# Forbearance Agreements in Funded Credit Arrangements*

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## Introduction

The economic conditions that currently prevail have created for both lenders and borrowers a difficult environment in which to work out the many loan agreements that are now, or soon will be, in material default. On the one hand, confronted with credit markets that are still challenged, borrowers have few options to refinance their troubled loans. On the other hand, lenders have been disappointed that foreclosure on their collateral often now generates recoveries far below the amount of the debt secured by that collateral, leaving them with significant unsecured deficiency claims that may be uncollectible. One tool that can be useful to both sides under these circumstances is a forbearance agreement that memorializes and implements a consensual forbearance arrangement between the parties.

Forbearance agreements have been used in the United States for many decades.[1] Despite their long history, however, they have been all but ignored by law reviews and other scholarly journals as well as by professional publications directed toward practicing lawyers.[2] This article seeks to fill this vacuum by discussing the principal benefits of

[1]The earliest reported U.S. case that the author could locate involving a forbearance arrangement dates to 1788, Tuttle v. Bigelow, 1 Root 108 (Conn. Super. 1788), but forbearances doubtless were employed before then.

[2]A recent Lexis-Nexis search disclosed only a single three-page article in the indexed law reviews, law journals and similar publications discussing forbearance agreements generally in the context of defaulted credits. See William Barnett, The Forbearance Agreement: A Document Whose Time Has Come and Not Yet Gone, 112 Bankr. L.J. 181 (1995). Forbearance agreements are mentioned in passing in several other works in which a recent case or a particular issue was the principal subject of the article. See, e.g., Jeffrey W. Warren and Adam L. Alpert, The Enforceability of a Pre-Petition Waiver of the Automatic Stay: Beware the Terms of a Forbearance Agreement, 27-3 Am. Bankr. Inst. J 24 (Apr. 2008); Alvin L. Arnold, Financing: Forbearance Agreement Bars Counterclaim by Borrower, 26 Real Est. L. Rep. 7 (1996); Eric T. Berkman, Release Won't Shield Lender from Usury Claim of Borrower, Rules Mass. Superior Court Judge, Mass. Lawyers Weekly, Oct. 29, 2007; and Banking Brief, Forbearance Agreement Barred Debtor's Counterclaim Against Bank, 113 Banking L.J. 932 (1996).

Contracts denominated a "forbearance agreement" have occasionally been employed in contexts other than those involving the workout of a troubled credit, such as interstate water resource management and banking regulation, and such contracts have generated some law review attention. See, e.g., James H. Davenport, Softening the Divides: The Seven forbearance agreements, some concerns that the parties should address in their forbearance arrangements, and some other issues that lenders should appreciate in relation to forbearance agreements.

## The Context of Forbearance Agreements

In the classic forbearance arrangement, a lender conditionally agrees to refrain for a limited time (the "forbearance period") from exercising its rights and remedies under a defaulted credit agreement[3] while the borrower seeks to refinance, restructure or otherwise repay its debt or cure its defaults. Forbearance agreements are sometimes referred to as "standstill agreements." That label is unsuitable, however, because rarely do both parties to a forbearance agreement simply "stand still." Rather, the forbearance agreement often requires the borrower to make certain concessions and undertake new actions; adopts significant substantive amendments to the loan documents that go into effect immediately; and guides how the credit facility will operate during the forbearance period.

Forbearance arrangements are distinct from both "pre-workout agreements" and comprehensive restructurings, which are at the opposite ends of the workout negotiation continuum. Pre-workout agreements are the opening gambit in workouts. Their primary function is to facilitate negotiations by establishing that the parties may consider and discuss revising the loan terms, or renewing or extending

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Colorado River Basin States' Recommendation to the Secretary of the Interior Regarding Lower Basin Shortage Guidelines and the Operation of Lakes Mead and Powell in Low Reservoir Conditions, 11 U. Denv. Water L. Rev. 287 (2007); and Michael S. Levitt, The Abrogation of Forbearance Agreements: FIRREA's Ambiguities Demand a More Principled Analysis, 61 Geo. Wash. L. Rev. 1314 (1993). Those agreements are, of course, irrelevant to and beyond the scope of this article.

[3]The use of forbearance agreements is not limited to defaulted loans, and not all creditors and debtors that are parties to forbearance agreements are lenders or borrowers. Forbearance agreements can be used in respect of breaches under virtually any agreement that gives rise to a debtor-creditor relationship, such as sales contracts using trade credit, leases, licenses requiring payment of royalties, etc. Nevertheless, in the author's experience, they are used most commonly in credit arrangements that involve loans or other financial accommodations (such as letter of credit or bankers' acceptance facilities). Accordingly, this article focuses on forbearance arrangements in connection with such credit arrangements and refers to the creditors and debtors that are parties to them as "lenders" and "borrowers," respectively.

the loan, without prejudicing their respective rights, claims and defenses should they fail to reach a definitive restructuring agreement.[4] Because pre-workout agreements maintain the status quo of the lender and the borrower during the workout discussions, they, perhaps more than forbearance arrangements, provide a standstill. Comprehensive restructuring arrangements, conversely, result in both a cure or waiver of the borrower's defaults and a permanent revision of the terms of the credit facility. Forbearances are situated between pre-workout arrangements and comprehensive restructurings. Reduced to their essence, forbearance agreements merely suspend the exercise of a creditor's remedies temporarily while neither curing or waiving the borrower's defaults nor impairing the creditor's right to exercise its remedies ultimately.[5]

Various considerations may prompt a lender to enter into a forbearance arrangement rather than to exercise its remedies. Forbearances provide time, a commodity that is precious in workouts. Borrowers, of course, can use the time to seek replacement financing, to reorganize their business and to dispose of assets. Lenders, however, also often need the breathing space for various reasons, such as to consult with professionals; to formulate a workout strategy, which may require addressing disagreements among the members of a lending syndicate; to rehabilitate deficient loan documentation; and to correct problems in the creation or perfection of their liens, and/or to obtain new guarantees, collateral or other credit enhancements, all of which may dictate keeping the borrower out of bankruptcy for at least 90 days so as not to risk a preferential transfer under the federal Bankruptcy Code, 11 U.S.C.A. §§ 101, et seq.[6] Lenders typically also

[4] A secondary function of some pre-workout agreements is to have the borrower agree to bear the legal and other expenses that the lender incurs in negotiating a workout, whether or not the negotiations are successful. See David M. Stewart and Elizabeth Jaffe, Pre-Workout Agreements are Today's Lender Essentials, 242 N.Y.L.J., Aug. 24, 2009, at S4.

[5] See Deutsche Bank Nat. Trust Co. v. Williams, 62 A.D.3d 826, 879 N.Y.S.2d 552 (N.Y. App. Div. 2009) ("a forbearance agreement does not constitute a settlement of the foreclosure action"; accordingly, lender entitled to proceed with foreclosure action when borrower defaulted under terms of forbearance agreement).

[6] A bankruptcy trustee (which generally includes a debtor-in-possession) may avoid certain transfers, commonly called "preferences," made shortly before bankruptcy that benefit some creditors at the expense

receive additional fees and various other incentives for forbearing, as we discuss in Part III.H below.

