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# Forbearance Agreements and Guarantees

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# FORBEARANCE AGREEMENTS AND GUARANTEES[1]



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1 The authors are grateful to and have relied upon the following texts in preparing these materials: Heather M.B. Ferris and Sarah J. Nelligan's "Creditors' Issues: Forbearance Agreements and Settlement Agreements" published by CLEBC, Joanne E. Foot and Samuel H. Carsley's "Guarantees: Basic Considerations" published by OBA CLE, William EJ Skelly and Benjamin La Borie's "To Forbear (or Not) - The Inevitable Question" published in *Annual Review of Insolvency Law 2012*, and Harris & LeBreux' *Annotated Business Agreements* published by Thomson Carswell.

# I. Forbearance Agreements

## A. Introduction

When a debtor defaults on its obligations to a creditor, the next step is not always enforcement. Often the default may be short-term in nature, or there may be a viable work-out option, and the creditor is prepared to refrain - or forbear - from enforcement under certain conditions. The terms and conditions of this forbearance are often formalised into a forbearance agreement.

A carefully drafted forbearance agreement can offer numerous benefits for both the debtor and the creditor. For the debtor, the obvious advantage is that it gets to continue to operate its business and seek to restructure or remedy its default. The creditor gets to potentially avoid the time and cost of enforcement, as well as (discussed below) the potential to address any deficiencies in its security, to improve its security position, and to obtain the waiver of certain defences by the debtor and guarantors.

## B. Terms

There are a number of key terms that need to be addressed in a forbearance agreement, and which counsel should be careful to review. Remember that a forbearance agreement is a contract, and must meet the legal requirements of one.

### 1. Parties

While it may seem simple, it is important that the parties to a forbearance agreement be carefully considered. Naturally the debtor and the creditor need to be parties, but other parties may also be necessary. If there are guarantors, they should be added to provide relevant acknowledgements (addressed below) and potentially provide further security, and to ensure that the terms of the forbearance agreement do not invalidate the guarantee. Where there is a priority agreement among the creditors, it may be necessary for those other creditors to be a party to ensure that the terms of the forbearance agreement do not affect the forbearing creditor's priority.

### 2. Duration

One of the key provisions to any forbearance agreement is its term. This determines for how long the creditor is prepared to forbear from enforcement (providing there is no default by the debtor under the forbearance agreement). This will generally be one of the main points of negotiation for the forbearance agreement.

A forbearance agreement must meet the requirements of the basic law of contract, including consideration. Courts have held that granting forbearance can be sufficient consideration[2]. However, where the agreement does not provide for forbearance (for example, providing that the

2 Heather M.B. Ferris & Sarah J. Nelligan, "Creditor's Issues: Forbearance Agreements and Settlement Agreements", *Bankruptcy and Insolvency - 2014* (2014) Continuing Legal Education Society of British Columbia at 6.1.2, citing *Bank of Montreal v. No. 249 Seabright Holdings Ltd.*, 2014 BCSC 1094; *Benzie v. Kunin*, [2012] OJ No. 5280 (CA).

term expires "at the creditor's pleasure" or that the debts remain payable on demand), there may have been no consideration[3].

While a valid forbearance agreement will extend a limitation period, this is not the case where there is a failure of the contract for want of consideration.[4]

## 3. Acknowledgements

A further key point in any forbearance agreement will be certain acknowledgements of the debtor and, if applicable, the guarantor. These should be carefully reviewed by both counsel for the creditor and the debtor to determine that the statements are accurate. Once acknowledged as correct in the forbearance agreement, it can be very difficult for a party to argue otherwise later. For example, a debtor who acknowledges the default in its obligations to the creditor in a forbearance agreement will find it very difficult to maintain there was no default as a defence in a subsequent enforcement proceeding.

