Forbearance Agreements: Considerations For Debtors And Creditors

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A. Introduction

When borrowers default under their loan obligations, lenders have several options on how they wish to proceed, including: suing, realizing and enforcing on their rights to collateral, or exercising other remedies under the loan and security agreements. Another option that a lender might choose to proceed with is to enter into a form of forbearance arrangement with the debtor. In general terms, a forbearance arrangement between a lender and debtor typically acknowledges that a lender has the right to enforce upon its security at that time but will forbear from doing so for a period of time based upon a number of important considerations.

Forbearance agreements are mutually beneficial to both lenders and borrowers, and can serve a number of difference purposes, including, but not limited to:

for the borrower:

1. Providing more time for the borrower to address its financial and operational issues, including the time to solicit and secure potential sales, re-financing or investment opportunities;

2. Possibility of continued financing during the forbearance period; and,

3. Possibility of revised repayment terms during the forbearance period;

for the lender:

1. Obtaining additional collateral, security or guarantees to further or secure the debt;

2. Potentially enhancing the overall recovery of the file by allowing the borrower time to resolve its issues or by requiring the borrower to engage professional consultants or advisors to assist in identifying solutions to the distressed borrower;

3. Controlling the direction of the workout by requiring certain actions be taken by the borrower within a specific period of time; and,

4. Potentially strengthening the position of the lender if the workout fails by having the borrower acknowledge the debt, the validity of their security interest, the existence of certain defaults under the loan documents and the borrower's lack of any defenses or counterclaims.

[Practical Law Canada Finance, "Forbearance Agreements: Key Issues and Provisions" 2022 Thomson Reuters Canada Limited, at pages 2 and 3]

In addition, we have also seen in the years and months that have followed the Covid-19 pandemic a greater use and stronger reliance on forbearance agreements by lenders to navigate through the uncertain and challenging economic conditions that the pandemic created for both lenders and borrowers. Entering into forbearance agreements between the lender and borrower over this time frame has proven to be a valuable and pragmatic option to mitigate the impacts the pandemic had on these challenging business circumstances.

B. Essential Terms

A forbearance agreement is most often structured to contain certain key terms and provisions. These terms and conditions include, but are not limited to:

1. Preamble and Recitals

The preamble identifies the parties to the forbearance agreement, which includes the lender, the borrower and any guarantors. It is recommended that the guarantors be included as parties to the forbearance agreement. It is important in this part that the forbearance agreement state the loans, the security and the current principal and balance owing. Finally, this section outlines the consideration, namely, the debtor is in default and the lender has agreed to forbear enforcement, that is essential to the formation of the agreement.

2. Acknowledgment of Obligations by Borrower

This section requires the borrower (and the guarantors, if applicable) to acknowledge that certain defaults have occurred under the loan agreements and acknowledge the validity and enforceability of the loan and security documents. This part also typically has the borrower acknowledge that it has received the proper statutory notices of default and that it has no defenses or counterclaims to the lender's claims.

3. Payments of Debt During Forbearance Period

This section outlines the regularly scheduled payments the borrower must make on the existing debt during the forbearance period, including principal, interest and late fees. Typically, the terms of the forbearance agreement require that payment in full is due on the termination date in order that the loan arrangement between the lender and the borrower is terminated on the ending of the forbearance agreement.

This section may also include a requirement that the borrower pay a forbearance fee to compensate the lender for the increased risk they incur by forgoing immediate action and enforcement on the debt and security.

4. Additional Security Given by Borrower

This section may require the borrower (or the guarantor, as the case may be) to provide additional security, typically in the form of collateral mortgages of land or further guarantees. This section may also include the requirement that the borrower provide for a from of consent receivership order or consent judgment to be executed by the borrower or any guarantors that may be relied upon by the lender if a forbearance terminating event occurs.