## Negotiating and Drafting Issues

As one would expect, the degree of a forbearance arrangement's complexity usually reflects the sophistication of the parties and the size and complexity of the credit facility that is in trouble. Thus, forbearance agreements for large syndicated commercial credits tend to be more comprehensive than those in connection with single-lender loans to consumers or small businesses. Nevertheless, although the facts of each workout scenario are unique and not all of the issues discussed below may be applicable, the critical concerns in forbearance arrangements have much in common regardless of the specific situation.

## Parties to the Forbearance Agreement

Forbearance agreements are fundamentally bilateral contracts, with the parties that have received credit on one side and the parties that have provided the credit on the other side. If there is only one borrower and one lender, of course, both of them have to become parties to the agreement for it to be effective. The situation becomes only slightly more complicated where multiple parties are involved on one or both sides.

If there is more than one borrower, of course, each borrower should enter into the forbearance agreement. Where the credit has been guaranteed or otherwise enhanced by one or more guarantors or other sureties, the lender will want to ensure that the forbearance arrangement does not impair the guaranty or other credit enhancement in any respect or embolden any guarantor or other credit enhancer to assert that the lender's agreement to forbear effects a release of the guaranty or other credit enhancement. Therefore, even if the guaranties and other credit enhancement documents

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of others. Under 11 U.S.C.A. § 547(b), preferences are transfers made to or for the benefit of a creditor within 90 days (or one year, for transfers made to the transferor's insiders) before the petition date on account of an "antecedent debt" (i.e., a debt incurred pre-transfer) while the transferor was insolvent and that enable such creditor to receive more than it would have received in a liquidation under Chapter 7 of the Bankruptcy Code had the transfer not been made. Various defenses may be interposed under § 547(c) to preference attack, including that the transfer was a contemporaneous exchange for "new value" given to the debtor.

contain robust waivers of the guarantors' and other credit enhancers' suretyship defenses,[7] the lender should require that each guarantor and credit enhancer either (i) become a party to the forbearance agreement or (ii) expressly consent to the forbearance arrangement and acknowledge that its guarantee or other credit enhancement remains in full force and effect after giving effect to the forbearance agreement. A similar express consent and acknowledgement should be procured from any other creditor of the borrower that has subordinated its claims or liens to the claims or liens held by the lender.

For ease of reference in this article, the borrowers, guarantors and other credit enhancers are sometimes hereinafter referred to collectively as "loan parties" and individually as a "loan party."

On the credit providing side, multiple lenders may have extended credit separately, in parallel, or together, as part of a syndicate; and if there is a lending syndicate, those lenders may have appointed an agent to administer the credit, to be the secured party and to perform other functions on behalf of the lenders. Where there are multiple parallel lenders, each such lender should enter into the forbearance agreement, and the agreement should state that it is not to become effective until all of the lenders have done so. This is in the interest of not only the borrower, who, of course, wants to get the benefit of forbearance from each of its lenders, but also the other lenders; no one lender should be happy if it is required to forbear while a parallel lender who is otherwise similarly situated is not barred from taking action and can thereby promote itself at the expense of the other lenders. Where multiple lenders are together in a syndicate, action by the syndicate on most matters usually can be taken by fewer than all of the lenders so long as the action has been approved by the percentage of lenders required by the credit agreement. A forbearance agreement involving a lending syndicate should not become effective until it has been entered into by lenders who constitute at least the requisite majority, if the credit agreement permits a forbearance by less than 100% of the lenders, or by all of the lenders in the

[7]For a discussion of a surety's defenses, see generally Restatement (Third) of Suretyship and Guarantee §§ 37 to 49 (1996).

syndicate, if the credit agreement requires each lender's affirmative consent to be bound by a forbearance.[8]

Finally, if a lender has sold a participation in the loans owed to it by the borrower, its freedom to enter into the forbearance agreement may be constrained by the participation agreement. Many participation arrangements reserve to the selling lender the right to take or omit to take action without the participant's consent regarding all matters that arise during the administration of the credit other than a few key matters that are specified in the participation agreement.[9] This is particularly the case where the participation was sold at or near par as a part of the primary or a secondary syndication of the credit. Many other participation arrangements—especially where the participant is a distressed debt investor who bought the participation at a significant discount because the credit was already in trouble at the time of the sale—grant to the participant a veto over even routine actions by the selling lender to the extent that the lender's grant of such a veto is not itself prohibited by the underlying credit documentation.[10] Regardless of when a lender may have sold the participation, it should ascertain

[8] Alternatively, if there is an administrative agent that is empowered to bind each lender, that agent could enter into the forbearance agreement on behalf of the lenders. Forbearance arrangements, however, are not a routine, ministerial events in the course of the administration of a credit facility, and the suspension of the lenders' remedies can have major consequences. In practice, therefore, an agent is unlikely to enter into the forbearance agreement on behalf of the lenders unless and until it has received written instructions to do so from all lenders whose consent is required to approve the forbearance. Accordingly, having the agent act for the lenders provides little administrative or temporal convenience in this situation.

[9] The veto power of a participant in a par participation agreement is typically limited to the so-called "sacred rights" of a participant—any reduction in any principal, interest or fees payable by the borrower in which the participant has a participation; any extension of the final maturity of the participated loan (and, sometimes, any extension of the due date of any intermediate installment); any increase in the commitment participated to the participant; and sometimes (especially in asset-based credit facilities) any increase in the lender's advance rates above a stipulated level and certain releases of collateral. See generally Sandra S. Stern, Structuring and Drafting Commercial Loan Agreements § 12.10[1] (rev. ed. 2006).

[10] The assignments and participations section of many syndicated credit agreements is based on the assignments and participations section set forth in the "Model Credit Agreement Provisions" promulgated by The Loan Syndications and Traders Association. The current version of the

whether the participation agreement prohibits it from agreeing to one or more of the provisions of the forbearance agreement without first getting the participant's consent to do so, and it should procure any consent that may be required.

## Who Drafts the Forbearance Agreement?

When credit arrangements are originated, the principal loan documentation has traditionally been prepared by the counsel for the lender, although at the height of the economic boom that preceded the current recession it was not unusual for lenders who were competing vigorously for transactional business to allow their most attractive customers (particularly large leveraged buyout sponsors and investment grade companies) to draft some or many of the credit documents. Forbearance agreements, however, are not part of the initial package of loan documents. Rather, their appearance awaits the onset of a workout. By that time, something has gone seriously amiss in the credit and the cooperation and goodwill that accompanied the loan origination has likely dissipated, if not turned into outright obstructionism and acrimony. In workouts, the traditional order prevails—thus, forbearance agreements are almost universally prepared by counsel for the lender, not by the borrower or its attorneys, regardless of which side may have drafted the original credit documentation.

## Defaults Subject to Forbearance

The forbearance agreement should cover only those defaults under the credit documents that both (i) are currently in existence or are projected to occur during the forbearance period and (ii) are specifically listed by the borrower in the forbearance agreement. Lenders typically do not forbear as to existing defaults that are not disclosed by the borrower, nor do they forbear as to defaults that were

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Model Credit Agreement Provisions states that any agreement or instrument pursuant to which a lender sells a participation

> shall provide that such Lender shall retain the sole right to enforce this Agreement and to approve any amendment, modification or waiver of any provision of this Agreement; provided that such agreement or instrument may provide that such Lender will not, without the consent of the Participant, agree to any amendment, modification or waiver [with respect to the following: _______ / described in Section ___ [provision relating to amendments requiring unanimous consent of the Lenders]] that affects such Participant.

