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MATERIAL ADVERSE EFFECT CLAUSES AND COVID-19

What are MAE clauses?

Material Adverse Effect (MAE) clauses are used to protect a lender's position against the risk of a negative impact on a borrower's business in the event of unforeseen events and are common in finance documents.

As the COVID-19 crisis has developed, lenders have become increasingly concerned about recovering loans made to businesses that are particularly exposed to the COVID-19 crisis (notably in the hospitality, logistics, manufacturing and aviation sectors) and could therefore be at increased risk of bankruptcy. As a result, there has been fresh focus on whether lenders may consider relying on existing MAE clauses in their financing documents, with borrowers concerned as to the vulnerability of existing funding arrangements to MAE triggers where their credit and businesses have not been otherwise effected by the crisis in the short-term.

How are MAE clauses used in financing documents?[1]

In financing documentation, the concept of MAE can be used both as an *effect qualifier* with primary benefits for the borrower, where for example, a borrower represents that no litigation, arbitration or administrative proceedings have been initiated against it *which would have a material adverse effect* and also as a *standalone concept* with primary benefit to the lender, for example, a borrower represents that no material adverse effect or material adverse change has occurred with respect to its business or financial condition since a specific date.

The three most common ways in which MAE clauses are used in financing documents (in their own right, as a standalone) are:

- as a condition to funding;
- as a borrower representation that there has been no MAE since the signing of the loan agreement and its first drawdown and before each new drawdown (if relevant). It is usual for this to be in addition a condition to funding, since the truth of representations and warranties is a typical condition of funding, repeated at the start of every interest period;[2] and
- as an event of default, allowing the lender to terminate its commitment and demand repayment of outstanding loans on the occurrence of a MAE, or the right to refuse a further utilisation request.[3]

[1] For the purposes of this client alert, the concepts of material adverse effect and material adverse change can be considered to be interchangeable. Material adverse change clauses are classically found in purchase agreements in M&A transactions where a buyer will expect that the seller provides comfort that there has been no adverse change in the asset between signature of the purchase agreement and completion, although such clauses can be used in equivalent fashion in financing transactions.

[2] Clause 19 Representation, taken from the LMA Multicurrency Term and Revolving Facilities Agreement.

[3] There may be other effects in different types of financings. For example in a securitisation, the tripping of a MAE trigger may also give a lender the option to exercise draw-stop rights (the result often referred to as a "stop purchase event") and switch the securitisation into an amortisation phase.

Facility agreements in most financing structures provide a definition of MAE, with varying levels of complication, depending on the type of transaction and the negotiating power of the contracting parties. The definition often uses, as a benchmark, that found in LMA precedents[4]:

"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]]/[the ability of the Obligors (taken as a whole) to perform [their obligations under the Finance Documents]/[their payment obligations under the Finance Documents]; 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.]

What should transaction parties think about when considering MAE?

What should the MAE cover?

The LMA MAE may be broadened even further in some types of financings. For example, in a trade receivables securitisation where a borrower/originator typically has multiple roles and obligations as compared with a borrower's primary repayment obligation under a bilateral loan, the definition may, in addition to the above, identify material adverse effects on the ability of the transaction servicer (typically the originator or an affiliate of the originator) to service and administer the underlying receivables (which generate the cash-flow used to repay the lender's financing) and/or the ability of the originator to perform reporting obligations required under the transaction documents (transaction reporting being a regulatory obligation in many European securitisations).[5]

In light of the above, we would make the following observations:

- given the complexity of the security in many financing transactions, the definition of MAE should always extend to the enforceability of security granted to the lender with the result that the related MAE event of default is liable to be triggered by any event that adversely affects the ability of a lender to enforce its rights and remedies against a borrower; and

- broadening the scope of a MAE to cover the elements of the borrower's activities that are essential to the transaction and to the credit decision of the lender in extending its commitment has the effect of minimising the scope for interpretative debate where a lender seeks to cite the occurrence of a MAE.[6]

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[4] For example, Clause 1 (Definitions and Interpretation) of the Senior Multicurrency Term and Revolving Facilities Agreement for Leveraged Acquisition Finance Transactions (Senior/Mezzanine), 20 March 2020 (the "**LMA MAE**").

[5] See Article 7 of Regulation (EU) 2017/2402 of the European Parliament and of the Council of 12 December 2017.

[6] Although there are limits to this principle. In *Ipsos SA v Dentsu Aegis Network Ltd (previously Aegis Group plc) [2015] EWHC 1726 (Comm)* it was held that in the context of an M&A transaction the revision of a profits forecast between signing and completion would not in itself constitute an "adverse effect" (i.e., permitting a buyer to exit a transaction), the latter being limited to the factors underlying that revision.

Who should determine MAE?

Financing documents sometimes stay silent on the manner in which the existence of the MAE should be determined (meaning that the provisions do not include the subjective determination), meaning that it is more likely that a determination is made as an objective assessment and ultimately decided by a court or arbitrator. This is often the case when a financing involves an investment grade corporate borrower with a strong bargaining position. However, many financings will provide that the determination of MAE is a subjective determination of the lender, and this approach received implicit support in *Cukurova Finance International Ltd & Anor v Alfa Telecom Turkey Ltd (British Virgin Islands) [2013] UKPC 2 (30 January 2013)* ("***Cukurova***") where it was accepted that provided a lender rationally and honestly believes that the event gives rise to a MAE, a lender may be "judge in its own cause"[7].

