Will COVID-19 constitute a material adverse effect and/or material adverse change under existing loan arrangements?

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In this publication we look at the prospect of lenders relying on MAE and/or MAC provisions in existing loan arrangements to accelerate loans and/or enforce security.

Material Adverse Effect (MAE)

What is an MAE clause?

MAE clauses are almost always included in loan agreements. Their purpose is to act as a "sweeper" to allow the lender to take action when the lender feels its position has been prejudiced in a way which is not otherwise provided for in the loan agreement. On the face of it, COVID-19 is precisely the sort of event that an MAE clause is designed to cover (i.e. one that could not have possibly been foreseen when the loan was entered into by the parties).

A standard loan agreement will include a concept of "Material Adverse Effect" to qualify various obligations, including certain representations and undertakings. This means that certain events (for example non-compliance with environmental undertakings) will only result in a default if they have a Material Adverse Effect. This is useful because it protects the borrower against the risk that a minor breach of the loan agreement allows the lender to call in the loan.

The flip side of this is that loan agreements will usually also include an MAE specific event of default clause. This will be drafted along the following lines (this being the Loan Market Association's standard wording) and will provide that a default event will occur if: *"any event or circumstance occurs which the Lender [reasonably believes] has or is reasonably likely to have a Material Adverse Effect."*

What is a Material Adverse Effect?

The precise definition of Material Adverse Effect will vary from loan agreement to loan agreement. The Loan Market Association defines MAE for leveraged and real estate finance transactions as follows:

*"**Material Adverse Effect**" means [in the reasonable opinion of the Majority Lenders] a material adverse effect on:*

a. *the business, operations, property, condition (financial or otherwise) or prospects of the Group taken as a whole; or*
b. *[the ability of an Obligor to perform [its obligations under the Finance Documents]/[its payment obligations under the Finance Documents and/or its obligations under Clause [•] (Financial condition)]]/[the ability of the Obligors (taken as a whole) to perform [their obligations under the Finance Documents]/[their payment obligations under the Finance Documents and/or their obligations under Clause [•] (Financial condition)]]; or*
c. *the validity or enforceability of, or the effectiveness or ranking of any Security granted or purporting to be granted pursuant to any of, the Finance Documents or the rights or remedies of any Finance Party under any of the Finance Documents.]*

Note that this is a relatively complex, "lender friendly", formulation of Material Adverse Effect and that more borrower friendly provisions are often incorporated.

Borrower friendly formulation / less onerous	Lender friendly formulation / more onerous
Objectively assessed ("has a material adverse effect").	Subjectively assessed ("in the [Agent's] [Majority] [Lender's] [reasonable] [sole] opinion").
For syndicated transactions, the Lenders / the Majority Lenders determines there is an MAE.	For syndicated transactions, the Agent / any Lender determines there is an MAE.
Effect on business, operations, property or condition.	Effect on business, operations, property, condition (financial or otherwise).
Not future looking.	Future looking (inclusion of "prospects").
Has had [or will have] a material adverse effect.	May have / would [reasonably] be expected to / likely to have a material adverse effect.
Ability to perform payment obligations	Ability to perform any obligations.
Effect on the any member of the group	Effect on the borrower / material subsidiaries / group as a whole.

How Material Adverse Effect is defined will impact how and when lenders can rely on this provision.

Material Adverse Change (MAC)

What is an MAC clause?

Like MAE clauses, MAC clauses are intended to protect the lender in cases where there is change in events of circumstances. The concept of Material Adverse Change appears, as standard, in certain of the representations made by the borrower to a lender within a loan agreement. Whilst the drafting will vary, most loan agreements will contain the following standard representations dealing with MAC (this being the Loan Market Association's standard wording):

- *"There has been no material adverse change in its assets, business or financial condition (or the assets, business or consolidated financial condition of the Group, in the case of the Parent) since the date of the [Accountants' Report/Original Financial Statements]."*
- *"Since the date of the most recent financial statements delivered pursuant to Clause [x] (Financial statements) there has been no material adverse change in the assets, business or financial condition of the Group."*

These MAC representations tend to be repeating representations. For borrowers, this means that such representations will be made both during the course and aftermath of the pandemic. A breach of these representations (possibly after the expiry of a grace period) will be an event of default.

What is a Material Adverse Change?