See Model Credit Agreement Provisions, Successors and Assigns § (d) (2009).

not projected and that occur during the forbearance period. By employing this procedure, the lender can make its decision to forbear on an informed basis and can retain the freedom to exercise remedies or take other action if it is later surprised when an undisclosed existing default comes to light or a new, unprojected default occurs.

## Duration of the Forbearance Period

Although there is no required minimum duration for a forbearance period,[11] the forbearance agreement should state how long the lender will forbear. Forbearance periods typically commence on the date of the forbearance agreement, provided that all conditions to the effectiveness of the agreement have been satisfied, and they usually terminate on the earlier of a specified expiration date or the date on which a specified termination event occurs. Termination events usually include the existence of any default that the borrower has not acknowledged, the occurrence of any unprojected new default during the forbearance period, and the breach of the forbearance agreement itself by any of the loan parties. Since termination events enable lenders to cease forbearing before the forbearance period would otherwise expire, borrowers need to prevent the occurrence of a termination event if they are to get the benefit of the full forbearance period.

The imprudence of leaving the duration of the forbearance period indefinite may seem obvious, but some forbearance agreements nevertheless have done just that. Unsurprisingly, this can prompt a dispute regarding whether the lender's forbearance remains in effect, thereby postponing the lender's ability to exercise its remedies, or has expired, such that the lender can begin taking remedial actions. Courts facing this situation have ruled that a forbearance

[11]"Under New York law, forbearance of any length can constitute valid consideration." MM Arizona Holdings LLC v. Bonanno, 658 F. Supp. 2d 589, 593 (S.D.N.Y. 2009), citing Sun Forest Corp. v. Shvili, 152 F. Supp. 2d 367, 392 (S.D.N.Y. 2001). See also Strong v. Sheffield, 144 N.Y. 392, 394-95 (1895). Note, however, that the result may be different if a third party is involved in the arrangement. See, e.g., Baker v. Citizens State Bank of St. Louis Park, 349 N.W.2d 552, 559 (Minn. 1984) (where the sole shareholder of a corporate borrower provided a new guarantee and mortgage on his farm as a condition for the bank's promise to forbear in calling the borrower's loans, seven days between the bank's promise to forbear and its demand for payment was insufficient consideration for the new guarantee and mortgage as it was an unreasonably short amount of time).

agreement which lacks a definite period of forbearance require forbearance only for a "reasonable length of time."[12] Although this standard affirms that even an indefinite forbearance need not last indefinitely, it is too theoretical to provide useful guidance for the parties to a forbearance agreement. What forbearance period is "reasonable" will vary from case to case and can be established with precision only after the fact. Moreover, if a dispute regarding the duration of an indefinite forbearance period cannot be resolved without litigation, the practical effect of the lawsuit is likely to be adverse to the lender however the court ultimately may rule. This is because the time that the court may take to hear the case and render its decision may be so long—longer, perhaps by far, than even the longest forbearance period that could be perceived as "reasonable"—that any victory by the lender could be merely pyrrhic.

## Acknowledgements and Representations of the Loan Parties

To induce the lender to agree to forbear, the loan parties usually are required to make several acknowledgements that go beyond customary corporate representations[13] and that are intended to have an estoppel effect on the loan parties.[14] Necessarily, given the discussion in the Part III.D above, the borrower must acknowledge all defaults that are in exis-

[12] See, e.g., A&R Realty Co. v. Northwestern Mutual Life Ins. Co., 95 F.2d 703 (8th Cir. 1938); Brooksbank v. Anderson, 586 N.W.2d 789 (Minn. Ct. App. 1999); and Jamaica Tobacco & Sales Corp. v. Siegel, 40 A.D.2d 686, 336 N.Y.S.2d 258 (N.Y. App. Div. 1972).

[13] Customary corporate representations include, for example: the valid existence and due organization of the loan party; the loan party's good standing in the jurisdiction in which it was formed and, possibly, other jurisdictions where its being in good standing is important to the transaction; the loan party's having the power and authority to enter into and perform its obligations under the forbearance agreement; the due authorization, execution and delivery of the forbearance agreement by the loan party; the enforceability of the forbearance agreement against the loan party; and the loan party's entry into and performance of its obligations under the forbearance agreement will not violate or contravene laws and other agreements to which it is subject or by which it is bound.

[14] Whether, and to what extent, these pre-bankruptcy acknowledgements may estop the loan party or its creditors' committee after the loan party has become a debtor in a proceeding under the Bankruptcy Code are matters beyond the scope of this article. See, e.g., Howard J. Weg, Enforcing a Prebankruptcy Release of Claims and Rights, Los Angeles Lawyer, Feb. 2001.

tence at the inception of the forbearance period and that it projects will occur during that period. Since lenders agree to forbear only as to the defaults specified in the forbearance agreement and the existence or occurrence of any unspecified default triggers a termination event, it behooves borrowers to list all existing and anticipated defaults comprehensively and not to omit any.

Lenders also want the loan parties to acknowledge both the amount of the debt that is outstanding and that the debt is valid, owed absolutely and not subject to any offsets, credits, defenses or adjustments of any kind.

The amount of the debt outstanding typically includes principal; amounts which the lender may have to pay under outstanding letters of credit, bankers acceptances and other financial accommodations that it has made or issued for the borrower's account; accrued interest and fees payable to the lender; and accrued expense reimbursements and other sums that are payable by the borrower under the credit documents. The amount of the principal outstanding and the undrawn amount of the outstanding letters of credit, bankers acceptances and other financial accommodations usually can be fixed without much difficulty or disagreement between the parties. The same applies in respect of accrued interest that is charged at a fixed rate or at an agreed spread above a reference rate (such as the lender's prime rate or LIBOR), and in respect of fees that are computed mechanically (such as facility fees[15] and letter of credit and bankers' acceptance fees[16]) or periodically (such as monthly, quarterly or other periodic agency and collateral management fees). Two subjects do occasionally give rise to calculation disputes—the amount of default interest[17] provided for under the credit documents that has accrued; and the nature, amount and

[15]A facility fee—often called an "unused line fee," a "commitment fee" or another term—often is charged monthly or quarterly in arrears and computed as a percentage of the average daily amount of the committed credit facility that was undrawn during the prior calculation period.

[16]Letter of credit and bankers acceptance fees typically are charged monthly or quarterly in arrears and computed as a percentage of the average daily amount that was available to be drawn during the prior calculation period under the letters of credit and bankers acceptances issued by the lender for the borrower's account.

