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BANKING ADVISORY

COVID-19 – Return of the MAC, or Breathing Space?

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KEY POINTS

- Material adverse change (MAC) provisions focus on whether prevailing events and circumstances have a material adverse effect on the borrower.
- Case law suggests the key reference materials for assessing MAC, in the absence of drafting to the contrary, are a borrower's existing financial information rather than external market changes.
- It is of significance the pandemic has surfaced as we approach the March quarter date, meaning that financial reporting delivered mid-April may not show the full impact and provide a basis for calling MAC. Lenders are likely to adopt a wait-and-see approach for the time being.
- Lenders also will need to consider reputational issues with borrowers and the wider public in assessing whether to rely upon MAC as a footing for exercising their rights.

When global macro-economic shocks occur, borrowers and financiers alike may be eager to understand the application of MAC provisions in the context of their loan agreements. The technical, legal, commercial and practical implications of the coronavirus (COVID-19) remain to be fully understood and will continue to be digested by global markets for some time to come. What appears to be certain is economic demand and therefore borrower cashflow in the near future will decline. This Katten advisory discusses principles established in case law arising post credit-crunch which examined the application of MAC provisions in the context of that economic crises and seeks to anticipate how these might be applied in the time to come in light of the current global markets.

Introduction

MAC, or more precisely the occurrence of an event or circumstance which has a "*Material Adverse Effect*" (as defined in a typical a loan agreement, which is crucial as discussed below), at a very abstract level operates to enable a lender to have rights (such as to drawstop or even accelerate) where prevailing circumstances suggest a borrower might be in difficulty, even though the borrower might be in full compliance with its covenant package. The focus in evaluating whether MAC can be called is whether an event or circumstance has a *material adverse effect* on characteristics of the borrower group or their ability to perform their obligations under the finance documents.

In the context of COVID-19 and its unavoidable impact on the global macro-economy, borrowers might naturally be fearful their lenders will reach for the MAC clause and decide to withhold funding or even accelerate in circumstances where cashflow is about to become challenged.

There are however significant obstacles a lender will need to overcome if it is seeking to rely upon MAC.

Facts and Language Matter

It is worth noting that not every loan agreement will include a MAC, and on a number of large-ticket European leveraged deals, the provision simply does not feature at all.

Where MAC is included, it is fundamental that careful analysis of the facts and drafting of the MAC provision itself is undertaken to assess whether it is engaged. There are numerous permutations which are contemplated in the LMA model loan template so it will be imperative to consider the specific drafting in any given scenario.

Urvasco

A key case arising out of credit crunch litigation on the matter is *Grupo Hotelero Urvasco SA v Carey Value Added SL and Ors [2013] EWHC (Comm)* (Urvasco) which considered a hotel development funding agreement where the lender draw-stopped the borrower for breach of a repeating representation that "*there had been no material adverse change in the borrower's financial condition [over a period of time]*". It is a trial judgment, but stands as precedent for the following principles:

1) "*financial condition*" does not encompass matters such as prospects or external economic or market changes. A lender seeking to demonstrate material adverse change needs to show an adverse change by reference to the borrower's financial information over the period in question;
2) the adverse change must be material, especially relating to the borrower's ability to make payments under the loan, and it should not be temporary;
3) the lender must not have been aware of the changes at the time of contracting; and
4) it is for the lender to prove the breach.

The lender in *Urvasco* failed in proving MAC. The consequences of a lender failing to advance funds on the basis it has incorrectly alleged a default are damages for breach of contract *(Mulvenna v Royal Bank of Scotland [2003] EWHC Civ 112)*.

However it should be noted the lender in Urvasco succeeded in alleging it could draw-stop for other reasons relating to statements in the borrower's company reports which cast doubt on solvency.

Factors Making It Easier to Call MAC

A key differentiator from the *Urvasco* case is where drafting for MAC includes 1) reference to events having a material adverse effect on the "prospects" of the borrower; and 2) that the existence of MAC is determined "in the opinion" of the Lender.

Reference in MAC to "prospects" potentially opens up the borrower to forward-looking speculation about the impact of external economic or market changes. This would allow the lender to refer to a much wider range of sources rather than just backward-looking records to support a MAC allegation.

The scales are further tilted in the favour of a lender where it is entitled to determine, in its opinion, whether MAC has occurred. In this scenario a lender has broader scope to allege MAC provided they have not concluded so on a basis which is arbitrary, capricious, perverse or irrational *(Cukurova Finance International Limited and another v Alfa Telecom Turkey Limited [2013] UKPC2; Braganza v BP Shipping Ltd [2015] UKSC 17)*.

Reputation and Other Considerations

Governments and central banks are announcing quantitative easing measures to reduce the cost of borrowing and improve liquidity in the financial markets. Lenders will therefore be expected as intermediaries to pass through such financial enhancements to borrowers. Turning the taps off in these circumstances on the basis of MAC alone might be regarded as contrary to the spirit of public policy or even conflicting with the conditions on which such enhancements were made.

In relation to acceleration, we are not aware of any lender that has relied solely upon MAC to call a default. This is perhaps, on the one hand, because of the evidential difficulties in establishing MAC as outlined above, but also because attempting to exercise such a serious remedy in the absence of a hard payment default or financial covenant breach (or other significant breach) would generally be regarded as sharp practice.

Nonetheless, lenders rightly will want to avail themselves of all remedies in the face of economic headwinds to protect their position as early as possible. MAC can offer a viable basis at an earlier stage to take protective action, especially where the drafting caters for "prospects" to be taken into account and the lender's opinion to be determinative in assessing MAC.

Conclusion

The effects of COVID-19 remain to be seen. It is clear that for some borrowers cashflow will be challenged. The UK government is endeavouring to ensure credit remains available so that cashflow in the real economy remains liquid.

In the meantime, loan agreements should continue to be reviewed on a case-by-case basis, and particular attention should also be paid to the information covenants contained in a loan agreement. Lenders should look to see what financial information is required to be delivered that may shed light on the "*financial condition*" of the borrower group, and the frequency with which this information is to be provided. Ultimately, if external market factors translate into a deterioration of a borrower's condition, lenders will need to very carefully review the available information and properly understand how their MAC clauses should be interpreted should they intend to invoke a drawstop, call a default or perhaps alternately allow their borrowers much needed breathing space during these uncertain times.

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