CLIENT ALERT

Will Lenders be able to use COVID-19 to Invoke Material Adverse Change Clauses?

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The COVID-19 pandemic is unprecedented in modern times, and its economic impact is likely to be measured in years rather than months. Against that backdrop, in our recent bulletin, An English Law Perspective on COVID-19 and Contractual Disruption, we provided guidance to businesses on invoking and responding to force majeure clauses.

In this follow-up, we focus on material adverse change or "MAC" clauses. We summarise the principles governing the interpretation of such clauses, and then provide guidance to business lenders considering invoking them in the context of COVID-19.

Whilst we refer below to "lenders" and "loans", the issues raised in this note are relevant to all forms of commercial finance, and apply wherever MAC clauses are used in agreements between funders and their business customers.

MAC clauses and their interpretation

MAC clauses seek to protect lenders against unforeseen events or changes in the borrower's circumstances, in one or both of the following ways:

- They provide a "catch-all" event of default, enabling the lender to accelerate repayment of the loan and/or seek further security in the event of a material adverse change.
- They require the borrower, before drawing down on the facility, to represent that there has been no material adverse change since entering into the agreement or the last drawdown.

The definition of "material adverse change" can be one of the most heavily negotiated parts of a loan agreement, but will usually cover events that have a material adverse effect on: (i) the business, operations, condition (financial or otherwise) or prospects of the borrower; and/or (ii) its ability to perform its obligations under the agreement.

As for whether COVID-19 could give rise to such an event, there is no English law authority on the interpretation of MAC clauses in the context of pandemics or similar occurrences. In *Grupo Hotelero Urvasco SA v Carey Value Added SL* [2013] EWHC 1039 (Comm), however, Blair J gave the following general guidance:

- MAC clauses are construed in accordance with the normal principles of contractual interpretation. Thus, the Court will carefully examine the language used, in the light of the agreement as a whole and the facts known to the parties when they entered into it.
- Where the clause is limited to a change in the borrower's *"financial condition"*, this is assessed mainly by reference to the borrower's accounts and financial statements. Matters such as the borrower's prospects, and external economic or market changes, are not relevant to the enquiry unless expressly referred to in the clause.

- In order to be material, the change must: (i) significantly affect the borrower's ability to perform its obligations under the loan agreement, in particular to repay the loan; and (ii) be more than temporary in nature.
- A lender cannot trigger a MAC clause on the basis of circumstances of which it was aware at the time of entering into the agreement (unless conditions worsen in a way which makes those circumstances materially different in nature).

Guidance for lenders considering invoking MAC clauses as a result of COVID-19

In order to assess whether the impact of COVID-19 on the borrower could amount to a material adverse change, lenders should begin by carefully analysing the language of the relevant MAC clause, paying particular attention to:

- Whether the presence of "material adverse change" is determined objectively, or requires determination by the lender. If the latter, the lender will normally be expected to exercise its discretion in accordance with the principles set out by the Supreme Court in *Braganza v BP Shipping* [2015] UKSC 17, that is to say honestly and in good faith, and not in an arbitrary, capricious or irrational way. Lenders seeking to invoke such clauses should therefore document the basis for their decision.
- Whether the definition of material adverse effect is limited to the borrower's financial condition, or encompasses wider factors such as its prospects.
- What they have to prove in respect of the effect on the borrower. At the most generous end of the scale, the lender only need show that the change *"may"* affect the borrower in future, whilst more borrower-friendly agreements require the lender to prove that the material adverse effect has already been suffered.

Next, they should identify the 'change' on which they are seeking to rely. In most cases, this will be the COVID-19 outbreak and the Government lockdown measures introduced in response. If, however, loan agreements have been entered into with prior knowledge of these facts, lenders will need to focus on changes that have occurred since the contract date, for example the tightening or extension of lockdown measures.

Finally, lenders must assess whether the change has had a significant and lasting effect on the borrower's ability to perform the agreement (or will or may do so, depending on the language of the clause), with reference to its financial condition (and/or prospects or other factors permitted by the clause). Given that the UK government measures have forced many businesses to stop trading or fundamentally alter their business models, it is easy to see how they could make it harder for those businesses to repay loans. But it will be necessary in each case to examine the extent of the difficulties caused, and whether these are likely to be more than temporary. Some businesses will be impacted more than others by COVID-19, depending on factors such as their industry (for example, the travel, events and hospitality sectors have been particularly hard-hit) and geography (that is to say, whether they are located in a 'hot spot').

To that end, lenders should obtain as much financial information as possible from the borrower, including (if necessary) through their information rights under the loan agreement. They should also seek to understand the source of funds from which the borrower plans to repay the loan, as a borrower relying solely on trading profits is more likely to have suffered a material adverse change than one with substantial cash reserves. Finally, it is important for lenders to keep abreast of the financial support that the government is offering to businesses struggling as a result of COVID-19, because this may be enough to render immaterial an adverse effect that would otherwise be material.

Beware the Sting in the Tail

To finish with a brief note of caution – lenders that are considering invoking MAC clauses should tread carefully. Should their decision be disputed, the paucity of case law on the interpretation of such clauses, together with the close analysis required of the language of the particular clause and its application to the facts (which are rapidly evolving as the repercussions of COVID-19 become clearer), can make the outcome of litigation difficult to predict. Further, if they are found to have wrongfully called a MAC, they will not only suffer reputational damage, but may also be in breach of contract and be liable for consequential losses.

It would therefore be prudent for lenders first to consider negotiated outcomes, including waivers or amendments to loan agreements, if only to avoid uncertainty and delay. Even if negotiations are not possible, it may be easier to wait for a more defensible default event, such as the borrower breaching its financial covenants. Given the above guidance on the materiality threshold for MAC clauses, it seems that, in circumstances capable of giving rise to a MAC, such a breach would anyway be likely to occur in time. MAC clauses are commonly referred to as a 'last resort', and lenders would be well-advised to approach them as such.

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