The "standard" acknowledgements by a debtor and guarantors generally found in a forbearance agreement consist of:

(a) the amount of the debt, and the terms of the interest;

(b) the defaults by the debtor and/or guarantors;

(c) the nature and status of the loan documents, including security, held by the creditor are valid, enforceable and there are no defences;

(d) that the creditor is not required to lend anything further, nor make any accommodations to the debtor, and that the creditor's rights and remedies under the existing documents are maintained; and

(e) if demand has been made, acknowledging the demand and waiving any statutory notice periods.

## 4. Fees and Expenses

The creditor will likely include confirmation that all of its fees and expenses (including for their counsel) in negotiating, executing and enforcing the forbearance agreement, are for the account of the debtor and either will be added to the indebtedness or must be paid immediately. Usually a similar term is already provided in the existing loan documents, making this clause redundant. However, the debtor's counsel should confirm the provisions in the loan documents to determine if the creditor is broadening their entitlement.

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3 Janis P. Sarra, ed, *Annual Review of Insolvency Law 2012* (Toronto, Ont: Thomson Reuters Canada, 2013) at 308, note 14 citing *Bank of Nova Scotia v. Hallgarth* (1986), 32 DLR (4th) 158, 1 ACWS (3d) 440 (BCCA); but see *Callidus Capital v. Carcap Inc*, 2012 ONSC 163 at para. 28 where Mesbur J. affirmed such an agreement.

4 Janis P. Sarra, ed, *Annual Review of Insolvency Law 2012* (Toronto, Ont: Thomson Reuters Canada, 2013) at 308, notes 15-16, citing *Shook Estate v. Dickson Estate*, [1948] SCR 539; *Mortgage Insurance Co of Canada v. Grant*, 2009 ONCA 655 at para 30; *Hamilton (City) v. Metcalfe & Mansfield Capital*, 2012 ONCA 156 at para. 80; *Arrow-Kemp Heating and Air Conditioning Ltd v. Oddi*, [2009] OJ No. 1969 at para 10.

Counsel for the creditor should resist the inclusion of the term "reasonable" in agreements to pay costs as it is unclear and can lead to disputes.

## 5. Release of the Creditor & Creditor's Conduct/No Defences

The creditor will generally seek confirmation that the debtor and guarantor have no defences to their obligations to the creditor and in relation to the indebtedness. Counsel for the debtor/guarantors should be very careful of such a provision, as it can waive important defences which the debtor and/or guarantors may wish to raise at a later date.

## 6. Additional Security or Modification of Terms

The forbearance agreement offers an opportunity for the creditor to modify terms of the indebtedness, including raising interest rates, imposing fees, altering the reporting regime, or requiring changes to management (for example, the appointment of a chief restructuring officer). This can be important for creditors who want more oversight during the forbearance period where, generally, the risk has increased from a normal loan scenario. In doing so, creditors must be careful not to exert so much control that they are *de facto* in control of the debtor.

## 7. Fixing a Deficient Loan

Where a creditor determines that all or a portion of their loan or security is deficient, they may attempt to use the forbearance agreement to remedy the deficiency by getting necessary confirmations or additional security to replace deficient security.[5] The debtor/guarantors' counsel plays an important role in identifying deficiencies and ensuring that the debtor/guarantors don't unknowingly give up a defence/asset/etc.

## 8. Defaults

The forbearance agreement will generally contain a number of events of default, which are generally quite broadly drafted and include, among other things, further defaults under existing security, and a "material adverse change" in the "sole discretion of the creditor". The benefit of broad events of default to a creditor is to limit the risk to the creditor. Note that if too broad, there is a risk that there is no true forbearance and therefore a lack of consideration. The debtor's counsel should seek narrower events of default to ensure actual forbearance.[6]

## 9. Consents to Judgment and Appointment of Receiver

Creditors will often seek to have a consent judgment or a consent order appointing a receiver included in the forbearance agreement. When acting for a creditor, it is important to ensure that the form of judgment is finalised as part of the forbearance agreement, to avoid disputes later. Having a

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5 See generally Janis P. Sarra, ed, *Annual Review of Insolvency Law 2012* (Toronto, Ont: Thomson Reuters Canada, 2013) at 318.