[17]Loan agreements often give the lender the right to increase the rate of interest it charges after the occurrence of a default. However, especially in commercial credit arrangements, there can be significant differences in the essential features of the default interest rate provision, such as which

reasonableness of the charges and expenses (especially the fees and disbursements of the lender's legal counsel, financial advisors and other professionals) incurred by the lender for which the borrower may be liable. In the author's experience, disagreements on these subjects, however contentious, nevertheless tend to be resolved quickly because the amounts in dispute typically are small in comparison to the size of the overall credit and the parties have more pressing matters to address.[18]

Loan parties generally do not resist acknowledging that the debt is valid, owed absolutely and not subject to any offsets, credits, defenses or adjustments of any kind if they have not asserted any claims against their lenders and have little basis for doing so. If the loan parties have previously asserted a lender liability or other claim against the lender, however, the presence and scope of these acknowledgements

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defaults can trigger the right (for example, any default, only a payment default, or only those defaults that are agreed and specified in the credit agreement); whether the default rate applies automatically upon the occurrence of the required default or only if the lender elects to apply it; the starting date for the default rate (for example, the date of the occurrence of the required default or only the date upon which the lender elects to charge the default rate); and which loans bear the default interest rate (for example, all loans that are outstanding or only the amount of any payment of principal that was not paid when due). Fixed rate loans typically bear a default rate that is set at a fixed rate several percentage points higher than the non-default rate. Where interest is charged at an agreed spread above a reference rate, the default rate usually is implemented by increasing that spread by an agreed number of percentage points. If the credit facility provides for letters of credit, bankers acceptances or other financial accommodations, it is customary for the percentage rate for the related letter of credit, bankers' acceptance or other fees to be increased by the same number of percentage points as results from application of the default interest rate, if and when the default interest rate becomes applicable.

[18] The author's experience also reflects that the default interest and expense disputes typically are resolved in the lender's favor at the forbearance agreement stage. Borrowers may be willing to concede the points at this stage not only because they may have other, more pressing priorities to address, but because they may be able to revisit the issues during the negotiation of the comprehensive restructuring. Moreover, if no comprehensive restructuring is agreed to, the amounts at issue may merely increase the lender's already uncollectible deficiency. Nevertheless, if the forbearance agreement requires the payment at closing of all or a significant portion of the disputed interest and expense amounts, the borrower's cash reserves may be depleted unduly or the lender may have to advance the sums at issue so they can be paid (thus increasing the lender's funded exposure).

could (together with the release discussed in Part III.F below) become one of the most heavily negotiated provisions in the forbearance arrangement.

Loan parties also usually must acknowledge that all security interests and liens (perfected or otherwise) created under the existing loan documents are and remain valid and enforceable and are not impaired by the forbearance agreement. In addition, the forbearance agreement may contain a bringdown of the representations that the borrower made in the original loan documents, although the utility of this feature is debatable since well-prepared forbearance agreements exclude from the bringdown any breaches of the original representations that constitute, or are projected to trigger, a default.

For the reasons discussed in Parts IV.A and B below, the forbearance agreement should include a provision in which each loan party acknowledges that it reviewed the forbearance agreement and consulted with legal counsel concerning it, particularly where the borrower is an individual or a small business. More important, the lender should verify that such acknowledgement is more than mere words; it should make sure that the loan parties are, in fact, represented by competent legal counsel.

All of the acknowledgements discussed in this section can be made in recitals or representations, but whatever their form, it is their substance that matters. Lender's counsel should ensure that all of the loan parties' acknowledgements and representations, regardless of their form and substance, expressly survive the closing of the forbearance agreement.

## Release by the Loan Parties

It is common for lenders to require, as a condition to agreeing to forbear, that the loan parties release the lender and its affiliates, agents, employees and representatives from any and all claims and liabilities relating to the forbearance agreement and the underlying existing credit arrangement.[19] The release acts as a bookend to the acknowledgement discussed in Part III.E above that the debt is valid, owed

[19] Note that the release is unilateral; lenders do not mutually release their loan parties or credit enhancers in forbearance agreements. As with pre-bankruptcy acknowledgements, whether, and to what extent, pre-bankruptcy releases may bind a bankruptcy debtor or its creditors' committee are matters beyond the scope of this article.

absolutely and not subject to any offsets, credits, defenses or adjustments of any kind. As with that acknowledgement, loan parties tend not to resist providing a release if they have not asserted any claims against the lenders and have little basis for doing so, but they may negotiate heavily if they have previously asserted lender liability or other claims against the lender.

The 1996 case of *Bank of Boston Connecticut v. Avon Meadow Associates*[20] illustrates what can happen when the release provision of a forbearance agreement is drafted with less than complete clarity. In *Avon*, the lender sued the borrower and guarantor in 1991 to collect a $2.2 million construction loan; the defendants counterclaimed, among other things, that that the lender breached an oral agreement to fund the project to completion; and the lender pleaded the forbearance agreement between the parties as a special defense to the counterclaim. The case was tried before a jury, which had to decide whether the alleged oral agreement existed, whether the lender breached that contract and whether the forbearance agreement released the lender from liability for any such breach. A key issue was how to interpret Paragraph 2 of the forbearance agreement, which read as follows:

> Debtor and Guarantor jointly and severally acknowledge and affirm the Debt represented by the Note, Mortgage, Guaranty and any other documents executed in connection therewith. Debtor and Guarantor further represent that, as of the date hereof, no defense, setoff or claim exists with respect to Bank, either matured or unmatured, contingent or certain, direct or indirect, which could be raised in defense or in diminution of the amounts claimed under the said Note. Further, Guarantor and Debtor hereby covenant and agree that they will execute such documents as Bank may reasonably request, which documents will serve to forever waive and release any defense, claim or counterclaim by Debtor or Guarantor against Bank for any action occurring prior to the date of this Agreement.[21]

Through interrogatories, the jury indicated that it found the existence of an oral commitment to fund the condominium project to completion. Additionally, it responded that the lender breached this oral contract and also violated the Connecticut Unfair Trade Practices Act. The jury neverthe-

[20] Bank of Boston Connecticut v. Avon Meadow Associates, 40 Conn. App. 536, 671 A.2d 1310 (1996).

[21] *Id.* at 538–39, 671 A.2d at 1312, n.3.

less returned a verdict in favor of the lender both on its claim and on the defendants' counterclaim because it found either that the forbearance agreement constituted a release by the defendants of their counterclaim or that the defendants were estopped to assert their counterclaim.[22]

On appeal, the defendants contended that, because Paragraph 2 used the word "claim" in the second sentence and the phrase "claim or counterclaim" in the third sentence, the release contained in the forbearance agreement was unambiguous and applied only to "claims," not to the defendant's counterclaim. Accordingly, the defendants argued, the trial court should have made a ruling to this effect as a matter of law instead of referring the issue to the jury. The appellate court, however, said that the terms in the second and third sentences were inconsistent and conflicting. Thus, the issue was properly given to the jury for the determination of what the parties intended when they entered into the forbearance agreement. The defendants also argued the forbearance agreement did not effect a present release because the wording of the third sentence of Paragraph 2 called for a release to be executed by the defendants in the future, this was never done and there was no evidence that all material terms of the proposed release were agreed upon among the parties. The appellate court, however, opined that, under appropriate circumstances

> a promise to execute a release in the future may be enforced as a release regardless of whether a release is in fact actually executed. This general principle is qualified, however, to the extent that if such a contract "is to be specifically enforced, it is necessary that its potential terms be sufficiently definite that the nature and extent of the parties' obligation can be ascertained."[23]

Because one of the defendants had testified on the subject of the release, the appellate court determined that there was sufficient evidence regarding the terms of the proposed future release to support the jury's finding. It thus affirmed the jury's verdict.

