in many forms, but typically contain the following common elements:

> (a) acknowledgments by the borrower and guarantors (collectively, the obligors) as to the existence and continuation of the “live” defaults and the lender’s right to cease funding, accelerate the debt and foreclose liens; confirmation of the outstanding principal balances of the loan facilities and any overadvance or overformula balance; acknowledgment of the enforceability of the loan documents and the perfection of the lender’s liens; reaffirmation of the obligors’ obligations under the loan documents; acknowledgements that the obligors will derive direct and/or indirect benefit from the forbearance; and acknowledgment that the lender has performed its obligations under the loan documents;

(b) agreements as to the financial terms of the forbearance, such as interest rate (which may be different from the original interest rate under the loan documents); forbearance fee; a reduction to, or permanent cessation of, the lender's commitment to extend additional credit; lender's discretion over any subsequent advances or credit extensions; new prepayment requirements; reduction of overadvance or overformula balances; and possibly additional limitations upon use by the obligors of proceeds, of asset sales or other dispositions;

(c) additional covenants restricting the obligors, including additional or more frequent financial reporting; the appointment of a restructuring officer; cessation of certain financial covenants and/or the maintenance of certain new covenants or liquidity requirements; cash dominion or lockbox arrangements; requirements that the obligors raise additional equity or subordinated debt; cessation of payments on subordinated debt; cessation of any otherwise permitted dividends or distributions; and maintenance of strict compliance with the other covenants in the loan documents;

(d) conditions to closing and effectiveness of the forbearance, including satisfactory results of any required appraisals, field exams and lien searches; execution and delivery of additional lien documents or replacement notes or guaranties from additional obligors (taking into consideration that the forbearance period may extend more than 90 days after new liens or new guaranties for purposes of preference analysis in the bankruptcy context);

(e) representations and warranties by the obligors, such as due authorization of the forbearance agreement and documents required to be executed and delivered: no additional default other than the forbearance defaults; no litigation affecting the loan documents or other material litigation; and a bring down of the representations and warranties contained in the loan documents as of the date of the forbearance;

(f) an enumeration of subsequent events of default that will terminate the forbearance period and/or that could result in the lender's availing itself of all rights and remedies available to it regardless of the forbearance arrangement, including breach of covenants or requirements set out in the forbearance agreement, or the occurrence of new or additional events of default enumerated in the loan documents; and

(g) releases by the obligors of claims against lender (which would include a full release of claims and waiver of defenses by the obligors for any acts or omissions occurring prior to the effectiveness of the forbearance agreement), and indemnities by the obligors in favor of lender with respect to claims, losses or damages arising prior the forbearance agreement, in each case usually memorialized as a reaffirmation and bring down to what is already contained in the loan documents.

Prior the lender entering into the forbearance agreement it will want to conduct post default due diligence to ensure, among other things, that its liens have properly been perfected and the loan documents otherwise do not contain any discrepancies or deficiencies that could create a material impediment to their enforcement and the realization of remedies by lender. Such due diligence may include a documentation review by counsel, lien searches to confirm lien filings, and appraisals of fixed and capital assets. Additionally, the lender may conduct a review of other instruments evidencing other indebtedness or preferred capital, such as intercreditor or subordination agreements. In the event that the borrower has incurred other senior or junior indebtedness, the lender will want to review the intercreditor or subordination terms to make sure that any restricted payments of, or lien securing, such indebtedness, have been, and are being, addressed, controlled and perhaps blocked in the manner provided in such arrangements.

There are many different kinds of umbrellas to deal with different kinds of downpours. Similarly, different forbearance arrangements can be put into place to accomplish varying goals. Prior to drafting and finalizing a forbearance agreement and related documentation, it's important to establish a plan and a strategy to successfully implement that plan. Is the distress resulting from an industry-wide downturn or is it more situational to the borrower? Has the borrower lost a meaningful portion of its market share and can it be rehabilitated? A material dilution of accounts receivable or a material deterioration of liquidity, an increased cash-burn and an ability (or inability) to scale down the business will be some of the leading indicators of whether the lender will use the forbearance as an opportunity to (a) permit the borrower to work through its problems or to raise junior capital and/or refinance the credit, or (b) shore up the lender's position and prepare for more serious events, such as a bankruptcy or forced liquidation. In addition to conducting a documentation review, the lender will want to take a fresh look at its sources of repayment (*i.e.*, cash flow from operations, liquidation of collateral, guarantor support, if any) as it formulates its strategy. These decisions will not be made in isolation however – the lender will be subject to regulatory oversight and loan portfolio considerations, for example, while on the other hand, the borrower will be under pressure from its stakeholders, capital and other debt providers, trade creditors, and industry counterparties.

Technology has provided meteorologists with enhanced tools to predict with greater probability, and better prepare the public for, significant rainstorms. Similarly, lenders now have more tools available to them than ever to sound the distressed credit alarm bells. In certain circumstances, the forbearance agreement can be an effective tool in providing cover during a distressed credit transaction – striking the proper balance between giving the borrower the time it needs to clean its house, while giving the lender a bit more certainty in its use of the tools available to it to modulate its credit and manage its risk during a turbulent period. Being able to carefully evaluate and diagnose the circumstances is critical to designing and implementing the plan, and being prepared for the next rainstorm.