6 For further information see Janis P. Sarra, ed, *Annual Review of Insolvency Law 2012* (Toronto, Ont: Thomson Reuters Canada, 2013) at 332-333.

signed judgment held pending default is far more useful than a clause in the forbearance agreement promising to provide one in an undetermined form.[7]

When seeking the appointment of a court-appointed receiver, the creditor must satisfy the court that the remedy is "just and convenient" and the remedy remains in the court's discretion. Accordingly, a consent receivership order acts as compelling evidence, but does not bind the court to appoint a receiver.

## 10. Interest

When drafting the provisions of a forbearance agreement, it is important to keep in mind the legislative provisions regarding interest.

The *Interest Act* (Canada)[8] provides that:

> 8 (1) 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.
>
> (2) Nothing in this section has the effect of prohibiting a contract for the payment of interest on arrears of interest or principal at any rate not greater than the rate payable on principal money not in arrears.

On its face, this provision seems rather simple: where there is mortgage security, an increased interest rate on default will not be effective. However, treatment by the courts has been inconsistent, and have allowed a number of "work arounds". For example, some courts have held that provisions that increase the interest rate at a fixed time unrelated to default (for example, 1 month before maturity), do not violate section 8 notwithstanding that the practical effect is to increase the rate for default.[9] The section does not require a valid or plausible business reason, so compliance with the letter of the section is often effective even if it violates the spirit.

In addition, counsel for creditors should be cognizant of section 374 of the *Criminal Code*[10], which makes it a criminal offence to receive interest in excess of an annual effective rate of 60%. Interest is defined as:

> the aggregate of all charges and expenses, whether in the form of a fee, fine, penalty, commission or other similar charge or expense or in any other form, paid or payable for the advancing of credit under an agreement or arrangement, by or on behalf of the person to whom the credit is or is to be advanced, irrespective of the person to whom any such charges and expenses are or are to be paid or payable, but does not include any repayment of credit advanced or any insurance charge, official fee, overdraft charge, required deposit balance or, in the case of a mortgage transaction, any amount required to be paid on account of property taxes[11]

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7 Janis P. Sarra, ed, *Annual Review of Insolvency Law 2012* (Toronto, Ont: Thomson Reuters Canada, 2013) at 322-323.

8 *Interest Act*, RSC 1985, c. I-15.

9 See for example *Equitable Trust Company v. Richardson et al*, 2012 ABQB 411.

10 *Criminal Code*, RSC 1985, c. C-46 [*Criminal Code*].

11 *Criminal Code*, s. 347(2).

Jurisprudence has interpreted "interest" in this context to include a number of items, such as application fees, monitoring fees, late and returned payment charges, processing fees, commitment fees and mandatory insurance.[12]

## C. Matters to Consider

### 1. Fraudulent Preferences and Conveyances

The F*raudulent Conveyance Act*[13] provides that:

> 1 If made to delay, hinder or defraud creditors and others of their just and lawful remedies
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> (a) a disposition of property, by writing or otherwise,
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> (b) a bond,
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> (c) a proceeding, or
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> (d) an order
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> is void and of no effect against a person or the person's assignee or personal representative whose rights and obligations are or might be disturbed, hindered, delayed or defrauded, despite a pretence or other matter to the contrary.
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> 2 This Act does not apply to a disposition of property for good consideration and in good faith lawfully transferred to a person who, at the time of the transfer, has no notice or knowledge of collusion or fraud.

The *Fraudulent Preferences Act*[14] provides:

> 3 Subject to section 6, a disposition of property by a person at a time when the person is in insolvent circumstances, is unable to pay the person's debts in full, or knows that he or she is on the eve of insolvency, is void as against an injured creditor, if made
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> (a) with intent to defeat, hinder, delay or prejudice creditors or some of them, and
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> (b) to or for a creditor with intent to give the creditor preference over other creditors or some of them.
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> …
>
> 6 (1) Nothing in sections 3, 4 and 5 applies, if the money paid, or the property disposed of bears a fair and reasonable relative value to the consideration, to a sale in good faith, to a payment made in the ordinary course of business to innocent persons, to a payment to a creditor, or to a disposition in good faith of property of any kind made in any of the following circumstances:
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> …
>
> (b) by way of security for a present actual advance of money in good faith;
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> …
>
> (5) Nothing in this section invalidates a security given to a creditor for an existing debt if, because of the giving of the security, an advance in money is made to the debtor by the creditor in the belief in good faith that the advance will enable the debtor to continue the debtor's business and to pay the debtor's debts in full.

