Material Adverse Change Clauses: Decoding a Legal Enigma

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When negotiating a financing commitment, a prospective borrower is often asked to agree that the lender may refuse to advance funds or may terminate the credit facility if there is a "material adverse change" or if an event occurs that has had or may have a "material adverse effect". The meaning of this limitation, commonly referred to as a MAC clause, and circumstances that would enable the lender to actually be able to rely on this limitation as a means of restricting credit or demanding repayment of outstanding advances are often unclear.

Lenders' insistence on including MAC clauses in financing commitments and credit agreements is often resisted by borrowers. Borrowers tend to view MAC clauses as reflecting a lack of confidence on the part of the lender in the borrower's business or managerial abilities, or an unwillingness by the lender to commit. Lenders tend to view the inclusion of MAC clauses as a necessary protection, functioning as a failsafe to protect them against gaps in diligence and unforeseen events.

Lawyers often struggle to explain to their clients the impact and utility of MAC clauses, regardless of whether they are acting for the lender or the borrower. In a recent case, an English court commented that "the interpretation of such provisions may be uncertain, proof of breach difficult, and the consequences of wrongful invocation by the lender severe, both in terms of reputation, and legal liability to the borrower".[1] Nevertheless, MAC clauses are often used in credit documents, particularly with borrowers of below investment grade credit quality.

Scope of MAC Clauses

MAC clauses can take different forms and cover different subject matter. However, in the financing context, MAC clauses generally focus on the following:

(a) the business, condition (financial or otherwise) and assets of the borrower, either separately or considered as a whole in the context of a loan to a corporate or business group; and

(b) the ability of the borrower to meet its obligations to the lender.

If the borrower has weak credit or a cyclical business, a MAC clause may also cover the business prospects of the borrower. If a loan is secured, a MAC clause may extend to the enforceability of the security granted to the lender. In other cases, a MAC clause may also include the enforceability of the loan documentation and the ability of the lender to enforce its rights and remedies against the borrower. In all cases, MAC clauses are primarily intended to enable the lender to protect its position based on an assessment of the overall health and stability of the borrower's enterprise.

Depending on the nature of the transaction, MAC clauses may also extend beyond just the borrower's business. In merger and acquisition transactions, where lenders are expected to provide committed financing for a future transaction, MAC clauses can sometimes include a material adverse change in the financial or capital markets or in a particular industry or economic sector relevant to the business of an offeror or its target. This type of MAC clause, commonly referred to as a "Market Out" clause, is typically a condition precedent to the availability of funding. However, "Market Out" clauses are not the primary focus of this article.

A MAC clause may sometimes expressly state who makes the determination whether a MAC has occurred (usually, of course, the lender). This can make the MAC concept difficult to use in the context of credit documents. For example, if the borrower makes representations in a credit agreement that are qualified by materiality, determined on the basis of whether something might give rise to a material adverse change affecting the borrower, the borrower cannot properly represent to the lender that no MAC exists if such determination is by definition made in the lender's discretion. If the parties wish

to delineate responsibility for determining the existence of a MAC, it is preferable not to build this into the definition of a MAC, but rather to specify elsewhere in the credit agreement how and when such a determination is to be made. More commonly, credit agreements do not explicitly address the manner in which the existence of a MAC is determined, but leave the definition of a MAC as an objective assessment that would ultimately have to be decided by a court or other independent adjudicator.

Use of MAC Clauses

The three most common ways in which MAC clauses are used in credit documents are:

1. as a condition to funding,
2. as a borrower representation that no MAC has occurred, which also functions as a condition to funding, since the truth of representations and warranties is a typical condition of funding, and
3. as an event of default, allowing the lender to terminate its commitment and demand repayment of outstanding loans on the occurrence of a MAC.[2]

When included as a condition or event of default, the determination of the existence of a MAC will initially be made by the lender, even where the credit agreement does not say so explicitly. Although if disputed, it is ultimately the determination of an adjudicator, when used in the context of representations, it is left to the borrower to determine the existence of a MAC and to the lender to object if it disagrees with the borrower's assessment.

A MAC may be defined retrospectively or prospectively — the latter, of course, is much more likely to be contentious if it is asserted that the MAC clause has been triggered. If the agreement refers to the occurrence of an event or circumstance which "has had" a material adverse effect or has given rise to a material adverse change, the MAC is defined retrospectively. The event or circumstance must have occurred. If the agreement refers to an event or circumstance that "could" or "could reasonably be expected to" or that "would" or "would reasonably be expected to" have a material adverse effect or give rise to a material adverse change, the MAC clause is prospective in nature. Some prospective formulations of MAC clauses are broader than others, depending on whether they are qualified by reasonableness and whether the test is one of probability ("would") or mere possibility ("could").

