

Alert | Health Emergency Preparedness Task Force: Coronavirus Disease 2019



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COVID-19: A Material Adverse Change in the UK?

The COVID-19 outbreak is officially a pandemic, the stock market has suffered its worst week since the Black Monday crash in 1987, and there is no certainty as to when the outbreak will end. This GT Alert considers whether the effects of the outbreak could constitute a material adverse change or material adverse effect (**MAC**) under a facility agreement or in the context of an M&A transaction.

For reference only, the Loan Market Association (LMA) defines a "Material Adverse Effect" as:

"Material Adverse Effect" means a material adverse effect on:

- (a) [the business, operations, property, condition (financial or otherwise) or prospects of an Obligor; or*
- (b) the ability of an Obligor to perform its obligations under the Finance Documents; or*
- (c) the validity or enforceability of, or the effectiveness or ranking of any Security granted or purported to be granted pursuant to any of, the Finance Documents; or*
- (d) the rights or remedies of any Finance Party under any of the Finance Documents].*

In the context of an M&A transaction, the definition is likely to be more bespoke (and will sometimes include specific examples of what might constitute a MAC, such as an impact on earnings or net assets of a certain amount), but will typically follow a formulation along the lines of:

"Material Adverse Change" means any matter, event or circumstance that has [or which would reasonably be expected to have] a material adverse effect on the business, assets or profits of the [Company] [Company's Group, taken as a whole].

Frequently the definition will also include certain carve outs, which try to limit a MAC to something which specifically impacts the target Company, rather than an industry-wide problem, such as:

provided that none of the following matters, events, or circumstances shall be deemed, either alone or in combination, to constitute a Material Adverse Change or be taken into account in determining whether there has been a Material Adverse Change:

(a) *matters, events or circumstances affecting the economy in any of [●] or the global economy or [European, US, Asian] or global capital markets, banking markets or financial markets, in each case, generally, including changes in financial or market conditions, prevailing interest rates, currency exchange rates and commodity or raw material prices;*

(b) *matters, events or circumstances that arise out of, or are attributable to, the industries in which the [Company] [any member of the Company's Group] operates and the markets (including geographic and products segments) in which the [Company] [any member of the Company's Group] conducts business [(provided that such matters, events or circumstances do not adversely affect the [Company] [Company's Group] in a disproportionate manner when compared to other companies carrying on the business in the industry)];*

(c) *acts of God, including earthquakes, hurricanes, floods, other adverse weather conditions or other natural catastrophes or epidemics or pandemics;*

MAC is a "catch-all" concept designed to capture unpredictable and unforeseen events or circumstances that would otherwise be difficult to legislate for specifically. However, despite its common inclusion in facility agreements and transaction documents (in various forms), the concept has rarely been interpreted by the courts and limited case law exists in relation to its application.

English Case Law Relating to MAC Provisions

English case law relating to MAC provisions is limited. However, following the decision in *Grupo Hotelero Urvasco SA v Carey Value Added SL and another*¹ (Grupo), which was later applied in the decision in *Decura IM Investments LLP and Others v UBS AG, London Branch*², the following general conclusions can be drawn:

- The party seeking to rely on the MAC clause will bear a **heavy evidential burden** in convincing the court that a MAC has occurred. This stems from: **public policy that favours the enforcement of signed deals where the commercial risks are discernible by the parties**, especially sophisticated parties, and are reflected in the agreed price; and from the court's awareness that MAC clauses are open to being used opportunistically in cases of lender's/buyer's remorse.
- The court's construction of a MAC clause is **fact and language-specific, making litigation outcomes difficult to predict**.

¹ *Grupo Hotelero Urvasco SA v Carey Value Added SL and another* [2013] EWHC 1039 (Comm).

² *Decura IM Investments LLP and Others v UBS AG, London Branch* [2015] EWHC 171 (Comm).