Unlike MAE, the concept of MAC is undefined in most loan agreements. However, it tends to be linked to a change in the assets, business or financial condition of the borrower. The fact that the material adverse change isn't dependant on a borrower's ability to fulfil its obligations under the loan agreement means that even if the borrower remains ultimately profitable, the very fact there is a decline in financial condition of the borrower could be a breach.

That said, one way borrowers may benefit from these MAC representations being linked to the date of their previous financial statements is that, such representations won't be breached if there is a gradual decline in the business' financial performance over a number of years; with each year's decline being "immaterial" for the purposes of the MAC representations but which taken in aggregate, would otherwise constitute a material adverse change. Unfortunately, this will be of little comfort to many borrowers dealing with COVID-19, where the impact on the business' financial health is likely to be stark and sudden.

Why does it matter to a borrower?

If a lender can prove a breach of an MAE / MAC clause, this will typically entitle the lender to:

- cancel any further commitment to advance funds (a so called "drawstop");
- declare that all amounts owing be immediately due and payable;
- declare that all loans become payable on demand;
- exercise its rights to recover all amounts owing, including the enforcement of its security (if any); and/or
- charge default interest on any indebtedness owing.

In most cases, we would expect that the lender will seek to understand the reason for a breach and look to find ways to assist the borrower in resolving the underlying problem in the first instance (see the below section entitled "*How likely are lenders to enforce MAE / MAC clauses?*"). However, where a lender is not willing or able to engage with a borrower on this basis, and has resolved to move to the enforcement phase, it will have a range of tools available to it. Here, lenders will primarily look to enforce any security (including third party security) provided in connection with the loan (e.g. debentures, legal mortgages over properties, assignments over account deposits etc.), as well as to recover under any guarantees.

The right to take enforcement action may be affected by the Government's proposed changes to UK Insolvency legislation in response to COVID-19. As announced by Alok Sharmawhich (Secretary of State for Business, Energy and Industrial Strategy) on 28 March 2020, this will include the introduction of a moratorium (a period in which creditors cannot take action whilst a business considers its restructuring options) and restricting creditors from presenting winding-up petitions. Full details of the proposed changes have yet to be announced, however we will be posting updates on our COVID-19 hub.

Assessing Material Adverse Effect / Material Adverse Change

The devil is in the drafting

In assessing whether there has been an MAE / MAC, the courts will look at the precise drafting of the MAE / MAC provisions and how these concepts are used operatively within the loan agreement.

Examples of common, but potentially key differences are set out below:

- whether MAE is assessed with reference to the borrower's ability to perform any obligations under the loan arrangements, or just its *payment* obligations;

- the inclusion of "prospects" in the definition of MAE as this adds a future looking element to the MAE and may imply an assessment of market economies as they pertain to the borrower; and
- the inclusion of "in the opinion of the lender" or similar phrases allows for subjectivity of the lender that may entitle a lender to call an event of default, irrespective of whether there is or will be an MAE. Even with a caveat of "reasonableness" it will be hard for a borrower to argue with a lender's determination that there has been an MAE (*BNP Paribas S.A. v Yukos Oil* [2005] EWHC 1321). In fact, all the lender needs to demonstrate for an MAE is that its view is "honest and rational" (C*ukurova Finance International Limited and Cukurova Holding A.S v Alfa Telecom Turkey Ltd* [2013] UKPC 2).

English cases dealing with MAE / MAC clauses within loan agreements

In the specific context of loan agreements, the leading English law authority dealing with an MAE / MAC is the High Court's decision in the case of *Grupo Hotelero Urvasco S.A. v Carey Value Added S.L.* [2013] EWHC 1039 (Comm).

This case provided the following guidance on MAE / MAC:

- **Significant and/or substantial:** the event or circumstance must "significantly" or "substantially" affect the borrower's ability to perform of its obligations under the finance documents, in particular its ability to repay the loan; or must “significantly increases the risks assumed by the lender.”
- **Duration:** the adverse effect must not "merely be temporary". Short term, transitory, "bumps in the road" are not enough to cross the requisite threshold and the adverse effect must be sustained.
- **Reference to financial information:** where an MAE / MAC clause is drafted in relation to the borrower's "financial condition", any determination should take into, first and foremost, the available financial information for that borrower, including its statutory and management accounts. However, other "compelling evidence" may be taken into account.

