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FINANCE AND BANKING ALERT

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THE SCOPE OF MATERIAL ADVERSE CHANGE AND MATERIAL ADVERSE EFFECT PROVISIONS IN FACILITY AGREEMENTS

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THE SCOPE OF MATERIAL ADVERSE CHANGE AND MATERIAL ADVERSE EFFECT PROVISIONS IN FACILITY AGREEMENTS

The breadth and scope of MAC and MAE clauses are often negotiated. In South Africa, the trend is for parties to adopt the Loan Market Association standard MAC and MAE clauses as a departure point.

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A facility agreement typically contains both a material adverse change (MAC) clause and a material adverse effect (MAE) clause, which entitle a lender to enforce repayment of a loan facility.

In a MAC clause, a loan is repayable if either the financial condition of the borrower is materially, adversely changed or the lender reasonably believes that an event or circumstance occurs which has or is reasonably likely to have a MAE. MAC clauses are ordinarily defined as being one of the two aforementioned events. In a MAE clause, a loan is repayable if a circumstance or event has or is likely to have a material adverse effect on the borrower's ability to repay the loan by adversely affecting:

(i) the borrower's ability to comply with its loan obligations; or

(ii) its business or condition (financial or otherwise); or

(iii) the enforceability of the finance documents.

A MAE clause is typically included as a representation, undertaking or warranty given by a borrower. If either a MAC or a MAE event occurs, the lender accelerates the loan and demands repayment. The loan maturity date is thus accelerated. MAC and MAE clauses are ordinarily separate events of default.

The breadth and scope of MAC and MAE clauses are often negotiated. In South Africa, the trend is for parties to adopt the Loan Market Association standard MAC and MAE clauses as a departure point. Unfortunately, there is no South African case law on the subject.

In England, the courts have dealt with the scope and enforceability of MAC clauses. In *Grupo Hotelero Urvasco S.A. v Carey Value Added S.L. (formerly Losan Hotels World Value Added I S.L.), London Value Added I Limited; Carey Value Added S.L. (formerly Losan Hotels World Value Added I S.L.) v Grupo Urvasco S.A.* [2013] EWHC 1039 (Comm), 2009 Folio 931, 2009 Folio 1692, QBD, Commercial Court, the High Court adjudicated a damages claim, at the centre of which lay, amongst others, opposing interpretations of a MAC clause. The facts and legal issues are complicated. We discuss only those issues that are relevant to this topic.

Carey Value Added S.L. (formerly Losan Hotels World Value Added I S.L.) (Carey) agreed to lend the euro equivalent of £70 million to Grupo Hotelero Urvasco S.A. (GHU) in two equal tranches available for draw down on 28 December 2007 and 15 January 2008. The loan agreement entered into contained these terms and was governed by Spanish law. This was accompanied by a share purchase agreement. The loan would enable GHU to fund the development of a hotel and apartments in central London. Carey loaned some of the money to GHU and then stopped doing so. GHU claimed that Carey's failure to lend more money breached the loan agreement and prevented the project's further development, resulting in a work stoppage in September 2008. GHU also claimed that had Carey fulfilled its loan obligations, *Carey claimed it was not obliged to continue to lend as GHU defaulted on the loan agreement.*

GHU would have completed the hotel and earned profits from the hotel's operations. GHU accordingly suffered damages in the amount of £71.38 million.

Carey claimed it was not obliged to continue to lend as GHU defaulted on the loan agreement. The defaults included defaults arising from applying the MAC clause in the loan agreement. Carey (i) counter-claimed against GHU for repayment of €55.40 million advanced under the loan agreement; and (ii) claimed against Grupo Urvasco S.A. under a guarantee.

The parties interpreted clause 8(h) of the loan agreement differently, which clause reads as follows:

> "There has been no material adverse change in its financial condition (consolidated if applicable) since the date of this Loan Agreement [21 December 2007]"

GHU contended that the term financial condition is limited to the company's financial position as contained in its financial statements, it excluded external economic changes or market changes and a company's prospects and if it were intended to include such issues it would have said so. Carey contended that the term financial condition was a general phrase with no inherent limitations. It included balance sheet, cash flow and liquidity, profit and loss items, their impact on the markets in which the company traded and general economic and market patterns.

The court acknowledged the dearth of English case law dealing with MAC clauses and that trial courts had failed to consistently interpret such clauses. It noted that the United States Delaware Chancery Court considered MAC clauses as *sui generis* and never found a MAC to have occurred. That being said, the High Court analysed and interpreted MAC clauses in detail. The court noted that MAC clauses are important if the borrower's financial condition has deteriorated, which may exonerate the lender from "throwing good money after bad". The court held that a lender seeking to enforce a MAC clause must show an adverse change in the borrower over an accounting period by assessing the borrower's financial information available in its interim financial statements or management accounts. According to the court, a broader construction of the term financial condition such as that submitted by Carey, becomes "wide ranging and imprecise." The court further held that the change must not be a temporary change and must significantly affect the borrower's ability to perform its obligations especially to repay the loan, before the change would be considered material. The court relied on US case law in *IBP Inc v Tyson Foods Inc 789 A2d 14 (Del Ch 2001) 65* and academic opinion

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The Grupo judgment is distinguishable from an earlier judgment of the English High Court where it held in BNP Paribas SA v Yukos Oil Company [2005] EWHC 1321 (Ch) that factors particular to the borrower's financial position, had a material adverse effect on its ability to repay a bank loan.

to endorse the approach that lenders could not invoke known or foreseeable circumstances such as economic decline, to trigger MAC clauses.

The Grupo judgment is distinguishable from an earlier judgment of the English High Court where it held in *BNP Paribas SA v Yukos Oil Company* [2005] EWHC 1321 (Ch) that factors particular to the borrower's financial position, had a material adverse effect on its ability to repay a bank loan. These factors included the arrest of the borrower's chief executive officer, a court order freezing the borrower's assets and an adverse judgment that the borrower owed $3.3 billion in tax liabilities. The Grupo principles were recently confirmed in *Decura IM Investments v UBS* [2015] EWHC 171 (Comm).

It is submitted that the Grupo principles will prevent lenders from invoking behavioural, economic or political factors as reasons to trigger their MAC rights, where such factors do not adversely affect borrowers' ability to repay loans. Lenders knowledge or foreseeability of pre-existing circumstances at the loan date will estop them from invoking their MAC rights. It is further submitted that the Grupo principles may well be applied to interpret the scope of a borrower's financial condition if a lender seeks to enforce a MAE clause.

A lender who wishes to invoke its MAC rights to accelerate repayment of a loan will have to prove that an adverse change in the borrower's financial position, evidenced in its financial statements, demonstrate that the borrower's financial condition has worsened such that it will be unable to repay the loan.

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