- The court will consider the words used by the parties in the context of the contract as a whole. The court will apply the usual English law principles of contractual interpretation to a MAC clause, giving careful consideration to the language agreed on by the parties, in the context of the wider contract and the facts known to the parties when they entered into it.
- A party cannot trigger a MAC **clause on the basis of circumstances of which it was aware on entering into the agreement, although it may be possible to invoke the clause where conditions worsen** in a way that makes them materially different in nature.
- The **materiality test** must be satisfied. In effect, that test comprises two elements. Firstly, **the change must be of sufficient magnitude**: the courts have emphasised the importance of the words "significant" or "substantial". Secondly, the effect must be **durationally significant**: a change must not merely be temporary or a short-term blip.
- The meaning of "financial condition" will be interpreted narrowly. Any consideration of a company's financial condition should start with an assessment of the company's financial statements at the relevant time. However, an enquiry as to financial condition is not necessarily limited to the company's financial information if there is other compelling evidence to show that an adverse change sufficient to satisfy a MAC clause has occurred. **A MAC will not be established by reference to a company's prospects or by external economic or market conditions unless the MAC clause specifically includes these words.**
- There must be a **causal link between the change and the adversity**.³ To make out a MAC, a party will need to show that the change relied on has caused the adversity that is alleged. For example, a change in a forecast is unlikely, in itself, to be causative of deterioration in the commercial prospects of a target business.

US Caselaw Relating to MAC Provisions

MAC clauses have come before the US courts. *Grupo* cited with approval the 2001 Delaware case of in *IBP Inc v Tyson Foods Inc*⁴ which was heard in the context of an M&A transaction. In that decision, the Delaware Court of Chancery construed the "material adverse effect" clause in the relevant agreement "... as best read as a backstop protecting the acquiror from the occurrence of unknown events that substantially threaten the overall earnings potential of the target in a durationally significant manner". The Court held that a MAC must not be temporary or transitory, reasoning that a short-term blip which would not affect the long-term earnings of a target would not be considered material.

In 2018, in *Akorn, Inc. v Fresenius Kabi AG*⁵, citing *IBP* and taking into account current M&A market practice, the Delaware Court of Chancery upheld a buyer's refusal to close a merger agreement ruling that the target had suffered a MAC when its financial performance and regulatory compliance had fallen so far below its pre-merger performance and representations to be material and durationally significant. The change was held material because the target's financial performance had drastically declined, using recognized financial metrics, since the signing of the merger agreement. In one year, the target's revenues had fallen by 25%, its operating income declined by 105% and its EBITDA declined by 86%. While that involved only one-year, the decline was significant since it covered enough of a time to avoid possible seasonal effect and showed no signs of abating. The court concluded that a 20% reduction in value of the

³ See *Ipsos S.A. v Dentsu Aegis Network Ltd* [2015] EWHC 1726 (Comm).

⁴ *IBP Inc v Tyson Foods Inc* 789 A2d 14 (Del Ch 2001) 65*IBP*.

⁵ *Akorn, Inc. v Fresenius Kabi AG*, 2018 WL 4719347 (Del. Ch. Oct. 01, 2018), *aff'd*, 198 A.3d 724 (Del. 2018).

target from a long-term perspective, which resulted from expected loss due to a material adverse change, qualified as an MAC.

These are merely two examples of decisions by one US court and merely illustrate a possibility in the US.

City Code on Takeovers and Mergers

It is also worth noting the approach taken by the Panel on Takeovers and Mergers, in the context of UK public takeovers governed by the City Code on Takeovers and Mergers. Whilst not directly applicable to private M&A, it does help to illustrate the strict approach taken in analysing MAC clauses. In explaining its approach, the Code Committee said that it considers that the "*normal assumption should be that shareholders and the market expect that protective conditions will not be invoked*".

WPP had made a public Takeover Code regulated offer for Tempus. Following the terrorist attacks on the World Trade Centre on September 11th 2001, WPP had argued that there had been a material adverse change in the prospects of Tempus and sought to invoke a MAC condition contained in its offer document. In Panel Statement 2001/15 published on 6 November 2001, the Takeover Panel ruled that WPP could not invoke the MAC condition, in the context of Rule 13 of the Takeover Code, which provides that that the circumstances that give rise to the right to invoke a condition must be "*of material significance to the offeror in the context of the offer*".⁶

The Panel ruled that "*... meeting this test requires an adverse change of very considerable significance striking at the heart of the purpose of the transaction in question, analogous, as the 1974/2 Panel statement put it, to something that would justify frustration of a legal contract*".

The meaning of "material significance to the offeror" in the context of an offer should be determined objectively. However, depending on the circumstances, the views of the offeror board and any other informed views, such as those of the offeree, should be given appropriate weight. According to the Panel, all parties acknowledged that the burden of proof was on the offeror to prove "material adverse change".