5. Forbearance Period

This section outlines the forbearance period which typically ends by the earlier of a specified date or the occurrence of an event of default under the forbearance agreement. A typical forbearance period is less than one year. Borrowers prefer this period to be as long as possible whereas lenders prefer a short time period in order to maintain control over the workout. This section also provides for the lender to consider requests for extensions of the forbearance period by the borrower – but does not create an obligation on the lender to do so.

6. Suspension of Limitation Periods During Forbearance Period

As will be discussed later in this paper, in Saskatchewan there is at least some uncertainty as to whether at common law a forbearance agreement suspends the running of applicable limitation periods without expressly providing for such suspension of limitation periods. As a result, it is recommended that the forbearance agreement include a provision that the debtor agrees that any applicable limitation period, whether under *The Limitations Act*, SS, 2004, c L-16,1 or otherwise, shall not run during the forbearance period.

7. Events of Default

This section specifies the events that allow the lender to terminate its obligations to forbear and exercise its rights. Some common events of default include, but are not limited to:

(a) the borrower breaches any term of the forbearance agreement;

(b) the borrower breaches any representation or warranty of the forbearance agreement;

(c) the Borrower effects or permits to occur any fraudulent preference, fraudulent conveyance or settlement in breach of the *Bankruptcy Insolvency Act*, *The Fraudulent Preferences Act* (Saskatchewan), or any similar legislation;

(d) a receiver, or trustee is appointed to take possession of substantially all the property of the borrower; or,

(e) the occurrence of any other event which, in the opinion of the lender, acting reasonably, may materially and adversely impact the priority and enforceability of the security or the realizable value of the security.

8. Rights and Remedies Upon Default

If an event of default has occurred, the lender has the right to exercise the remedies provided for in this section, which include, but are not limited to:

(a) terminate the forbearance period immediately; and,

(b) the right, without any further demand or notice whatsoever, the enforce the repayment of the obligations then outstanding and owing.

9. Conditions Precedent

This section provides for the conditions that the borrower (and, guarantors, if applicable) must meet before the forbearance agreement becomes effective. These conditions include, the delivery of certain documents, including additional security, if such security is required, officers certificates and the payment of the forbearance fee, if such fee is required.

10. General Provisions

This section includes the boilerplate provisions that one would normally find in a standard forbearance agreement. These boilerplate provisions include, where notices for each party are to be delivered to, the binding effect of the agreement on the parties' respective heirs, executors and assigns, the governing law that will interpret the agreement, which is typically the same jurisdiction as the loan agreements, and that the agreement can be executed in counterparts and can be delivered by way of electronic transmission (PDF).

[See generally, Practical Law Canada Finance, "Forbearance Agreements: Key Issues and Provisions" 2022 Thomson Reuters Canada Limited, at pages 4 to 14]

While the above is not an exhaustive list of the fundamental terms of a forbearance agreement, the above provisions provide for the general framework for such an agreement.

C. Promises to Waive Statutory Rights

Two statutes that are particularly relevant to agreements between creditors and debtors in Saskatchewan, including forbearance agreements, are *The Saskatchewan Farm Security Act*, SS, 1988-89, c S-17.1. (the "*SFSA*"), and the federal *Interest Act*, RSC, 1985, c I-15 (the "*Interest Act*").

i. The *SFSA*

The *SFSA* provides a wide range of protections for debtor farmers in Saskatchewan. These protections include, among other things:

1. Comprehensive pre-action proceedings with respect to farm mortgages, involving:

    (a) a notice of intention and initial investigation by the Saskatchewan Farm Security Board;
    (b) mediation between the mortgagee and debtor farmer;
    (c) preparation of a report by the Saskatchewan Farm Security Board;
    (d) an application for an order permitting the mortgagee to commence an action. (Part II, sections 9 and 11-20);

2. A prohibition on the mortgagee from charging costs and fees to a farmer, subject to limited exceptions such as party-party legal costs (Part II, section 33);

