



Legal Considerations of Forbearance Agreements



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Legal Considerations of Forbearance Agreements

A forbearance agreement may be proposed by a borrower or lender because of a borrower's temporary inability to honor the covenants of a loan contract. Specifically, the lender agrees not to foreclose or take other legal action in exchange for a borrower's acceptance of revised loan terms. The ultimate purpose of a forbearance agreement is to bring the original loan contract current. A forbearance agreement is a temporary measure to assist delinquent borrowers while preserving the financial interests of a bank or other lending institution.

Loan Payment Delinquency

When a borrower is unable to honor the legal covenants of a loan contract due to a failing economy, temporary unemployment or other unexpected financial circumstance, it may be in the best interest of the lender to institute a forbearance agreement or some other viable remedy. Other courses of action that could be pursued are loan modification, short refinancing, short sale or even judicial foreclosure proceedings.

Personal and commercial loans generally involve some level of risk for a lender. Bad economic times can lead to business failures and high unemployment rates. The value of commercial retail space, for example, can suddenly plummet. If a loan is highly leveraged or founded upon overly optimistic economic assumptions, the viability of a loan can deteriorate quickly.

A borrower may experience payment shock when the interest on an adjustable rate mortgage (ARM) or line of credit suddenly increases dramatically. Similarly, the value of commercial or private real estate can tumble, deteriorating the value of the collateral that was pledged to secure the loan. A commercial borrower's business revenue may also be negatively affected.

When the financial position of a borrower is upside down, or the borrower is unable to meet the covenants associated with a loan contract, banking administrators are obligated to evaluate the value of the collateral against the outstanding balance owed by the borrower.

Even a forbearance agreement isn't guaranteed to repair the viability of a troubled loan. Since a forbearance agreement is intended to bring an original loan contract current, the forbearance may actually increase the financial burden of the borrower. The forbearance agreement may include a higher payment for a prescribed period of time (usually between six and 12 months), an interest rate increase, forbearance fees, additional collateral to secure the loan or a requirement to pay down the loan.

Even after a forbearance agreement is in place, it may become necessary for the lending institution to approve additional extensions to avoid foreclosure or other remedial action. Forbearance simply means that a banking institution agrees to delay the legal consequences of violating the loan covenants in exchange for certain financial considerations. The ability of a borrower to meet the terms of a forbearance agreement and bring the original loan current will ultimately determine the disposition of the loan.

Loan Covenants

Violating a loan covenant can result in the foreclosure of collateral or a requirement to enter into a forbearance agreement. The lender will retain an attorney to draw up acceptable forbearance terms, but many borrowers also retain a lawyer or business consultant to negotiate on their behalf. Under certain circumstances, a lender may be willing to waive a covenant default. Subsequent loan defaults are likely to be met with stronger action. Among the most common reasons for a covenant default are the following:

- Failure to meet an annual 30 day payout
- Failure to meet a cash flow covenant
- Failure to meet a leverage covenant

Any of the previously cited covenant violations could necessitate the imposition of a temporary forbearance agreement to avoid foreclosure of the collateral that was pledged to secure the loan. The provisions of a forbearance agreement are negotiable between the lender and borrower.

Some of the more common elements of a typical forbearance agreement are described below:

- Recitals-a summary of the obligations that pertain to the borrower and lender, including loan amount, terms, defaults and collateral
- Date of termination-specifies the period of time during which the lender agrees to forebear judicial action or foreclosure (usually between six and 12 months)
- Forbearance fees-amount to be paid to the lender in consideration of the forbearance (one percent is most common)
- Scope of forbearance agreement-clearly defines what the lending institution will or will not do while the forbearance agreement is in effect

Most lenders will not accelerate debt, discontinue lending or enter a judgment during a period of forbearance. A lending institution may require a commercial borrower to infuse more equity into a failing business or retain the services of a consultant that specializes in reviving struggling businesses. A forbearance agreement may also include elements that govern the borrower's ability to file for bankruptcy or seek a jury trial in a court of law.

Mortgage Defaults

Although most banking institutions are unwilling to enter into a forbearance agreement with a delinquent borrower, many homeowners hire an attorney to negotiate with the lender. Personal circumstances such as the loss of a job, divorce or personal injury can temporarily disrupt a borrower's ability to make the required mortgage payments. A forbearance agreement places a temporary hold on the borrower's mortgage payments for a specified period of time. Most lending agencies will not provide forbearance relief for more than six months.

A borrower may be required to make additional payments until the loan is current in consideration of a lender's willingness to forebear the debt that is overdue. Therefore, forbearance agreements represent an effective means of preserving home ownership during difficult financial times.