Borrowers should be clear that the judgment in *Cukurova* in itself is a sobering justification of any negotiating request that such clauses be "objective" or requiring a lender to "act reasonably" in making its determination as to whether a MAE has occurred (as is in fact indicated as an option in the LMA MAE).

Difficulties in relying on MAE clauses

Lenders tend to view MAE clauses as a necessary protection, functioning as a catch-all to protect them against potential gaps in the due diligence process and designed to capture events that are unforeseen/unpredictable and hence cannot be specifically catered for in the documentation.

However, MAE triggers are not often called upon by lenders.

It is often the case that the circumstances that lead to a triggering of a MAE will also trigger specifically negotiated default clauses - such as non-payment or insolvency proceedings - which represent quantifiable and ascertainable events and are much more certain from the perspective of implying a contractual intention between the parties to a document. This has contributed to the reality that MAE provisions are relatively rarely interpreted by the courts, and as such, it is difficult to establish the approach a court would take when assessing MAE clauses. The most significant recent authority is the judgment in *Grupo Hotelero Urvasco SA v Carey Value Added SL & Anor [2013] EWHC 1039 (Comm) (26 April 2013)* ("***Grupo Hotelero***"), which provides information on the tests to be met for a material adverse change clause to be relied upon, and which provides some useful direction as to reliance on MAE provisions in financing documents:

- for an adverse change to be considered material, it must "significantly" affect a borrower's ability to perform its obligations. This test is an intentionally high benchmark given the seriousness of a lender having the power to suspend lending or call a default, which may propel a borrower towards insolvency;

- an adverse change must not be temporary in nature if it is to be considered to be material - it must have a lasting effect on the company in question;

[7] It is worth noting that lender-friendly facility documentation usually includes a standalone MAE event of default trigger and a representation from the borrower that a MAE has not occurred. With an MAE event of default that is dependent on the opinion of the lender, facts that are not known to it at the time of its determination are unlikely to be able to be used at a later date if its determination is subject to challenge, whereas in the case of a borrower's representation that a MAE has not occurred, the lender is more likely to be able to rely on information that might not have been available to it at the time of making its determination under the MAE event of default.

- a lender cannot trigger a material adverse change clause on the basis of circumstances it knew about at the time of execution of the financing agreement, unless these circumstances have themselves materially changed;

- where the material adverse change clause is limited to a material adverse change 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) but not to the exclusion of other significant evidence of a company's financial condition (in the *Grupo Hotelero*, for example, the fact that GHU had ceased to pay bank debts);

- evidence of general external economic or market changes would not of itself constitute a material adverse change as the borrower at issue may perform better (or worse) than the sector in question; and

- the burden of proof is on the lender to prove the breach.

Meanwhile, a party that declares a MAE should be aware that if this is wrongfully declared it is at risk of being liable to the other party for a repudiatory breach of contract. For example, in a revolving securitisation structure where a MAE is drafted as a stop purchase event, a lender's failure to fund in the absence of a MAE (and any other actionable stop purchase event triggers), would likely be a breach of that lender's contractual commitment to fund.

Covid-19

Currently, the long term economic effects of Covid-19 are unknown and as such it is difficult to assess whether lenders will rush to call MAEs. Our feeling at this point is that this will be relatively unlikely, particularly in light of the 2002 - 2004 SARS epidemic where, even before lenders had the benefit of the cautionary clarifications of *Grupo Hotelero*, lenders by and large did not resort to MAE triggers. Instead, we predict that:

- the medium and long term pressure on corporates will lead to the calling of the more standard events of default, such as breaches of financial covenants (including covenants based on cash flow metrics and balance sheet)[8];

- there will be (and in our experience, there is already) a marked increase in concern from both borrowers and lenders with regard to the specific drafting of MAE provisions and whether COVID-19 should be specifically excluded from the scope of MAE (per the borrower concerns) or whether it should be explicitly mentioned within the scope of MAE as opposed to assuming that COVID-19 effects should fall within the existing scope of a generalised MAE provision (per lender concerns); and

[8] For example, in securitisation structures employing borrowing base facilities, there is an increased likelihood of seeing breaches of covenants based on the proportion of defaulted or delinquent (i.e. overdue) receivables to the overall portfolio of securitised receivables, resulting in stop purchase events (leading to amortisation) or events of default (leading to acceleration of the financing facility).

- lenders will increasingly use the existence of MAE as a "soft" tool to initiate discussions with borrowers to the extent that there are concerns with the ability of a business to withstand difficult times.

The reality is that the market is still in the early stages of generating a coordinated and principled reaction to the effects of COVID-19, and even now when the crisis is some six months old. Ultimately, lenders in particular should be aware of the guidance under *Grupo Hotelero* pointing out that (a) external economic or market changes should not of itself constitute a MAE, (b) a lender cannot trigger a MAE clause on the basis of circumstances it knew about at the time of execution of the financing agreement, unless these circumstances have themselves materially changed, (c) the difficulties in determining whether an event or circumstance affecting a borrower/originator is "significant" or "temporary".

We would caution that there will considerable reputational risk in calling MAE in times when markets and governments tend towards forbearance and financial support. The UK Government in its 'Dear CEO' letters[9] together with the PRA[10] have made their expectations clear, placing pressure on lenders to 'maintain and extend lending despite the uncertain economic conditions').

[9] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/875266/COVID_19_and_Bank_Lending__25_March_2020_.pdf

[10] https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/letter/2020/covid-19-ifrs-9-capital-requirements-and-loan-covenants.pdf

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