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12 See *Garland v. Consumers Gas*, [1998] 3 SCR 112 and subsequent cases.

13 *Fraudulent Conveyance Act*, RSBC 1996, c. 163.

14 *Fraudulent Preferences Act*, RSBC 1996, c. 164.

After the insolvency of a debtor, its creditors may argue that the new security provided under a forbearance agreement was a fraudulent conveyance or preference. To establish a fraudulent preference, the attacking creditor must show that a disposition was made to a creditor, when the debtor was insolvent or on the eve of insolvency, with the intent to prefer the creditor over other creditors.

For fraudulent conveyances, it is not necessary to show that the debtor was insolvent at the time of the disposition, only that the debtor, in making such a disposition, did so with the intent to delay, hinder, or defraud creditors.

Both *Fraudulent Preferences Act* and *Fraudulent Conveyance Act* provide a good faith defence for dispositions made with good and valuable consideration, i.e., fair market value and not just a peppercorn. While past consideration is no consideration, as noted above a disposition to secure an existing debt may be for good consideration when there is an aspect of forbearance. In *Glegg v. Bromley*[15], the court noted:

> I think that where a creditor asks for and obtains a security for an existing debt the inference is that, but for obtaining the security, he would have taken action which he forbears to take on the strength of the security, and I cannot think that this inference is rebutted by the fact that the reason why he asks for the further security is his desire to obtain a benefit for himself at the expense of another creditor who may shortly be in a position to take the subject-matter of the proposed security in execution.[16]

In addition to these provincial legislative provisions on fraudulent conveyances and preferences, section 95 of the *Bankruptcy and Insolvency Act* (Canada)[17] allows setting aside a disposition to a creditor, where the effect of the disposition is to give the creditor a preference, and section 96 of the *Bankruptcy and Insolvency Act* provides that a court may declare an undervalue disposition void or order payment of the difference in value between the amount disposed and the consideration received.

## D. Ethical and Loss Prevention Points

Counsel for either creditors or debtors should be cognizant of its obligations under the *Code of Professional Conduct for British Columbia* (the "*Code*").

Chapter 2.1-1 of the *Code* provides that a lawyer owes a duty to the state, to maintain its integrity and its law. A lawyer should not aid, counsel or assist any person to act in any way contrary to the law. Chapter 2.2-1 provides that a lawyer has a duty to carry on the practice of law and discharge all responsibilities with honour and integrity.

In regards to potential fraudulent transactions, the *Code* outlines certain provisions which counsel should be aware of.

Under chapter 3.2-7 of the *Code*, when acting for a client, a lawyer must not engage in any activity that the lawyer knows or ought to know assists in or encourages any dishonesty, crime, or fraud. Related to this, chapter 3.2-8 provides that, if, while retained by a client, a lawyer knows or ought

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15 [1912] 3 KB 474 as cited in *Chan v. Stanwood*, 2002 BCCA 474.

16 *Ibid*. at 491-2.

17 *Bankruptcy and Insolvency Act*, RSC 1985, c. B-3.

to know that he or she is or would be assisting a client in fraud or other illegal conduct, the lawyer must withdraw from representation of the client.

Counsel should be cautious not to breach its obligations due to an unscrupulous client.

When dealing with unrepresented debtors, counsel for the creditor risks an argument that the forbearance agreement was unconscionable, coerced and the result of duress or undue influence. The retention of independent legal counsel for the debtor can be of crucial importance. Likewise, independent legal advice for guarantors should be required by creditors where a guarantor is unsophisticated or deriving no clear benefit (for example, the spouse of a debtor's principal).