Whether a MAC clause is broadly or more narrowly worded is often closely linked to the credit quality of the borrower and the inherent risks associated with the nature of the borrower's business. In the case of borrowers operating in cyclical industries or in industries that bear greater risk to lenders, such as environmental risk, or in jurisdictions where the legal protections to lenders are less robust, lenders may want MAC clauses to address "possible" rather than "probable" risks, in order to provide an earlier exit mechanism. In dealing with borrowers of higher credit standing, lenders may be content to address only probable risks. Ultimately, the context within which a MAC clause is being considered, in particular the factors of risk, cyclicality and credit quality, among other considerations, and the character of the risks facing the lender should determine the scope and wording of the MAC clause.

MAC clauses are commonly found in most small and mid-market financing transactions as a condition to advance, as a representation from the prospective borrower and as an event of default. However, from time to time, a financial institution may insist on the inclusion of a MAC clause even in the context of higher grade financing, where the inclusion of a MAC clause is uncommon, bordering on exceptional when dealing with borrowers of higher investment grade standing.

The inclusion of MAC clauses in conventional financing arrangements can raise significant concerns for borrowers. Where a borrower pays a lender for committed financing, the inclusion of a MAC clause as a condition to financing suggests that the lender has not truly committed to provide financing, leaving the borrower with a question as to the value of the purported commitment. The determination of a MAC may strip the borrower of the funding for which it paid a commitment fee to the lender, resulting in the borrower forfeiting the commitment fee paid. If the lender requires a MAC on initial funding, the more palatable option for the borrower is the inclusion of it as a representation. Presented in such fashion, the lender can more readily justify the inclusion of the MAC on the basis that it agreed to provide its commitment conditional on a set of facts presented to it by the borrower. In this case, it is the borrower who makes the determination that no MAC has occurred and the lender relies on the borrower's representation. If this approach is adopted, the parties must still focus on the manner in which the MAC clause will be worded. Furthermore, the MAC clause should include some temporal limitation, such as since the date of the last financial statements delivered by the borrower to the lender, so that the borrower can reasonably make the determination that no MAC has occurred.

Perhaps the transaction type that can be most heavily impacted by the inclusion of a MAC clause is the financing of a merger and acquisition transaction, and in particular hostile take-over bid financing, where the conditions to a take-over bid (which will often translate to material conditions to funding of the offeror's lender) are often material in determining the likelihood of an acquiring party launching a successful bid.

In the Province of Ontario, the *Securities Act* requires the offeror in a take-over bid to have made "adequate

arrangements" to pay for securities in cash or partly in cash where the securities are being deposited under the bid.[3] Where financing has been lined-up by the offeror to provide such "adequate arrangements", it may be subject to conditions "if, at the time the bid is commenced, the offeror reasonably believes the possibility to be remote that, if the conditions of the bid are satisfied or waived, the offeror will be unable to pay for the securities deposited under the bid due to a financing condition not being satisfied".[4]

These statutory requirements have been interpreted by some lawyers as requiring an offeror to repeat all material financing conditions in its bid conditions. However, the more prevalent view would be that the inclusion of financing conditions in a take-over bid merely requires a reasonable assessment by the offeror of the likelihood of it failing to meet the financing conditions. In this regard, however, the inclusion of a MAC can sometimes be quite problematic.

Bid conditions will often include a MAC clause in respect of the target. Accordingly, a corresponding MAC clause in respect of the target as a financing condition would seem acceptable. In such case, care must be taken to ensure that the bid condition and financing condition operate in tandem. The offeror will determine whether a MAC has occurred under the bid condition, whereas the lender has the discretion to make this determination under the financing condition. The offeror and the lender may not take the same view whether a MAC has occurred. The offeror may be at risk in relying on a MAC where the market perceives that the offeror is not making the MAC determination independently, but is being forced to take that position by its lenders. Accordingly, if a MAC bid condition in respect of the target is replicated as a financing condition, care should be taken by the offeror to waive the condition only in conjunction with a parallel waiver by its lender. The description of a MAC condition in respect of the target in a bid circular may also have to disclose that the offeror will have to rely, at least in part, on its lender's determination whether a MAC has occurred.