The effect of the adverse change must be long lasting. The Panel held that any temporary effect on profitability was not sufficient to satisfy the "material significance" test. A purchaser of a company for strategic reasons was "*clearly investing for the long term and therefore something of material significance to such an offeror 'in the context of the offer' had to be long term*".

Application to the COVID-19 Outbreak

The below guidance looks to apply the English case law to the COVID-19 outbreak.

Will the outbreak constitute a MAC in itself?

Circumstances not specific to a borrower (i.e., the general outbreak) will not in itself constitute a MAC, however, the detrimental effects of the outbreak on a borrower's financial (or business) condition could, in theory, lead to a MAC. In the context of a facility agreement, a change would usually only be deemed "material" if it would affect the borrower's ability to perform its obligations under the facility agreement (i.e., to repay the loan). When determining what constitutes a MAC, a lender would only be able consider a borrower's future inability to perform its obligations as a result of the outbreak if the MAC provision specifically included the ability to assess the future prospects of the borrower.

⁶ This statement used to be contained in the Notes on Rule 13 – it is now included as Rule 13.5 of the Code.

Is the outbreak durationally significant enough to constitute a MAC?

A key takeaway from the English case law is that any change must not be temporary in order to be considered "material" in the context of a MAC.

A lender wishing to rely on a MAC clause may therefore face challenges demonstrating that any change to the borrower caused by the outbreak is long-term or terminal as opposed to temporary or recoverable. The duration of the COVID-19 outbreak remains uncertain, however, the effects for many are not generally expected to be everlasting.

In the context on an M&A transaction, much will turn on the drafting of the MAC provision itself, but in the absence of a specific trigger which could be invoked, again the courts are likely to look at the long-term impact of the outbreak on the target business rather than, for example, any impact of staff shortages in the short term.

Should alternative MAC wording be included in facility agreements going forwards?

A lender cannot trigger a MAC on the basis of circumstances that it was aware of at the outset, with the following statement cited in Grupo:

"General and/or sectoral economic decline that was known to, or should have been foreseen by, the party relying on the clause when he entered into the contract is unlikely to be held to constitute a material adverse change unless the wording of the clause is particularly clear on the point".

As such, lenders should consider including more targeted objective covenants to provide an "emergency exit" if required and we anticipate that lenders will be far more focused on insisting that the clause explicitly references "prospects", a material deterioration in forecasts and "look forward" events. Equally, strong borrowers may seek to try and negotiate M&A style MACs which typically expressly state in what circumstances the MAC shall not apply.

Buyers should consider, in the context of the outbreak, whether there are specific, objective triggers which would mean they would not want to continue with the relevant acquisition – for example, for a hospitality company, an objective number of covers or rooms which were no longer available to the public as a result of shut downs.

Will a MAC be more likely where a subjective standard has been included?

Absent of express words to the contrary, English law does not generally impose a duty to act in good faith or to act reasonably. But where the MAC clause is drafted so that it is determined by reference to a lender's opinion, the lender will be in a stronger position than if the test is an objective one: case law suggests that an event need not objectively have such an adverse effect, but it may be sufficient if it can be demonstrated that the person relying on the clause believed that the event had such an effect.

This was illustrated in the Privy Council decision in *Cukurova Finance International Limited and Cukurova Holding A.S v Alfa Telecom Turkey Ltd*⁷ (**Cukurova**). There the facility agreement contained a MAC event of default as "*Any event or circumstance which in the opinion of [ATT] has had or is*

⁷ *Cukurova Holding A.S v Alfa Telecom Turkey Ltd (British Virgin Islands) [2013] UKPC 2.*

reasonably likely to have a material adverse effect on the financial condition, assets or business of [CFI]".

It was held on the facts, that the lender had actually formed an opinion, which was "honest and rational", that there had been a material adverse effect on the financial condition, assets or business of the defendant, and therefore the MAC clause did apply:

"It was (and is) common ground that, in order to satisfy clause [MAC clause], an event need not objectively have such an adverse effect: all that is required is that [ATT] believes that it has such an effect. It is also common ground that the belief has to be both honest and rational".⁸

Similarly, in the pre-Grupo case of *BNP Paribas SA v Yukos Oil Co*⁹, the loan agreement stated that an event of default would occur "if any event or circumstance occurred which (in the reasonable opinion of [the lender]) had or might reasonably be expected to have a Material Adverse Effect". The definition of "Material Adverse Effect" was linked to the borrower's ability to perform its obligations under the loan agreement. On the facts, the court held that the borrower could not disprove that the lender's opinion that circumstances had occurred that had or might reasonably be expected to have a material adverse effect, was unreasonable. While the facts were particularly clear-cut in this example as to the borrower's ability to repay the loan in light of its actual liabilities, the case highlights the improved position that a lender may be in when a MAC clause is drafted by reference to a subjective standard.