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[22] "Although it seems inconsistent that the jury found either that the forbearance agreement constituted a release or that the defendant was estopped from asserting its counterclaim, the interrogatories to the jury were phrased in this particular manner." Bank of Boston Connecticut v. Avon Meadow Associates, 40 Conn. App. at 539, 671 A.2d at 1312, n.4.

[23] *Id.* at 543, 671 A.2d at 1314, citing Ismert & Assoc., Inc. v. New England Mutual Life Ins. Co., 801 F.2d 536, 542 (1st Cir. 1986).

The lender in *Avon* prevailed in the end, but the victory was hardly a sure thing. A different verdict could easily have been rendered and sustained. The case, moreover, lasted more than half a decade, required a trial before a jury as well as an appeal, and doubtless cost the lender a considerable amount of time and financial resources. The risk and expense of litigation that the lender incurred could have been avoided had Paragraph 2 been drafted to avoid internal inconsistency and to provide a present release rather than an agreement to provide a release in the future.

## Loans During the Forbearance Period

The lender will have to evaluate whether it will continue to extend credit to the borrower during the forbearance period or whether to suspend its lending commitment or terminate it altogether. If new loans or other financial accommodations continue to be made, the forbearance agreement should set forth the maximum amount of the loans, the advance rates for forbearance period loans that are based on collateral availability, the interest rates applicable to the forbearance period loans, and all other terms and conditions governing these loans. If cash collateral secures the borrower's outstanding obligations and the borrower needs cash during the forbearance period, the lender may prefer to allow the borrower to use such cash collateral in lieu of or in addition to taking borrowings. In that case, the forbearance agreement should include provisions governing the use of the cash collateral.

## Lender Compensation During the Forbearance Period

Forbearance agreements typically address at least three matters relating to lender compensation. First, since lenders take additional credit risk during a forbearance period, borrowers usually have to pay a fee to compensate the lenders for the heightened risk. Such forbearance fees can take various forms (for example, all upfront, payable over time, larger for syndicate members who agree to forbear and smaller for those who do not, or increasing if targeted loan repayments are not made by specified dates). Second, because the borrower has defaulted under the existing credit agreement, the default rate of interest set forth therein may have been triggered, causing an increase in the interest payable to the lender. The forbearance agreement should address whether the lender will forbear from instituting the default rate of interest during the forbearance period in addition to forbearing from exercising its other rights and remedies.[24] If the credit agreement gives the borrower an option to accrue interest based on a periodic reference rate (such as LIBOR) in addition to a spread over the lender's daily prime lending rate, the forbearance agreement should also memorialize whether the reference rate pricing option will be suspended during the forbearance period.[25] Third, especially if the loan documents are silent on the issue, forbearance agreements typically provide for borrowers to pay the costs and expenses (including legal fees) incurred by the lender in connection with the forbearance arrangement and any subsequent workout negotiations, whether or not the latter result in a comprehensive restructuring. Payment of all such costs that have accrued to the commencement of the forbearance period ordinarily is a condition to closing.[26]

## Rehabilitative Provisions

A forbearance agreement presents an opportunity—indeed, may be dictated by the need—for lenders to apply the curative arts. If the loan or security documentation suffers from material deficiencies, or if significant problems impair the

[24] *See supra* notes 18–19 and accompanying text.

[25] Lenders are inclined to eliminate the LIBOR or other pricing options that were available to the borrower prior to the workout, and limit the borrower to the bank's fluctuating prime or base rate pricing plus an agreed spread, for several reasons. Lenders generally achieve a higher yield with base rate-based pricing than they do with LIBOR or other pricing options. LIBOR and most other pricing options also involve fixing a rate for a specified maturity—usually expressed as an "interest period"—and may trigger breakage fees if the loans bearing this pricing have to be paid before the last day of the applicable interest period. Since lenders are more likely to accelerate a loan that is in workout, they are more likely to be unwilling to take the heightened risk of breaking an interest period and triggering breakage fees. Additionally, lenders that do not match fund their LIBOR or other alternative pricing may be reluctant to assume the risk that interest rates generally increase during an interest period. Such an occurrence would reduce the lenders' yield on the alternatively-priced loans by increasing the lenders' funding costs without a corresponding increase in the rate paid by the borrower until the end of the interest period. Prime or base rate pricing, in contrast, fluctuates daily to reflect the general interest rate environment, and normally any change in the prime or base rate results automatically in an equal and immediate change in the rate charged to the borrower.

[26] See also supra note 19 and accompanying text.

validity or perfection of the lender's liens, the lender should require that all amendments and other steps necessary to rehabilitate the documentary and collateral flaws be undertaken as conditions to the forbearance. Before agreeing to forbear, therefore, it is prudent for lenders to reexamine their loan files specifically to ascertain whether any such problems exist and can be cured in connection with the forbearance agreement.

## Forbearance Period Covenants

Forbearance agreements typically require that borrowers comply during the forbearance period with covenants that supplement those set forth in the loan documents. It is wise for lenders to stay abreast of any improvements or declines in the borrower's condition during the forbearance period. Forbearance agreements therefore often require the flow of information from the borrowers to the lenders to increase significantly during the forbearance period. Borrowers often have to provide financial and collateral reporting much more frequently and with far greater detail than hitherto. Borrowers may be required to prepare a detailed budget covering their expenses during the forbearance period, to agree not to deviate by more than an agreed degree from that budget, and to report periodically (often weekly) on their compliance with the budget. When crafting such covenants, however, lenders should beware lender liability; accordingly, they should avoid becoming so involved with the borrower's business affairs that they can be accused of crossing the line between creditor and manager.[27] To insulate against the specter of lender liability, as well as to ensure that the borrower is advised by competent professionals who are experienced in managing distressed businesses, lenders may also require in the forbearance agreement that the borrower engage, pay for and cooperate with a turnaround consultant that is acceptable to the lender.[28]

It is not unusual for lenders to require that the loan par-

[27]For a discussion of lender liability issues in workouts, see generally Edward F. Manino, Lender Liability and Banking Litigation § 2 (2009).

[28]Particularly in the case of a troubled credit, when expenses of the borrower have eroded forecast profit margins, lenders have a legitimate interest in proposing work force reductions or salary decreases. When such steps are forced upon an unwilling borrower, and are also done on a large-scale basis affecting even key personnel, control problems arise. Typically, however, this factor does not, by itself, lead to imposition of li-

ties provide new or additional collateral, guarantees or other credit enhancements in consideration for the forbearance. If this is the case, the forbearance agreement should describe with sufficient specificity what is to be provided, by what date and in what manner. Lenders doubtless appreciate that if a loan party thereafter becomes a bankruptcy debtor within the applicable preference period (*i.e.*, 90 days if the lender is not an insider of the debtor, one year if the lender is an insider[29]), the grant by that loan party may be vulnerable to avoidance as a preferential transfer. The risk of preference attack, however, rarely deters lenders from taking the credit enhancement since even if the attack were successful the lender would be put back in the same position as it held pre-forbearance. Rather, the likelihood of such an attack should be factored into how much value to ascribe to the new enhancement when negotiating the forbearance agreement and how long to extend the forbearance period.[30]

Lenders may also require borrowers to conduct asset sales during the forbearance period to raise cash that can be used

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ability upon a lender for a borrower's obligations. Lenders can best protect themselves in this area by requiring the borrower, through a consultant of its own choice acceptable to the lender, to formulate appropriate measures to implement personnel and pay reductions at a level consistent with the borrower's financial obligations.