3. Special protections for homesteads (Part III, sections 43-44);

4. A regime governing the seizure of farm implements that requires two notice periods (Part IV, sections 45-64);

5. Exemptions that apply not only to judgment enforcement but also to security agreements (Part V, sections 65-75).

Significantly, the protections of the *SFSA* cannot be waived, whether initially by loan and security agreements or subsequently by a forbearance agreement. Section 105(2) of the *SFSA* provides that:

> Except as otherwise provided in this Act, every agreement or bargain, verbal or written, express or implied, entered into after May 24, 1988, that:
> (a) either:
> (i) this Act; or
> (ii) any provision of this Act; shall not apply or that any benefit or remedy provided by this Act shall not be available;
> or (b) in any way limits, modifies or abrogates or in effect limits, modifies or abrogates any benefit or remedy described in clause (a);
> is null and void and of no effect.

Practically, the effect of section 105(2) of the *SFSA* will be that lenders will have limited options in seeking to extract promises from debtor farmers requesting forbearance. Section 105(4) of the *SFSA* creates a narrow exception to the application of section 105(2), providing that agricultural corporations can with prior independent legal advice agree in writing that all or any of the provisions of Part IV dealing with the seizure of farm implements shall not apply. There is, however, an exception to the exception: an agricultural corporation may not waive the protection of section 46 of the *SFSA*, which provides that where there is a sale, the vendor's right to recover the unpaid purchase money is limited the vendor's security interest in the item sold, such that the

vendor cannot recover by way of any other collateral: *VFS Canada Inc. v Friesen*, 2022 SKQB 133 at para 33, 2022 CarswellSask 265.

ii. The Interest *Act*

By comparison with the *SFSA*, the federal *Interest Act* is a short and simple statute. The most relevant provision of the *Interest Act* is very likely section 8(1), which provides that:

> No fine, penalty or rate of interest shall be stipulated for, taken, reserved or exacted on any arrears of principal or interest secured by mortgage on real property or hypothec on immovables that has the effect of increasing the charge on the arrears beyond the rate of interest payable on principal money not in arrears.

Parsing section 8, there are four requirements for the application of this provision: 1) the covenant in question must impose a fine, penalty or rate of interest, 2) the penalty, fine or rate of interest must relate to arrears of principal or interest, 3) the fine, penalty or rate of interest must have the prohibited effect of increasing the charge on the arrears beyond the rate of interest payable on principal money not in arrears, and 4) the arrears of principal or interest must be secured by a mortgage on real property: *P.A.R.C.E.L. Inc. v Acquaviva*, 2015 ONCA 331 at paras 53-56, 2015 CarswellOnt 6733.

The question we are concerned with is whether a mortgagee can extract from a mortgagor a higher rate of interest than that which is provided for in a mortgage by way of a forbearance agreement. The case law from Ontario would appear to establish two principles.

First, an agreement (whether called a forbearance agreement or otherwise) cannot in substance amend an existing mortgage to provide for a higher rate of interest on default or maturity. In *Moore v Rosenberg*, 206 ACWS (3d) 416, 2011 CarswellOnt 9156 at para 13 (*Moore*), the Ontario Superior Court of Justice expressly ruled that a mortgagor cannot contract out of s. 8 of the *Interest Act*. The Court's ruling in *Moore* is consistent with the broader principle that parties cannot waive statutory provisions enacted in the public interest: *Potash v Royal Trust Co*., [1986] 2 SCR 351, 1986 CarswellMan 353 at para 43. Practically, the prohibition on waiving or contracting out of section 8 of the *Interest Act* simply means that a forbearance agreement should not provide that the interest rate payable under a mortgage is thereafter payable at a higher rate than that provided for in the mortgage.