# II. Guarantees

## A. Introduction

Guarantees are a mechanism used to secure the proceeds advanced by the creditor where a debtor's assets are insufficient to fully secure its loan obligations. In such cases, creditors will request other individuals and/or business associations, presumably with deeper pockets, to guarantee the repayment. With a small business for example, creditors will often ask the principal for a personal guarantee as evidence of its commitment to the business.[18]

Under a guarantee, the guarantor will promise the creditor that in the event that the debtor does not pay its debt or cannot otherwise perform its obligations under the loan agreement, the guarantor will perform these obligations. In a secured transaction, each guarantor will also provide security in its property and assets to secure performance of its obligations under the guarantee.

## B. Terms

### 1. Consideration

There must be consideration for the guarantee. Usually this is the loan made to the debtor. A guarantee given after the original loan was fully advanced requires fresh consideration. As discussed in Joanne E. Foot and Samuel H. Carsley, "Guarantees: Basic Considerations", Commercial Agreements: Negotiation, Drafting and Key Aspects (YLD) (2009) Ontario Bar Association Continuing Legal Education, this fresh consideration could be "the advance of additional funds on the strength of the guarantee, a promise to extend further credit, a restructuring of the terms of payment of the existing indebtedness or, … an agreement to forbear ...".[19]

### 2. Multiple Guarantors

In the case of multiple guarantors, counsels should consider the extent to which the parties intend each guarantor to be responsible for the totality of the guaranteed liabilities. The parties may intend

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18 Gregory Harris and Paul LeBreux, Annotated Business Agreements (Toronto: Thomson Carswell, 2002) (loose-leaf 2007 - Rel. 2), ch 3 at 83-84.

19 Joanne E. Foot and Samuel H. Carsley, "Guarantees: Basic Considerations", *Commercial Agreements: Negotiation, Drafting and Key Aspects (YLD)* (2009) Ontario Bar Association Continuing Legal Education at 9.

to limit the obligations of each individual guarantor, or express the liability of the guarantors collectively as joint and several.

## 3. Waiver of Common Law Defences

Standard form guarantees of banks and other financial institutions are drafted to exclude all rights and defences available to a guarantor at common law. Commonly, there will be one broad inclusive clause designed to waive all conceivable defences, and followed by a list of specific waivers, which may include:[20]

(a) the guarantee is in addition to other guarantees and security;

(b) the guarantor is aware of the documentation relating to the underlying transaction;

(c) none of the following affects the obligations of the guarantor under the guarantee:

 (i) changes to the credit arrangement made by the creditor with the debtor;

 (ii) compromises made with the debtor or others;

 (iii) amendments to the related documents;

 (iv) changes relating to the debtor including death or amalgamation;

 (v) incapacity of the debtor;

 (vi) irregularities relating to extensions of credit;

 (vii) insolvency of any other person; and

 (viii) the unenforceability of any other obligations;

(d) there is no requirement to enforce against others prior to making a demand on the guarantee;

(e) there is no reduction in liability of the guarantor resulting from payment from other sources;

(f) the guarantor's obligations under the guarantee are reinstalled in the event that a payment from another source is voided;

(g) the liability of the guarantor arises immediately following demand being made on the guarantor, irrespective of other steps taken by the creditor;

(h) there is no waiver resulting from delay in enforcement of guarantee; and

(i) the guarantor waives any rights of set-off it may have against the debtor.

## 4. Indemnity Clause

Guarantees are not indemnity agreements in the strict sense of the term. An indemnity creates an independent obligation: a promisor undertakes to indemnify the promisee against loss or liability regardless of whether there is a default by some other person. In contrast, a guarantee is a collateral

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20 Joanne E. Foot and Samuel H. Carsley, "Guarantees: Basic Considerations", *Commercial Agreements: Negotiation, Drafting and Key Aspects (YLD)* (2009), Ontario Bar Association Continuing Legal Education, at 15.

agreement. It protects against a default in the performance of another party. Consequently, most guarantees include an indemnity clause to satisfy the creditor in case the guarantee fails.

