3VB'S FINANCE COLUMN: IS CORONAVIRUS A MATERIAL ADVERSE CHANGE?

Rebecca Zaman of 3VB asks: Will Covid-19 entitle lenders to exercise Material Adverse Change (MAC) clauses in financing contracts? MAC clauses are extremely common in finance documents but have not proved to be particularly useful during past market disruptions. This time, she argues, the extraordinary events triggered by the Covid-19 pandemic may well be enough to trigger a MAC clause. As usual everything depends on the drafting of the clause.

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THE REAL THING

The world is in the grip of a pandemic. Europe is in lockdown and countries around the world have closed their borders. The UK faces months of the most severe restrictions on civilian life since the Second World War, at enormous predicted cost to every sector of the economy. While these measures are undoubtedly necessary to save lives, many businesses will struggle to remain afloat over the coming year. They – and the banks and financial institutions which lend to them – will be weighing up their risks and obligations in the months ahead.

Issues for the banking and finance sector

Many good businesses will suddenly and unexpectedly be at risk of going under, particularly in the hard-hit aviation and hospitality/leisure industries. They will be desperate to weather the crisis long enough to trade their way out of trouble on the other side. (At time of writing, the UK government has just announced a £330 billion business support package, but it remains to be seen how this is rolled out and whether it is enough.)

Lenders, meanwhile, will be concerned about their prospects of recovering loans made to businesses which are or are likely to be in jeopardy. Lenders may also baulk at fulfilling scheduled drawdowns pursuant to loan agreements with businesses in struggling sectors.

As the Covid-19 crisis deepens, those advising lenders will likely consider relying on material adverse change (**MAC**) clauses where available in the finance documents to seek further security, exercise any draw stop rights, and/or accelerate a loan.

Relying on MAC clauses can be a risky business for lenders:

- The stakes are high: if the lender gets it wrong and refuses a draw down or calls an event of default when not entitled to do so, it risks becoming liable to the borrower for a repudiatory breach of contract (potentially expensive if that breach drove the borrower into insolvency).
- Guidance is limited: Each MAC clause of course turns on its own wording and the context of the contract in which it appears. Moreover, English courts have interpreted MAC clauses on only a handful of occasions, meaning there is some uncertainty as to the likely approach.

On the other hand, if the lender decides not to exercise MAC clause rights in circumstances where the borrower's position and the value of its security have deteriorated and continue to do so, the lender may end up substantially out of pocket should the borrower enter administration or insolvent liquidation.

A lender's right to rely on a MAC clause will of course always turn on the specific wording of that clause in the context of the agreement between the parties. Subject to that critical caveat, this article suggests that – in some cases – the Covid-19 pandemic and the government response may of itself be inferred to have caused a MAC to a borrower's ability to repay a loan.

MATERIAL ADVERSE CHANGE ("MAC") CLAUSES

MAC clauses (and material adverse effect (**MAE**) clauses) routinely appear in corporate loan agreements but are rarely interpreted by courts. For more information, see *Practice note, Material adverse change (MAC) clauses in finance document*s.

These kinds of clauses usually operate to protect lenders' positions in one or both of two ways:

- First, a MAC representation: facility agreements usually require borrowers to represent that no MAC has taken place between signing of the agreement and drawdown. Where parties have agreed a revolver or otherwise intend subsequent drawdowns, the borrower is usually required to repeat the MAC representation before each additional drawdown. Generally, the lender is not obliged to lend in the absence of the repeated MAC representation.

- Second, a MAC event of default: in addition to specific and foreseeable events of default (such as the borrower entering into administration or cross-defaults under other credit agreements), a MAC event of default is designed to "sweep up" unforeseeable events or circumstances which may materially and adversely affect the borrower, its ability to perform under the finance documents, and the value of the security granted in connection with the facility. Where a MAC event of default has taken place, this would generally entitle the lender to seek further security and/or accelerate the loan.

MAC clauses tend to be specifically negotiated and bespoke to the agreement at issue, with the following issues usually hotly contested between the parties:

- Scope of MAC: whether the MAC expressly captures a deterioration in the borrower's business, operations, property or prospects (most favourable to the lender), or is expressed as limited to the borrower's financial condition, or (most favourable to the borrower) only arises when a precise test is met, such as a change in the borrower's credit rating.

- Present or future MAC: Whether the event or circumstance must have already caused a MAC, or whether the lender can anticipate a MAC in the future as a result of the event.

- Probability: Where the MAC is anticipated, whether the event or circumstance "will" or "is likely to" cause a MAC, or whether it is sufficient to show that it "may" do so.

- Subjective vs objective: Whether the lender is entitled to exercise a MAC clause where in *its opinion* a MAC has taken place (which is subject only to requirements of rationality and honesty) or whether the existence of a MAC is to be objectively determined.

COURT GUIDANCE

The leading English court decision on the interpretation of MAC clauses is that of Mr Justice Blair in *Grupo Hotelero Urvasco v Carey Value Added SL and Another [2013] EWHC (Comm) 1039* (*Grupo Hotelero*).