Second, a forbearance agreement that provides for payment of interest <u>during a period of forbearance</u> at a rate higher than the rate payable under a mortgage prior to default or maturity does not offend section 8 of the *Interest Act*. In *Stawro v Mayfield Holdings Inc*., 2016 ONCA 710 at para 14, 2016 CarswellOnt 15047, the Ontario Court of Appeal found that an increased interest rate on a mortgage was simply the lender's price of forbearance, and observed that "there is nothing about such a negotiation that offends s. 8 of the *Interest Act*". In *Monk Development Corporation v CVC Ardellini Investments Inc*., 2019 ONSC 127, 2019 CarswellOnt 1819, the Ontario Superior Court ruled that a provision in a forbearance agreement which allowed for the payment of a reduced amount of principal if done so during the period of forbearance did not have the effect of increasing the interest rate payable on the principal balance and did not contravene section 8 of the *Interest Act*.

D. <u>Judicial Commentary on Forbearance Agreements</u>

The Courts have on many occasions been asked to interpret and/or enforce the terms of a forbearance agreement, but there is little in the way of common law rules that apply specifically to limit the scope or enforceability of these agreements. Having said that, a substantial portion of judicial commentary on forbearance agreements relates to two particular issues:

1. The issue of whether there is adequate consideration; and

2. The issue of whether a forbearance agreement suspends the running of applicable limitation periods.

i. <u>Consideration</u>

It is well established that a promise to forbear is good consideration. For example, In *Versatile Credit Corp v Rak*, 7 ACWS (3d) 447, 1987 CarswellSask 829 at para 1, the Saskatchewan Court of Appeal readily agreed with the Chambers Judge's conclusion that an agreement to forbear from seizing and selling certain collateral was good consideration for the debtor's promise to pay $8,000.00 secured by two chattel mortgages.

The authorities are not in agreement, however, with respect to the issue of whether the act of forbearance itself constitutes good consideration. In *Royal Bank v Kiska*, [1967] 2 OR 379-393, 1967 CarswellOnt 125 (*Kiska*), the Ontario Court of Appeal ruled that a creditor's actual forbearance will constitute consideration for promises made by the debtor or a third party. In that case, the defendant guaranteed repayment of certain debts of his brother to the plaintiff bank after the brother had repeatedly urged the defendant to provide the bank with a guarantee to forestall any enforcement steps by the bank, and the bank was in a position to take action against the brother, but the bank had never offered terms of forbearance or otherwise insisted that the defendant provide a guarantee. The majority concluded at paragraph 19 that "Looking upon the guarantee at no higher than a promise offered for an act of forbearance, unless the offer be withdrawn before the act be performed, upon the performance of the act of forbearance the contract was complete and enforceable against the defendant." Laskin, J.A. wrote a dissenting opinion, observing that "The plain fact is that the bank cannot have it both ways. It cannot rely on the subsequent fact of forbearance to bind the defendant (who expected but did not get a promise of forbearance in return for his guarantee) and at the same time sue the defendant on the written document."

By contrast, in *Canadian Imperial Bank of Commerce v Cedar Hills Properties Ltd.*, 70 ACWS (3d) 1085, 1997 CarswellBC 1557 (CA) (*Cedar Hills*), the British Columbia Court of Appeal ruled that actual forbearance is insufficient and that only a promise to forbear constitutes good consideration. In that case the plaintiff bank lent the defendant funds pursuant to two debentures providing for repayment by certain deadlines, subject to the bank's right to demand the loans. The defendant debtor failed to pay the bank by the payment deadlines, and the bank twice purported to agree to extend the deadline for payment in exchange for "processing fees". The bank took the position that consideration for the processing fees was given by the bank's agreement to extend the payment deadline and by the bank's actual forbearance. Yet, the Court agreed with Laskin J.A.'s dissenting opinion in *Kiska*, ruling that the bank's restraint in enforcing its rights was not good consideration in the absence of a promise to forebear. The Court further concluded that the bank had not in fact given any promise to forebear because in each instance where it purported to extend

the payment deadline, the bank reserved the right to demand the loan at any time, rendering such extensions meaningless.

ii. Forbearance Agreements and Limitation Periods

In Saskatchewan there is at least some uncertainty as to whether at common law a forbearance agreement suspends the running of applicable limitation periods without expressly providing for such suspension of limitation periods. Thus, in seeking to ensure that limitation periods do not run during a forbearance period, legal counsel for creditors in Saskatchewan should not rely on the common law and should ensure that any forbearance agreement expressly provides that limitation periods do not run.