English cases dealing with MAE / MAC clauses within M&A agreements

Whilst the judicial commentary on MAE / MAC within loan agreements is limited, the issue has arisen in several instances within the context of merger and acquisition agreements ("**M&A Agreements**"). Whilst MAE / MAC clauses tend to be more heavily negotiated in M&A agreements compared to loan agreements (with express, seller friendly, carve outs for pandemics being a more regular feature), these M&A cases are nevertheless helpful when evaluating MAE / MAC in the context of loan agreements.

Significant and/or substantial:

In the case of *Levison v Farin* [1977] 2 All ER 1149, the seller had warranted to the buyer in the following terms:

"save as disclosed…between 31 December 1972 and the completion date…there will have been no material adverse change in the overall net assets of the [target] on the basis of a valuation adopted in the balance sheet allowing for normal trade fluctuations."

The court here stated that a 20% reduction in net asset value of the company would be "material" for these purposes. Of course, this may be of limited assistance when determining MAE / MAC in the context of loan agreements. Typically, MAE / MAC clauses in loan agreements will be measured against a number of metrics, and it isn't clear whether the court in *Levison v Farin* [1977] 2 All ER 1149 would have reached the same conclusion on MAC, had it needed to evaluate more than simply a decrease in net asset value. Nevertheless, it provides a useful indication of what would be considered "material" by the courts.

Reference to financial information:

In *Levison v Farin* [1977] 2 All ER 1149, MAC was tested against the balance sheet of the company, but noting that the balance sheet was referred to expressly within such MAC clause. In the case of *Thomas Witter v TBP Industries* [1996] 2 All ER 573, however, the sale agreement contained the following warranty:

"Since the 31st December 1988 (but disregarding the sale hereby agreed) … there has been no material adverse change in the financial or trading position of the Business"

Here, the court was willing to assess the "financial or trading position" of the business using the balance sheet to assess its profitability and specifically, its performance against the budget and financial projections.

As an example of where the courts have taken into account other "compelling evidence" when assessing whether an MAE has occurred (as per the court's comments in *Grupo Hotelero Urvasco S.A. v Carey Value Added S.L.* [2013] EWHC 1039 (Comm)), the court in *BNP Paribas S.A. v Yukos Oil* [2005] EWHC 1321 did consider such factors as Yukos Oil's enormous tax liabilities in excess of $3 billion, the CEO of Yukos Oil being imprisoned, the revocation of Yukos Oil's operating licence, and a press release from Yukos Oil acknowledging its possible insolvency.

Guidance from the Takeover Panel on MAE / MAC clauses

The Takeover Panel (whose function is to issue and administer the City Code on Takeovers and regulated takeovers of companies) may give further insight into how the courts will evaluate MAE / MAC. Of particular note is the Takeover Panel's decision with respect to the proposed acquisition of Tempus Group plc ("**Tempus**") by WPP Group plc ("**WPP**"). WPP (the large advertising and media group) contended that the bombing of the World Trade Centre on 11 September 2001 resulted in a MAC to the prospects of Tempus (a media buying agency).

Significant and/or substantial:

In rejecting WPP's arguments, the Takeover Panel held that a MAC must be:

"of very considerable significance striking at the heart of the purpose of the transaction…meeting this test requires an adverse change of very considerable significance striking at the heart of the purpose of the transaction in question, analogous…to something that would justify frustration of a legal contract."

However, the Takeover Panel has since diluted this position. In Practice Statement No. 5 2004, the Takeover Panel stated that:

"…the appropriate test for the invocation of a condition is whether the relevant circumstances upon which the offeror is seeking to rely are of material significance to it in the context of the offer – which must be judged by reference to the facts of each case at the time the relevant circumstances arise…in the case of a MAC, or similar, condition, whether the above test is satisfied will depend on the offeror demonstrating that the relevant circumstances are of very considerable significance striking at the heart of the purpose of the transaction…whilst

the standard required to invoke such a condition is therefore a high one, the test does not require the offeror to demonstrate frustration in the legal sense."

Duration:

Consistent with the courts comments in *Grupo Hotelero Urvasco S.A. v Carey Value Added S.L.* [2013] EWHC 1039 (Comm), the Takeover Panel when dealing with WPP/Tempus did signal that determining MAC involved an evaluation of the "longer term prospects" of the company and that "a temporary effect on profitability was not in itself sufficient." It suggested that for any adverse changes to be "material", it would expect such changes to last for longer than a year.