### 5. Interest and Expenses

Interest and expenses should also be addressed in the guarantee. Typically, interest accruing from the date of demand by the creditor to the date of payment will be included providing that costs and expenses of the creditor relating to the enforcement of the guarantee or any of its rights thereunder are payable on demand and will accrue interest. The applicable interest rate should be included, along with a provision that all these amounts are owed by the guarantor in excess of the guaranteed liabilities.

### 6. Assignment Clause

A guarantee is a personal obligation; it does not provide the creditor with any security, as no interest in property is created. Most guarantees, however, include an assignment clause, whereby all debts and liabilities of the debtor to the guarantor are assigned to the creditor. The assignment clause creates a security interest in these debts and may be helpful to the creditor where no other security has been granted in support of the guarantee. Note that this security interest must be perfected by registration in the Personal Property Registry because it is a security interest under the Personal Property Security Act.[21]

### 7. Postponement Clause

Creditors may rely on a general postponement clause to prohibit the payment of any amount by the debtor to the guarantor prior to the creditor being fully paid. If the creditor is aware of a particular debt, counsel for the creditor should obtain a specific postponement of such debt. Counsel for the guarantor must caution against very broad postponement clauses which may restrict payment of salaries or other amounts required in the ordinary course of business.

### 8. Subrogation Clause

Because the general structure of guarantees is that the guarantor pays amounts under the guarantee in satisfaction of the debtor's obligation, when the guarantor does so a right to indemnification from the debtor is triggered. This can give rise to issues of priority amongst creditors. To address this, guarantees often include a clause deferring all rights of the guarantor to claim against the debtor until the creditor has been paid in full.[22]

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21 *Personal Property Security Act*, RSBC 1996, c. 359.

22 Joanne E. Foot and Samuel H. Carsley, "Guarantees: Basic Considerations", *Commercial Agreements: Negotiation, Drafting and Key Aspects (YLD)* (2009) Ontario Bar Association Continuing Legal Education at 18.

## C. Matters to Consider

### 1. Financial Assistance

At any time a corporation is being asked to provide a guarantee, counsel should consider whether the business corporation statute under which the corporation was incorporated contains any financial assistance rules. It is also necessary to review the articles and by-laws of the corporation to ensure that there have not been any limitations or restrictions imposed on the corporation in relation to the giving of a guarantee.[23]

### 2. Additional Defences Used by Guarantors

Guarantors can raise a number of defences generally available in contracts so as to render their guarantees unenforceable, for example:[24]

(a) there is an uncertainty, e.g., in a key term of the guarantee;

(b) there is a misrepresentation, e.g., relating to the nature of the guaranteed liabilities;

(c) the debtor exerts an undue influence on the guarantor, rendering the guarantor unable to exercise its independent judgment, e.g., solicitor and client, trustee and beneficiary, husband and wife, parent and child;

(d) the guarantor was under physical, psychological or economic duress, and as a result executed the guarantee against its free will; and

(e) the guarantor does not understand its obligations under the guarantee, e.g., due to senility, language barrier, or a lack of education or business experience.

### 3. Independent Legal Advise (ILA)

It is advisable that the guarantor obtain ILA, particularly in cases when the guarantor is receiving no apparent benefit from the underlying transaction for which the loan is being advanced. ILA can provide an evidentiary basis for resisting some of guarantor's defences. To be effective, the ILA must be given by a counsel who is actually independent, i.e. not acting for the debtor or the creditor, nor involved in the underlying transaction, and who is fully informed about the nature of the guaranteed liabilities.

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23 For a more complete discussion, see Joanne E. Foot and Samuel H. Carsley, "Guarantees: Basic Considerations", *Commercial Agreements: Negotiation, Drafting and Key Aspects (YLD)* (2009) Ontario Bar Association Continuing Legal Education at 7-8.

24 Gregory Harris and Paul LeBreux, Annotated Business Agreements (Toronto: Thomson Carswell, 2002) (loose-leaf 2007 - Rel. 2), ch 3 at 83-84.