When it comes to delinquent loans, every circumstance is unique. Since a forbearance agreement does not eliminate debt, a private or commercial borrower may have to consider other debt relief solutions to alleviate a deepening financial crisis. The following legal options may be available to a financially strapped homeowner:

- Loan modification
- Short sale
- Deed in lieu of foreclosure

Forbearance Agreements

Under federal law, a homeowner must miss at least four payments before a lender can initiate foreclosure proceedings. A homeowner that is experiencing temporary financial difficulty should speak with the lender or a foreclosure attorney after missing one or two mortgage payments. The lender may be willing to modify the loan, thereby avoiding the need for more stringent measures. Unfortunately, many financially troubled borrowers rely on inaccurate information obtained from the Internet or wait until it's too late to negotiate a mutually beneficial arrangement with the lender. The process of instituting a foreclosure agreement with a delinquent borrower usually includes the following basic steps:

- The lender will determine that the borrower has violated a loan covenant and declare the loan to be in a state of default. In essence, the loan has matured, requiring the borrower to pay the loan obligation in full. The inability of a borrower to pay the lending institution in full results in default and the need for a forbearance agreement.
- The lending institution will retain a lawyer to draw up a forbearance agreement. The borrower will be expected to reimburse the lender for the cost of preparing the forbearance agreement. The borrower may also be required to pay additional fees associated with the generation and administration of the forbearance agreement.
- As indicated previously, the bank may include new terms and conditions since the original loan has matured. The terms of the forbearance agreement are negotiable, but the lender will most likely insist on terms that are favorable to the lending institution.

Forbearance agreements include legally enforceable provisions that will govern the relationship between the lender and borrower. The borrower may be asked to waive certain rights and agree to hold the lending institution harmless in the event of a dispute. For this reason, attorneys and consultants often play an essential role in negotiating the covenants and commitments included in the final draft of a forbearance agreement.

Forbearance agreements for commercial loans often include a plan for rehabilitating the financial health of a business. This could involve the provision of additional financial information to the lender, including collateral audits and cash flow forecasts.

Loan Modification Negotiations

When a borrower approaches a bank or other lender to request a modification to an existing loan, it can be helpful to have some knowledge of the loan criteria that lenders use to determine lending decisions. Although a lender may wish to avoid the imposition of a forbearance agreement, The financial standards that undergird all lending decisions will ultimately prevail.

There's more to the banking industry than may be readily apparent. For instance, when a borrower requests a lower interest rate, reduced payment or a revised amortization schedule, the bank may be subject to a loss share arrangement with the Federal Deposit Insurance Corporation (FDIC). This occurs when a failing bank is purchased by another bank under the supervision of the FDIC.

When a bank acquires a loan under the provisions of an FDIC loss share agreement, it may not be possible to obtain a loan modification. In other words, requesting a modification that benefits the borrower without giving something in return is a bad deal for the bank. Even if banking officials would prefer to approve the requested modification, violating the lender's loss share agreement with the FDIC isn't a viable option. Approval of the loan modification could trigger what is known as a troubled debt restructure, known in the banking industry as a TDR.

If a lender indicates that a loan modification cannot be approved because it would trigger a TDR, making the modification untenable, a borrower can offer the lender something in return to improve the lender's balance sheet. The borrower may be willing to accept a slight increase in the interest rate, pay a fee or pledge additional collateral to secure the modified loan.

It should be noted that some loans include a cross default provision. A cross default provision can complicate a loan modification proposal since more than one loan is involved. A borrower may ask a lender to accept a debt restructure, interest rate reduction or interest only payments.

Negotiating with the lender prior to violating a covenant can help avoid a loan default declaration and the imposition of a forbearance agreement. If the lender can accept minor modifications without triggering a problem with the FDIC, the result could be lower payments and an opportunity to return to economic viability. The bank will likely evaluate the following criteria:

- The lender will conduct a cash flow analysis of the borrowers personal and business revenue, often referred to as a global cash analysis. The borrower should include depreciation, interest, tax payments and personal expenses in the cash flow analysis.
- Most banks consider a debt coverage ratio of 1.2-1.3 to be acceptable. This means that a borrower's income must be 20 to 30 percent greater than their debt service obligations.
- A borrower should clearly understand their debt coverage ratio and the specific needs of a lender prior to submitting a loan modification proposal. If the existing loan includes a leverage covenant (debt to equity ratio) or a cash flow covenant (cash flow to total payments ratio), these important covenants must be honored by the borrower or waived by the lending institution.

Loan Covenant Waivers

When a borrower violates a loan covenant, a lender may be willing to waive the covenant on a temporary or permanent basis. If the lender agrees to waive a covenant, the borrower will receive a covenant waiver letter that specifies the specific covenant that has been waived and for how long. Once again, cross collateralized or cross default provisions may present a problem for the borrower. Certain collateral may have been used to secure more than one loan, and a default on one loan could trigger the default of another loan.

When a borrower realizes that they have violated a loan covenant prior to the renewal of a loan, they should immediately pursue a viable option for avoiding a declaration of default or the imposition of a forbearance agreement by the lender. Lenders rely on loan covenants to ensure that a borrower's profitability, liquidity and leverage are adequate to service personal or business debt during the term of the loan.