Guidance from US cases on MAE / MAC clauses

Finally, whilst not legally binding, there have been various US cases which are instructive when assessing MAE / MAC clauses appearing within loan agreements governed by the laws of England and Wales. Please note that these cases involve MAE / MAC clauses appearing in <u>both</u> loan agreements and M&A agreements.

Significant and/or substantial:

In the same vein as *Grupo Hotelero Urvasco S.A. v Carey Value Added S.L.* [2013] EWHC 1039 (Comm), the court held in the US case of *IBP, Inc. v. Tyson Foods, Inc.* [2001] 789 A.2d 14 that an MAE must be one which "substantially" prejudices the financial position of the company. To give some indication of what this may look like in figures, one can compare the following US cases:

Hexion Specialty Chemicals v. Huntsman Corp [2008] 965 A.2d 715	*Akorn v Fresenius* [2018] WL 4719347
EBITDA down 3% from 2006 and 2008 EBITDA predicted to be down 7% from 2007	Revenue for last 5 quarters down 29%, 29%, 34%, and 27%
25% of the business' divisions affected financially, 75% of business' divisions unaffected financially	Earnings per share for the last 5 consecutive quarters down 96%, 105%, 300%, and 170% percent
<u>No</u> MAE	MAE

Duration:

In the US case of *IBP, Inc. v. Tyson Foods, Inc.* [2001] 789 A.2d 14 (a case cited in *Grupo Hotelero Urvasco S.A. v Carey Value Added S.L.* [2013] EWHC 1039 (Comm)) the court held that a MAC required that the event or circumstance must "substantially threaten the overall earnings potential of the target in a durationally significant manner."

Whether an event or circumstance is "durationally significant" involved an assessment from "the longer-term perspective of a reasonable acquirer" over a sustained period. Although the company to be acquired had not met its financial metric for the relevant quarter, its business was cyclical in nature and the court emphasised that a determination of MAC must be evaluated in the longer term (in this case over years as opposed to weeks or months).

Finally, in *Akorn v Fresenius* [2018] WL 4719347, the US court reinforced that "short-term hiccups in earnings" are not sufficient to establish an MAE. The event or circumstance relied upon must be "consequential to the company's long-term earnings power over a commercially reasonable period, which one would expect to be measured in years rather than months." In this case, the effect was "durationally significant" as the business' finances had "dropped off a cliff" for five consecutive quarters.

Will COVID-19 be a Material Adverse Effect / Material Adverse Change?

The question of whether the effects of COVID-19 will trigger an MAE / MAC clause has yet to be litigated in England. However, reports are surfacing of parties withdrawing from acquisitions citing MAE / MAC. For example, asset manager Columbia Threadneedle is reported to have withdrawn from its deal to purchase a £510 million property portfolio from Manchester Airport Group, on the basis of MAC. It has yet to be confirmed whether the parties had actually signed the sale agreement (with Columbia Threadneedle relying on a MAE / MAC clause to renege from the agreement) or if Columbia Threadneedle simply pulled out of the deal prior to signing, citing MAC as the reason. However, this sort of behaviour does signal that parties may be looking to utilise MAE / MAC clauses in the future.

If the issue of COVID-19 does arise in the context of MAE / MAC clause within a loan agreement, the usual rules of construction and contractual interpretation will apply, and the courts will look at the wider context and the facts surrounding the transaction as a whole. What may constitute an MAE / MAC for one borrower, may not be an MAE / MAC for another!

As seen above, much will turn on the precise drafting of the MAE / MAC provisions and the burden of proof will rely on the lender to establish an MAE / MAC has occurred. Certainly, where the MAE / MAC clause involves an objective assessment, the courts have placed a high threshold on parties seeking to invoke such MAE / MAC. In doing so, the courts have given effect to the notion that parties should be able to discern all commercial risks at the outset of the transaction, and provide for these expressly in any agreements. Equally, where the parties have agreed for MAE / MAC to be assessed by the lender subjectively, it will not readily depart from this position, provided the lender has arrived as its decision honestly and rationally.