Where a MAC clause contains a subjective standard, the court will need to determine, as a matter of fact, whether the party seeking to invoke it has indeed formed an opinion that there is a MAC. This was a key point in the *Cukurova* decision where the Privy Council described the lender as a "judge in its own cause on the issue of whether the clause is satisfied".¹⁰

The party seeking to rely on a MAC should therefore always document its decisionmaking by, for example, recording minutes.

Should lenders look to enforce the MAC clause?

What if a lender calls an event of default under the MAC clause when no MAC has occurred?

*Concord Trust v Law Debenture Trust plc*¹¹ confirmed that a demand for repayment made by a lender in circumstances where no event of default is existing is simply ineffective, as opposed to a breach of any implied contract term (or any tortious wrong), and absent of express words, to the contrary, there is no implied term that a lender will not make an invalid demand.¹² Despite this decision, a lender will undoubtedly be concerned about potential liability if a wrongful declaration of an event of default triggers adverse reputational issues for the borrower or a cross-default under other borrowings (which may be triggered by a "declared" event of default even if the lender was not justified in declaring it).

Failing to honour an obligation to advance further sums

If, on reliance on the MAC clause, a lender was to refuse to advance further sums to a borrower under a loan which it is obliged to advance, and it is later determined that no MAC actually occurred, the lender would be in breach of its obligations and therefore in breach of contract. This would expose the lender to a

⁸ See para 45.

⁹ *BNP Paribas SA v Yukos Oil Co* [2005] EWHC 1321 (Ch).

¹⁰ See para 55.

¹¹ See decision in *Concord Trust v Law Debenture Trust plc* [2004] EWCA Civ 1001.

¹² Per Lord Scott at para 30 et seq.

claim for damages¹³¹⁴ and could involve substantial compensation for consequential loss to wrongly defaulted borrowers.

Wrongful enforcement of security

Wrongful enforcement of security may render a lender or a security agent liable in trespass or conversion¹⁵ and a borrower may be awarded substantial damages for loss arising out of the forced sale of its assets and loss of future profits from the business.

Conclusion

MAC clauses to-date have rarely been relied upon due to their ambiguous nature and limited judicial consideration and the consequences to the lender of making a "wrong call". As per the description in IBP Inc, such clauses have typically been viewed as a "backstop" and as means to bring parties to the table in a downturn, rather than being relied upon as a standalone cause of action. It is clear from both the English and US case law, that a lender wishing to exercise such rights not only has to consider reputational issues, but also needs to be aware of a number of evidential hurdles which need to be overcome. While some of these issues can be ameliorated by careful drafting, one of the main issues has been demonstrating that an event complained of is "durationally significant". The unprecedented uncertainties created by COVID-19 and the impact of it on MAC clauses, not only in the context of seeking to exit existing deals but also documenting new ones, may be far more significant than has been seen in previous financial crises.

For more information and updates on the developing situation, visit [GT's Health Emergency Preparedness Task Force: Coronavirus Disease 2019](#).

This GT Alert is limited to non-U.S. matters and law.

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¹³ See decision in *Mulvenna v Royal Bank of Scotland* [2003] EWHC Civ 1112.

¹⁴ Damages are compensatory, and are intended to place the claimant in the same position as if the contract had been performed. Damages for breach of contract are subject to the principles of remoteness, causation and mitigation.

¹⁵ These are tortious wrongs. The general aim of an award of damages in tort is to put the injured party in the same position as he would have been in if the tort had not occurred. Damages in tort aim to restore the claimant to their pre-incident position. In tort, no question of loss of bargain can arise: the claimant is not complaining of failure to implement a promise but of failure to leave him alone (*McGregor on Damages* (Sweet & Maxwell, 20th edition, 2017, Ch. 24)).

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