*Id.* at § 2.02[2][c] (citations omitted). Nevertheless, lenders

> should avoid the direct selection and retention of agents or consultants to run a borrower's business, or to advise the borrower on economies or improved methods of doing business. A better alternative for the lender is to require the borrower to implement economies to restore the financial condition required by the loan documentation through plans developed by consultants of its own choice, who are acceptable to the lender. Lenders may wish, for example, to propose a list of three to five professionals acceptable to them, one of which can be selected by the borrower at its option.

*Id.* at § 2.02[2][e]. The consultant's substantive recommendations for the borrower's business are not typically reflected in covenants at the forbearance agreement stage but are likely to become the subject of negotiation for the comprehensive restructuring. The forbearance agreement's mandate that a consultant be engaged is, however, often the first step in this process.

[29] 11 U.S.C.A. §§ 547(b)(4), 101(31).

[30] The "new value" defense to a bankruptcy preference, discussed *supra* at note 7, is not available for a forbearance. Established case law makes clear that merely forbearing from exercising existing remedies does not constitute "new value" as defined in 11 U.S.C.A. § 547(a)(2). *See*, *e.g.,* In re ABC-NACO, Inc., 483 F.3d 470 (7th Cir. 2007); Lyndon Property Ins. Co. v. Eastern Kentucky University, 200 Fed. Appx. 409, 2006 FED App. 0651N (6th Cir. 2006); and In re Pameco Corp., 356 B.R. 327 (Bankr. S.D.N.Y. 2006).

to pay down the loans in part. Furthermore, if the lender has a lien on receivables but has not taken dominion over the cash proceeds when the receivables are paid, it may require that the borrower implement a cash management arrangement that gives the lender dominion over the future cash proceeds. This way, should the loan parties breach the forbearance agreement, the lender will be able to apply its most liquid collateral immediately to reduce the loan balance.

## Waiver of the Automatic Stay in Bankruptcy

Some forbearance agreements contain a provision in which the borrower agrees that, if it subsequently becomes a bankruptcy debtor, it will waive the automatic stay against creditor enforcement actions that otherwise goes into effect under Section 362 of the Bankruptcy Code[31] upon the filing of the bankruptcy petition. It is axiomatic that prepetition waivers of a debtor's right to file a petition for relief under the Bankruptcy Code are *per se* unenforceable. However, a debtor's prepetition waiver of its right to object to a secured creditor's motion for relief from the automatic stay is neither *per se* unenforceable nor *per se* enforceable. Rather, bankruptcy courts consider the issue on a case-by-case basis, with some decisions giving effect to the waiver to lift the stay[32] and others declining to lift the stay despite the waiver.[33]

In *In re Bryan Road, LLC*,[34] a 2008 case involving a forbearance agreement that contained a stay waiver, Bankruptcy Judge George Olson identified four non-exclusive factors that should be used in determining whether to give effect to the prepetition waiver and thereby lift the automatic stay: (1) the sophistication of the party making the waiver; (2) the consideration for the waiver, including the creditor's risk and the length of time the forbearance is to continue; (3) the impact of the waiver on other parties, including unse-

[31] 11 U.S.C.A. § 362.

[32] *See, e.g.,* In re Bryan Road, LLC, 382 B.R. 844 (Bankr. S.D. Fla. 2008); In re Cheeks, 167 B.R. 817 (Bankr. D.S.C. 1994); and In re McBride Estates, 154 B.R. 339 (Bankr. N.D. Fla. 1993).

[33] *See, e.g.*, In re Deb-Lyn, Inc., No. 03-00655-GVL1, 2004 WL 452560 (N.D. Fla. Mar. 11, 2004); Farm Credit of Cent. Fla., ACA v. Polk, 160 B.R. 870 (M.D. Fla. 1993); and In re Sky Group Int'l, 108 B.R. 86 (Bankr. W.D. Pa. 1989).

[34] In re Bryan Road, LLC, 382 B.R. 844 (Bankr. S.D. Fla. 2008).

cured creditors and junior lienholders; and (4) the feasibility of the debtor's reorganization plan.[35] After evaluating the facts in light of these factors, Judge Olsen elected to enforce the forbearance agreement's waiver and granted the lender's motion to lift the stay.

Despite the lender's success in *Bryan Road*, the enforceability of a prepetition forbearance agreement's waiver of the automatic stay is difficult to predict and depends on the facts of each case. Such provisions are an invitation to litigation in bankruptcy court, albeit a fight the lender may not fear and (especially if the parties are already in conflict with each other) indeed may welcome. Lenders can easily justify incorporating stay waivers routinely in their forbearance agreements on the venerable theory that doing so cannot hurt and might help. Nevertheless, lenders' counsel who include them in the documents they draft should caution their clients not to rely upon them unduly.

## Miscellaneous Provisions

Well-drafted forbearance agreements should include the boilerplate provisions that are customary in loan documentation generally, such as clauses dealing with further assurances, notice requirements, waivers, severability, governing law, venue, integration and execution in multiple counterparts. Since the loan parties' breach of the forbearance agreement should trigger the early termination of the forbearance period, it is advisable to incorporate in the forbearance agreement a discrete breach provision that is distinct from the default provisions of the loan agreement. Finally, the lender might consider requiring as a condition precedent that the loan parties furnish an opinion of their counsel as to the enforceability of the forbearance agreement against them.

## Other Forbearance Agreement Issues

Not all forbearance arrangements end successfully in a

[35]In re Bryan Road, LLC, 382 B.R. at 844. Judge Olson also noted "As a general proposition, prepetition waivers of stay relief will be given no particular effect as part of initial loan documents; they will be given the greatest effect if entered into during the course of prior (and subsequently aborted) chapter 11 proceedings." *Id.* For a more extensive discussion of *Bryan Road* and the postpetition enforceability of prepetition waivers of the automatic stay from the debtor's perspective, *see* Warren and Alpert, *supra* note 3, at 24.

refinancing or restructuring, and some loan parties breach the forbearance agreement. An appreciation of some of the issues that may arise as a result of the breakdown of the forbearance is thus appropriate.

## Economic Duress, Fraudulent Inducement and Other Attacks on Contract Formation

It is not unusual for desperate loan parties, after the fact, to interpose a litany of assertions of lender misconduct that have as their goal denying that a valid forbearance contract was ever formed. Such allegations are particularly popular, and may have some resonance, where the loan party alleging it is an individual or small business.

One common defense is a loan party's claim that it entered into the forbearance arrangement solely under "economic duress" imposed by the lender. Three elements are necessary to establish economic duress: (1) that one side involuntarily accepted the terms of another; (2) that circumstances permitted no other alternative; and (3) that the other party's coercive acts caused the circumstances.[36] A claim of economic duress is difficult to establish[37] and must be asserted promptly.[38] Moreover, it cannot be sustained where a lender threatens merely to exercise contractual and legal rights and

[36] 17A Am. Jur. 2d Contracts § 218 (2004).