In respect of COVID-19, it may be difficult to assess whether its impact on particular borrowers will be "significant" or "substantial". For some businesses, COVID-19 has actually led to a surge in income (e.g. video-conference company Zoom and PPE manufacturers 3M). However, some businesses will invariably feel the effects of COVID-19 (e.g. those in the retail, hospitality and travel sector), and for many the damage is already showing. In these cases, demonstrating that there has been a "significant" and/or "substantial" impact may not be a tall order for lenders! Of course, it is impossible to know how long any adverse effects will last, and so a lender might struggle to establish the MAE / MAC is of a significant duration *at this stage*. Whether COVID-19 is transitory or not will become clearer as our understanding of the pandemic deepens. We would expect lenders to keep the position under review, with a view to relying on an MAE / MAC clause once some degree of permanency can be established. Again, this may not be difficult for some businesses.

When assessing "durational significance", we should note that much of the case law dealing with MAE / MAC (many of which are US cases) concerns M&A agreements. Many of these cases point to an assessment of the long term viability of the business. However, the timeframe may be somewhat contracted in the case of loan agreements, where payment obligations will occur more frequently (usually, monthly or quarterly depending on the type of loan). When determining MAE / MAC in this context, we predict that the borrower's ability to make upcoming payments will be given greater prominence. Nevertheless, we foresee that "durational significance" may be the most difficult element for lenders to substantiate when relying on MAE / MAC clauses.

How likely are lenders to enforce MAE / MAC clauses?

Market practice had shown that it was almost inconceivable for a lender to rely solely on an MAE / MAC clause; typically citing other, more quantifiable and well-defined, events of default such as a missed interest payment or breach of a financial covenant.

By their design, MAE / MAC clauses are drafted widely to capture unknown events that could affect lenders. The corollary is that such provisions are open to interpretation. When a lender decides to call an event of default, it will usually instruct solicitors to conduct a review of the finance documents; not just to verify the validity of their security (if any), but also to check they can rely on said events of default. Solicitors will never provide an un-caveated opinion on whether an MAE / MAC clause has been triggered, and lenders have therefore generally been reluctant to risk calling an event of default based on a concept so nuanced.

Lenders may be particularly reticent to rely on an MAE / MAC clause, given the potential liabilities of wrongfully calling a default. Whilst in English law there is no obligation for lenders to call a default "lawfully", this may expose the lender in the following ways if it later transpires that no MAE / MAC has occurred:

- liability for trespass and/or conversion for enforcing security against the borrower's assets without proper cause;
- breach of contract for any refusal to make further loans under any loan arrangements; and/or
- damages for losses suffered as a result of any cross-defaults arising under third party agreements.

How financial institutions will react to COVID-19 with respect to MAE / MAC clauses has yet to be fully tested. Provided a borrower is servicing its payment obligations, we would expect lenders to take a pragmatic approach to any potential events of default on the basis of MAE / MAC. For major lenders, there are reputational issues to consider.

Whilst private equity and other lenders may have a more aggressive attitude, we would not expect major clearing banks to call in loans based on an MAE / MAC alone. Rather than as a tool for formally accelerating loans, we anticipate most lenders will use a potential MAE / MAC breach as a bargaining chip to discuss amendments to existing loan arrangements (e.g. increasing interest rates). The exception may be if a lender finds that the value of their security is rapidly declining, and has no other events of default it can point to call for repayment at that juncture. However, even then, there may be practical (e.g. the unavailability of receivers to take control of security assets during the COVID-19 lockdown) and/or legal reasons (e.g. the proposed changes to UK Insolvency legislation – see above) which will make enforcement at this stage unpalatable or unfeasible to lenders.

Our experience over the past few weeks is that where possible, banks are willing to engage with their customers to help them through this crisis. To date, we have not seen a spike in lenders looking to accelerate loans and enforce their security. The key for businesses looking to obtain the same level of forbearance and co-operation from their lenders is to maintain an open, transparent and consistent dialogue as the pandemic continues. We therefore encourage borrowers to speak to their lenders at the earliest opportunity if they are experiencing (or are expecting to experience) any issues related to COVID-19.

How Blake Morgan can help

Blake Morgan can advise on the terms of your existing loan arrangements, and assist you with any measures required to see your business through these difficult times. Please contact Rebecca McCabe-North, Jake Holmes or Kath Shimmin.

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