Loan covenants may be waived temporarily or permanently at the sole discretion of the lending institution. As mentioned previously, loan modification negotiations, including covenant waiver proposals, should always take the legal and financial needs of the lender into consideration.

Loan Approval and Renewal

When a loan application is disapproved or a lender decides not to renew an existing loan, revised lending standards or new financial circumstances may be to blame. Even when a borrower has a sterling financial record, a loan application may still be disapproved. Moreover, a bank may decide not to renew an existing loan, even though the borrower made every payment and honored every loan covenant. Surprisingly, the same lender may approve a loan application that was previously denied. The financial position and lending priorities of the lender are always subject to change.

Lending priorities often change due to economic conditions or a loan portfolio riddled with loan defaults. The bank may be constrained by regulatory controls that prevent them from lending in prescribed areas. A bank that previously held a sizable amount of debt in a particular industry may suddenly reconfigure its loan portfolio to emphasize personal home mortgages due to a favorable home mortgage climate. The lender may also have tightened their loan acceptance standards.

If a borrower's cash flow has declined, an existing loan may not be renewed. Similarly, when a borrower's leverage ratio is diminished by economic circumstances, an anticipated loan renewal may not be forthcoming. Most lenders regard a debt to net worth ratio that is greater than three to one to be a troubling omen. It is the responsibility of the borrower or borrower's agent to present a strong proposal that meets the lender's current priorities and lending standards.

From the perspective of a well-run lending institution, every loan package should minimize the possibility of default. The following criteria, or the five C's of lending, have traditionally been employed by lenders to determine the level of risk associated with a given loan application:

- Character
- Collateral
- Cash flow
- Credit
- Conditions

It should never be assumed that a maturing loan will automatically be renewed. Most banks actively reevaluate existing loans to determine whether they meet the lender's current lending standards. If the loan does not fit into the lender's core loan portfolio, the loan will probably not be renewed. This can be frustrating for a customer that met all their loan obligations. Lenders make loans that offer a comfortable level of risk in a given financial environment.

Aside from changing financial circumstances, new bank ownership or leadership may result in revised priorities. The new leadership may lack experience with certain kinds of loans. Banks tend to specialize in particular areas of the economy. Banking officials may not be accustomed to evaluating certain industries or accepting specific kinds of collateral. It may also be that certain loans simply didn't perform as expected.

When a borrower is forced to search for another lender due to new lending priorities or regulatory restrictions, finding a new lender becomes a vital necessity. First of all, the borrower and lender should approach the matter of a loan renewal decision at least 90 days before the loan is scheduled to mature.

In the event that the lender indicates a willingness to renew the loan, a letter of commitment should be sought by the borrower. The commitment letter will outline the anticipated loan covenants, including any additional collateral or audit requirements. If it appears that renewal is unlikely, the borrower should immediately begin forging a banking relationship with other potential lenders. It's always wise to consult the FDIC's data base to locate a lender that is in excellent financial health.

Every lender expects potential borrowers to be prepared with updated financial statements and a revenue projection for at least the next 12 months. Banks routinely provide customers with a checklist of vital information that will be required to process and approve a loan application.

Many borrowers also utilize the services of a business consultant to prepare a loan application or negotiate on their behalf. An experienced consultant can recommend solutions to relieve severe financial problems, especially a loan default or forbearance. Among the services that may be offered by a business consultant are the following:

- Strategic alternatives
- Comprehensive financial review
- Banking review
- Banking negotiations
- Cash flow analysis
- Financial strategic planning
- Financial health checkup
- Troubled Loan Negotiations

Although a borrower may have no other choice than to enter into a foreclosure agreement, the financial restrictions may seem daunting. It is absolutely essential to negotiate forbearance agreement terms that meet the needs of both parties. A forbearance agreement can allow a borrower to financially recover, but it's important to realize that a forbearance agreement is only a temporary measure. Therefore, it is essential that the terms of a forbearance agreement are financially realistic. A forbearance plan may include a 12 month projection of a borrower's cash flow, anticipated revenue and the cost of debt service. If the forbearance agreement includes a plan to sell collateralized property, the listing agent and marketing plan will also be included.

When a borrower that is experiencing financial difficulty fails to propose a financial plan, the lender may have no other choice than to insist on a forbearance agreement or initiate foreclosure proceedings. A forbearance agreement often includes rather stringent measures to protect the financial interests of the lender.

When relevant financial metrics indicate that a borrower's financial position is in jeopardy, the bank may institute certain restrictions, including limitations on accounts payable, net worth and credit line balance. Even when a borrower is doing everything possible to cut expenses and liquidate expendable assets to raise operating capital, a forbearance agreement may be the last remaining hope of a lender.

Lending institutions never look forward to imposing a forbearance agreement. Unfortunately, a home or business owner may not have access to the capital necessary to meet the financial covenants of the loan. The bank wants to be paid in full as soon as possible. The terms of the agreement are negotiable, but the financial interests of the bank will be afforded the highest of priorities.

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