[37] Duress is a defense to an otherwise valid contract. Contracts signed under economic duress are voidable. However, one party's dire financial straits alone are insufficient to invalidate a contract on the grounds of duress or economic coercion. For economic duress sufficient to render a contract voidable the pressure applied must have been wrongful or unlawful. Mere hard bargaining is not enough. The mere fact that one is in a difficult bargaining position due to desperate financial circumstances does not support the defense of economic duress.

*Id.* (citations omitted).

[38] *See* VKK Corp et al. v. Nat'l Football League, 244 F.3d 114 (2d Cir. 2001) (waiting 30 months before asserting an economic duress claim forfeits any right to assert such claim); Bank Leumi Trust Co. of New York v. D'evori Int'l, Inc., 163 A.D.2d 26, 558 N.Y.S.2d 909 (N.Y. App. Div. 1990) (economic duress claim was insufficient when delayed more than six months); Bethlehem Steel Corp v. Solow., 63 A.D.2d 611, 405 N.Y.S.2d 80 (N.Y. App. Div. 1978) (a claim of economic duress must be pleaded "promptly" or the contract will be deemed affirmed); and Port Chester Elec. Constr. Corp. v. Hastings Terraces, Inc., 284 A.D. 966, 134 N.Y.S.2d 656 (N.Y. App. Div. 1954) (failure to assert a claim for duress nearly a year after filing an original and amended answer constitutes waiver of the claim and affirmation of the contract).

remedies it already has.[39] Nevertheless, having to litigate an economic duress case can be time-consuming, costly and a nuisance.

Fortunately, if the loan parties are, or at least have the opportunity to be, advised by legal counsel in connection with their negotiation of and entry into a forbearance agreement, the lender is effectively insulated against an accusation of economic duress so long as it has not threatened bodily harm.[40] Therefore, to preempt the assertion of a claim of economic duress, or at least to promote the speedy defeat of such a claim on a motion for summary judgment, lenders should make sure that the loan parties have the opportunity to consult with, and better yet actually are represented by, legal counsel. The forbearance agreements, in turn, should include a provision in which each loan party acknowledges that it has reviewed the forbearance agreement and has had the opportunity to consult with a lawyer concerning it.

Another claim that loan parties, especially individuals and small businesses, have sought to interpose as a defense to a lender's enforcement of a forbearance agreement is that the lender "fraudulently induced" them to enter into the arrangement or induced them via "fraudulent misrepresentation." Although the precise formulation of the elements of the substantively similar claims of fraudulent inducement and fraudulent misrepresentation vary somewhat from state to state, in general a loan party alleging such claims must show that: (1) the lender knowingly made a material false representation of fact or concealed a material fact, (2) the lender intended to defraud the loan party thereby, (3) the loan party

[39] *See, e.g.*, Friedman v. Bache & Co., 321 F. Supp. 347 (S.D. Fla. 1970). *See also* Grand Income Tax, Inc. v. HSBC Taxpayer Fin. Services, Inc. No. 08-CV-346 (CBA), 2008 WL 5113646, at *6 (E.D.N.Y. Nov. 25, 2008); In re Pre-Press Graphics Company, Inc., 310 B.R. 905 (Bankr. N.D. Ill. 2004); and Edge of the Woods v. Wilmington Sav. Fund Soc'y, FSB, No. CIV.A.97C-09-281-JEB, 2001 WL 946521, at *15 (Del. Super. Aug. 16, 2001).

[40] "There can be no duress where the contracting party is free to consult with counsel, in the absence of threats of actual bodily harm." 17A Am. Jur. 2d Contracts § 218 n.11 (2004), citing Carrier v. William Penn Broadcasting Co., 426 Pa. 427, 233 A.2d 519 (1967). *See also* Morales v. Rent-A-Center, Inc., 306 F. Supp. 2d 175 (D. Conn. 2003); Degenhardt v. The Dillon Co., 543 Pa. 146, 669 A.2d 946 (1996); and Three Rivers Motors Co. v. Ford Motor Co., 522 F.2d 885, n.17 (3d Cir. 1975).

reasonably relied upon the representation, and (4) it suffered damage as a result of such reliance.[41]

When negotiating the forbearance agreement, there are several precautions that a lender can take to minimize the risk of having to face a fraudulent inducement or fraudulent misrepresentation charge. First, it should ensure that none of its officers or agents makes on the lender's behalf any misrepresentation or any commitment that the lender does not intend to honor. Second, all representations and commitments that the lender intends to make should be memorialized in the forbearance agreement. Furthermore, the forbearance agreement's integration clause should make clear that the agreement supersedes all oral statements and prior writings and that the only undertakings of the lender on which the loan parties are relying are those expressly set forth in the agreement. Finally, as previously discussed, the lender should encourage the loan parties to be represented by an attorney and should require them to acknowledge in the forbearance agreement that they have consulted, or at least had the opportunity to consult, legal counsel concerning the agreement. Although the participation of a loan party's counsel should, in theory, have no impact on the validity of the loan party's subsequent allegation that it was fraudulently induced to sign the forbearance agreement, it may have a salutary effect in practice. A review of several cases leads to the inference that judges may be reluctant to give credence to such an allegation when the complaining party was represented by counsel in connection with the negotiation and documentation of the forbearance agreement.[42]

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[41] *Bonanno, supra* note 12, 658 F. Supp. 2d 589, 593, citing Lumbermens Mut. Casualty Ins. Co. v. Darel Group U.S.A. Inc., 253 F. Supp. 2d 578, 583 (S.D.N.Y. 2003). *See also* Media Network, Inc. v. Long Haymes Carr, Inc., 678 S.E.2d 671 (N.C. Ct. App. 2009); and Amouri v. Southwest Toyota, Inc., 20 S.W.3d 165 (Tex. Ct. App. 2000). *See generally* 37 C.J.S. *Fraud* § 13. As with other claims of fraud, allegations of fraudulent inducement must be pleaded with particularity. In re Margaux Park Partners, Ltd., No. 08-43388, 2009 WL 5061806, at *5 (Bankr. E.D. Tex. Dec. 15, 2009). *See generally* Fed. R. Civ. P. 9(b) and analogous rules under state civil procedure statutes, such as N.Y.C.P.L.R. § 3016(b).

[42] *See, e.g.,* Bi-Rite Petroleum, Ltd. v. Coastal Refining & Marketing, Inc., 282 F.3d 606 (8th Cir. 2002); *Bonanno, supra* note 12; and *In re Margaux Park Partners, Ltd.*, *supra* note 42 (merger clause in a loan agreement and a negotiating agreement was sufficient to bar a fraud claim because both parties were represented by counsel and dealing at arms-length).

## Usury

State usury laws hold an exalted status in the world of lending because they form part of the public policy of the state. Thus, according to Williston, they:

> cannot be evaded by any circumvention or waived by the debtor, no matter what form or pretense is used by the lender. And . . . the right of a borrower to pursue the excessive interest must not be defeated by permitting the lender to demand and the borrower to give a release or other acquittance so long as the lender retains the usury . . ..[43]

As a result, lenders should recognize that the release provision of a forbearance agreement may not shield them from a subsequent allegation that they violated an applicable usury statute, however heavily the agreement may have been negotiated and whether or not the borrower was represented by counsel.