In *Hamilton (City) v Metcalfe & Mansfield Capital Corp*., 2012 ONCA 156, 2012 CarswellOnt 2578 (*Metcalfe & Mansfield*), the Ontario Court of Appeal provided a concise statement of the law with respect to the effect of a forbearance agreement on the running of limitation periods in Ontario. At paragraph 73 the Court cites the Supreme Court of Canada's decision in *Shook v Munro*, and states that:

> At common law, a creditor and debtor can agree to forbear enforcement of a debt, and such an agreement would suspend the limitation period for the period of forbearance. In order to achieve this result, the creditor must promise not to enforce the debt, and the debtor must provide some consideration in exchange for this promise. In other words, a creditor's promise to forbear will not suspend the limitation period unless the debtor provides consideration for that promise: *Shook v. Munro et al*, 1948 CanLII 8 (SCC), [1948] S.C.R. 539.

The Ontario Court of Appeal explained its rationale for adopting this rule at paragraph 75 in *Metcalfe & Mansfield*:

> The cases relied on provide a means by which parties can agree to suspend the limitation period for an action to enforce payment on the debt. This makes sense because, if a creditor and debtor agree to change the repayment terms of the debt obligation, they have essentially renegotiated their debt agreement. So the limitation period for the creditor's action to collect on the debt would not run because – due to the agreement to change the repayment terms – the debtor is not effectively in default.

The law is the same in Alberta, and in *Sucker Creek First Nation v Canada (Attorney General)*, 2013 ABQB 199, 2013 CarswellAlta 465, the Alberta Court of Queen's Bench provided an alternative rationale for the common-law suspension of limitation periods during periods of forbearance. With a view to determining whether a five-year limitation period had expired, and upon having concluded that the parties had entered into a forbearance agreement, the Court observed that:

> the parties have entered into a forbearance agreement and implicit in any such agreement must be the notion that forbearance prejudices neither party. It follows that forbearance agreements necessarily imply an extension of the five year limitation for as long as the forbearance continues. There is no uncertainty in this. The parties will know exactly what that means for them and their litigation. There will be no surprises. Where there is a forbearance agreement, there will be no applications to dismiss until the five year limitation plus forbearance period has expired.

In *Superior Canadian Livestock Auction Ltd. v Stewart*, 2014 SKQB 394, 2014 CarswellSask 817 (*Stewart*), the Saskatchewan Court of Queen's Bench addressed the question of whether sections 11 and 21 of *The Limitations Act*, SS, 2004 (the "*Limitations Act*"), precluded the extension of a limitation period by way of a forbearance agreement. Subsection 21(1) of the *Limitations Act* provides that:

> Subject to subsection (2), if an agreement expressly provides for the extension of a limitation period, the limitation period is altered in accordance with the agreement.

Subsection 11(1) of the *Limitations Act* allows the limitation period with respect to claims for payment of a debt, recovery of property, the enforcement of a charge on property or relief from such enforcement by the acknowledgement of such claim, and the remaining subsections of section 11 establish the rules governing the acknowledgement of claims. The debtors in *Stewart* took the position that sections 11 and 21 of the *Limitations Act* together disallowed the extension of a limitation period by any means other than an express agreement or an acknowledgment. The Court decided the matter on other grounds, however, and at paragraph 20 only assumed (without making a determination) that the applicable limitation period could have been altered by a forbearance agreement.