Grupo Hotelero Urvasco (***GHU***), a Spanish hotel company, claimed against a Spanish fund (***Carey***) for its refusal in June 2008 to advance funding under a facility agreement. GHU claimed that, but for Carey's refusal to advance funds, it would have completed the development of a hotel on time and without penalty and begun profiting from its operation. Carey contended that the 2008 bursting of the Spanish property bubble meant that a MAC to GHU's financial position had taken place, and it was entitled to refuse draw-down.

Whilst noting that the proper application of any MAC clause will turn on its own terms, Blair J made the following observations:

- Materiality:
  - A change is only "material" if it affects a company's ability to perform its obligations under the relevant agreement, and particularly, to repay the loan.
  - The change must be "significant" to meet the threshold of "materiality" (given the seriousness of the lender having the power to suspend lending or call a default, which may propel a borrower towards insolvency).
  - In order to be material, an adverse change must not be temporary in nature – so even if the event giving rise to a MAC is temporary, the MAC it causes must have a lasting impact on the company and its ability to perform under the agreement.
- Evidence:
  - Where the MAC clause is limited to a MAC to a company's "*financial condition*", this is to be determined primarily by reference to its financial information (such as its interim financial information and management accounts).
  - However, courts will consider other compelling evidence of a company's financial condition, such as (in that case) the fact that GHU ceased to pay bank debts in June 2008.
  - Evidence of general external economic or market changes (such as, in that case, the precipitous crash of the Spanish property market and the impact on the construction sector) would not of itself constitute a MAC as the borrower at issue may perform better (or worse) than the sector in question.
  - A MAC must involve a *change* – consequently, a lender cannot trigger MAC clauses on the basis of circumstances it knew about at the time of agreement, unless these circumstances have themselves materially changed.

COVID-19 AND LOCKDOWN

Grupo Hotelero is often relied upon for the proposition that general evidence of economic/sectoral recession (such as the 2008 crash) does not of itself demonstrate a MAC in a borrower's ability to perform its obligations under a finance document.

It is suggested that the Covid-19 pandemic and the government actions taken in response may require a gloss on this.

Of course, any lender considering whether the current climate has caused a MAC to its borrower should take care to draw specific causal links between the pandemic and the MAC contended for. It is not enough, for example, to rely on the fact that the tourism industry is struggling without considering the specific position of the tour operator borrower in question, including where appropriate its group position and its overall resourcing to repay the loan in question (even if facing months of losses).

However, the pandemic raises unique features which may prompt lenders and courts to take more expansive approaches to MAC clauses in some cases.

Businesses can't trade

Covid-19 has prompted lockdowns across the world, with significant and obvious impacts on the face-to-face service industry which are likely to continue for months ahead. It is submitted that this impact far exceeds that of 2008's market crash and weak consumer demand, where (as Blair J noted) a player in the construction sector might still outperform that sector.

In the UK, the pandemic has prompted businesses in face-to-face sectors to close their doors or else fundamentally change the way they do business (e.g., dine-in restaurants switching to delivery), and the operating restrictions are likely to become more severe. The ability of businesses in this sector to trade at all, let alone at a level to turn a profit or service loans, has been dramatically reduced where not removed altogether.

It is suggested that, where a lender knows that its borrower intends to generate the funds necessary to repay a loan through trading, but the borrower's ability to trade has been significantly curtailed if not stopped altogether by Covid-19, this may of itself constitute a MAC to the borrower's financial condition. This situation is even more likely to engage a MAC clause which is drafted to encompass deterioration in the borrower's business and general prospects. (Lenders should however be careful to monitor government announcements regarding assistance for affected businesses, which may affect the position.)

When can the MAC clause be exercised?

It is further suggested that, in these circumstances, and subject to the drafting of the MAC clause, the lender may be able to call a MAC at the point the writing is on the wall for the borrower. For example, at the point that Covid-19 has forced trade to slow or stop and it becomes apparent that the closure will be on a scale and for a timeframe sufficient to prevent the business from earning enough to repay the loan.

A similar point was considered in an Australian case, *Minumbra Lancewood Pty Ltd v AM Lancewood Investment Nominees Pty Limited* [2013] NSWSC 1929. The NSW Supreme Court found that a MAC had taken place when a borrower failed to achieve certain occupancy rates for an accommodation village, with the result that the lender could anticipate that the borrower would not generate enough revenue to enable repayment of the 30-month facility. The borrower's submission that a MAC would not arise till shortly before payment fell due was said to be *"tantamount to a submission that a person who falls out of an aircraft has not suffered a material adverse change until the person hits the ground"*.

Whilst *Minumbra* concerned a lender-favorable MAC clause (encompassing adverse changes to the borrower's business or its financial condition), the court nevertheless directed its inquiry to the question identified in *Grupo Hotelero*: the borrower's financial ability to perform its obligations under the loan agreement. Notably, the court found that changes in the borrower's market and its failure to meet budget expectations (where sufficiently serious) would also constitute a MAC under this clause.