A 2007 case from the Commonwealth of Massachusetts, *LR5-A Limited Partnership v. Meadow Creek, LLC*,[44] illustrates this principle. There, to finance a real estate development project in Dracut, Massachusetts, the lenders had made a series of loans to the borrowers at an interest rate that exceeded the rate permitted under Massachusetts G.L. c 271, § 49, the Massachusetts Criminal Usury Statute. The borrowers subsequently went into "serious default" on the loans, which caused a need for periodic additional financing and foreclosures. In connection with two of those additional financings, the parties entered into two forbearance agreements, each of which contained broadly worded provisions purporting to release the lenders from all prior obligations and defaults. Litigation ultimately ensued in which, among other things, the borrowers asserted various claims against the lenders, including the lender's usury law violations, while the lenders interposed the forbearance agreement releases as a bar to the borrowers' claims. Faced with various cross-motions for partial summary judgment and after considering more than 100 years of Massachusetts precedents, the Court concluded that "G.L. c. 271, § 49 is sufficiently infected with public policy such that it cannot be

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[43] 9 WILLISTON ON CONTRACTS § 20:54 (4th ed.). (Citations omitted.)

[44] LR5-A Limited Partnership v. Meadow Creek, LLC, No. 06-2804 BLS1, slip op. (Mass. Supp. Oct. 17, 2007).

the subject of an ordinary release or waiver."[45] It thus denied the lenders' cross-motion and allowed the borrowers' cross-motion in limited part only, "to the extent that the release language in the two forbearance agreements does not eviscerate or bar the claims under G.L. c. 271, § 49."[46]

## Consumer Protection Statutes

Loans made to individual borrowers for non-business purposes may be governed by various federal and state consumer credit and consumer protection statutes and regulations, and those laws are likely also to apply to a forbearance agreement relating to any loan that was subject to them. Predictably, the consumer borrowers who were parties to several recent forbearance agreements raised the lender's alleged non-compliance with applicable state consumer protection laws as a defense to the enforcement of the lender's rights under the forbearance agreements.[47] Where a prospective forbearance agreement relates to a consumer loan, therefore, the lender should ensure that the agreement complies with all consumer protection laws and regulations that may be applicable. This is especially appropriate now, when many lenders are responding to the huge number of defaults under home mortgages and consumer credit card debts by expanding their voluntary and regulatorily-encouraged[48] loan modification and forbearance programs.

[45] LR5-A Limited Partnership v. Meadow Creek, LLC, No. 06-2804 BLS1, slip op. at 4 (Mass. Supp. Oct. 17, 2007).

[46] LR5-A Limited Partnership v. Meadow Creek, LLC, No. 06-2804 BLS1, slip op. at 5 (Mass. Supp. Oct. 17, 2007).

[47] *See* Deutsche Bank Nat'l Trust Co. v. Perfetto, No. 08-107659-CZ, 2010 WL 571823 (Mich. App. Feb 18, 2010) (forbearance agreements did not violate Michigan consumer protection laws because the agreements were not deceptive or misleading); Hinton v. Wachovia Bank of Delaware National Association, 189 Fed. Appx. 394, 2006 WL 1751293 (6th Cir. 2006) (forbearing lender held not liable for alleged violation of Tennessee Consumer Protection Act where defaulting borrower unable to show any damages resulting therefrom. However, lender's failure to state the sum certain of the "regular payment" amount required under forbearance agreement could mislead the reasonable consumer, and the Court cautioned that the lender would be "well advised" to state the payment obligations more clearly "as we have no sympathy for a lender that makes it difficult for its debtors to comply with payment obligations.")

[48] The Obama Administration is promoting several programs offering assistance to financially strapped homeowners by reducing mortgage pay-

## Forbearance Agreements as Executory Contracts

Lenders should recognize that, at least in cases under Chapter 13 of the Bankruptcy Code (Adjustment of Debts of an Individual with Regular Income),[49] forbearance agreements are generally enforceable against the lender in the bankruptcy of a borrower when the parties have used the contract to afford the borrower the opportunity to avoid foreclosure.[50] Where a borrower has become a debtor under the Bankruptcy Code during the middle of a forbearance agreement's forbearance period, both sides to the forbearance agreement have material unperformed obligations—at a minimum, the borrower still has to pay some or all of the debt it still owes and the lender still has to forbear for some period of time. Accordingly, such a forbearance agreement can constitute an "executory contract" that the debtor can assume or reject under Section 365 of the Bankruptcy Code.[51] A debtor may seek to assume after the date of the bankruptcy petition a forbearance agreement that was consummated prepetition if its terms are advantageous to the debtor, even where the lender might have been unwilling to provide such favorable forbearance terms if the debtor had been in bankruptcy when the forbearance was being negotiated and despite the lenders objection to the assumption.[52] Lenders ordinarily cannot use a so-called "ipso facto"

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ments and providing other foreclosure alternatives to reduce foreclosures. *See, e.g.,* Press Release, Administration Announces Second Round of Assistance for Hardest-Hit Housing Markets (March 29, 2010), *available at* http://makinghomeaffordable.gov/pr_03262010.html (summarizing the HFA Hardest Hit Fund); and Fact Sheet, Making Home Affordable, Update: Foreclosure Alternatives and Home Price Decline Protection Incentives, *available at* http://www.financialstability.gov/roadtostability/homeowner.html (explaining the Making Home Affordable Program and foreclosure alternatives and home price decline protection incentives).

[49] 11 U.S.C.A §§ 1301, et seq. For a discussion of executory contacts in bankruptcy, *see generally* 3 Colliers on Bankruptcy § 365 (Lawrence P. King ed., 15th ed. 2009). The absence of reported cases in point makes it unclear whether the same principle applies to corporate reorganization cases under Chapter 11 of the Bankruptcy Code.

[50] *See* In re Ward, 392 B.R. 788 (Bankr. W.D. Mo. 2008); and In re Riley, 188 B.R. 191 (Bankr. D.S.C. 1995).

[51] 11 U.S.C.A § 365.

[52] *See, e.g., In re Ward*, *supra* note 51 (despite lender's objections, Chapter 13 debtor permitted to assume in its Chapter 13 plan the prepetition forbearance agreement that contained a partially-performed payment plan that modified the payments required under the loan).

clause—a provision that terminates the forbearance agreement automatically in the event of the borrower's bankruptcy, insolvency or financial condition—to avoid the risk that the debtor will assume a forbearance agreement. Section 365(e)(1) renders ipso facto clauses generally unenforceable in bankruptcy. However, the debtor cannot assume an executory contract to make a loan, or extend other debt financing or financial accommodations, to or for the benefit of the debtor,[53] so a forbearance agreement may not be subject to assumption postpetition if it provides for extensions of credit by the lender during the forbearance period that had not yet been advanced as of the petition date.

## Conclusion

Although forbearance agreements are not new, their use is increasingly relevant in today's economic climate. A well-structured and drafted forbearance arrangement may provide both borrowers and lenders with the time necessary to address a troubled loan situation satisfactorily.

[53] 11 U.S.C.A § 365(c)(2).