While a MAC clause relating to the target is not uncommon in an acquisition financing, a MAC clause relating to the offeror is less common and potentially more problematic. On the one hand, it can be argued that the offeror should have little concern about the inclusion of such a MAC clause in its financing arrangements, as it is in the best position to assess the likelihood of its ability to satisfy such a condition. Nevertheless, a MAC clause in respect of the offeror can send a signal to the target and the market generally that the offeror's lenders have concerns about the offeror and its business and that they have not fully committed to the financing of the acquisition transaction.[5]

In a hostile take-over bid, a MAC clause in respect of the offeror can seriously affect the market's evaluation of the bid, as the bid conditions will be scrutinized skeptically and the bid may be perceived as highly contingent. Where the offeror is much larger than the target and the acquisition will not substantially change the nature or scope of its business, the offeror may reach the conclusion that there is a very low likelihood of a MAC affecting it and it may choose not to repeat the MAC financing condition as a bid condition. Where this is not the case and the acquisition, if completed, would completely transform the business of the offeror, it may be very difficult for the offeror to conclude that the possibility of a MAC is so remote that it can take the risk of not replicating the MAC condition in its bid. In such cases, drafting the MAC clause so as to be limited to probable events rather than possible ones and including an objective standard of reasonableness can limit the risk to the offeror, but they cannot eliminate entirely the uncertainty created by the MAC condition.

Meaning of MAC Clauses

There has been very limited consideration in Canadian jurisprudence of MAC clauses in the financing context. The scope and application of a MAC clause in the financing context was considered in *Doman Forest Products Ltd v. GMAC Commercial Credit Corp*,[6] although the case was not ultimately decided on the issue of whether a material adverse change had occurred. In this case, the credit agreement included an event of default on the occurrence "of any change in any of the Obligor's condition or affairs (financial or otherwise) which has a Material Adverse Effect". "Material Adverse Effect" was defined broadly to include, amongst other things, "a material adverse effect, as determined by Lender in its sole discretion, on, as the case may be, the condition (financial or otherwise), operations, assets, property, business or prospects of [Doman] on a consolidated basis".[7]

The Court considered whether the lender should be permitted to rely on the MAC clause, in other words whether the occurrence of a MAC was material to it, in circumstances where the lender had adequate collateral to protect its position (the agreement contained no financial covenants). The Court determined that materiality was to be determined with reference to the language of the agreement. As the definition referred to Doman's "financial condition", materiality was not confined to the collateral, allowing the lender to consider the entirety of the borrower's financial circumstances. This included information that it received prior to entering into the loan agreement, which served as a baseline to determine whether there had been a change in circumstances which had a material adverse effect.[8] Further, the Court concluded that "the standard of materiality is to be measured by GMAC in its discretion, and not by measuring materiality against the objective standard of a reasonable lender in GMAC's circumstances",[9] although the Court did require that

such discretion be exercised reasonably based on *bona fide* considerations notwithstanding the right of GMAC to make the determination in its sole discretion.

The Court's decision supports the right of a lender to rely on a MAC clause in accordance with its literal terms, without tempering its application based on other factors. Furthermore, the Court accepted the right of the lender to exercise the discretion explicitly given to it, so long as it acted reasonably and gave due consideration to the facts supporting its determination. However, if the credit agreement had contained objective measures of the financial health of the borrower, such as financial covenants, the Court might have required the lender to take these into consideration in assessing the materiality of a change in the borrower's financial condition. Given the Court's statements regarding determining materiality with reference to the "language of the agreement", it may be more difficult for a lender to rely on a MAC clause in an agreement that also contains financial covenants in circumstances where the borrower is otherwise in compliance with such covenants.

In the more recent English decision in *Grupo Hotelero*,[10] the credit agreement included a representation from the borrower that "[t]here has been no material adverse change in its financial condition (consolidated if applicable) since the date of this Loan Agreement". The making of this representation was a condition to the availability of funding. The lender refused to advance funds on the basis of the occurrence of a material adverse change in the financial position of the borrower, concluding that the borrower was not able to make the representation truthfully.

The Court held that in order to give effect to what the parties stipulated in their agreement, it should consider what a reasonable person would have understood the parties to have meant. Unlike the language considered in the *Doman* decision, the agreement did not give discretion to the lender to determine if a material adverse change had occurred, but rather appeared to contemplate an objective criterion. The Court focused on five factors for consideration in the interpretation of MAC clauses.

First, the Court found that "an assessment of the financial condition of the debtor should be determined with reference to available financial information, beginning with financial statements at the relevant times, and a lender seeking to demonstrate a MAC should show an adverse change over the period in question by reference to that information."[11] Further, it found that a borrower's "financial condition" does not include matters such as the borrower's prospects or external economic or market changes.[12] The Court did not limit its consideration of the borrower's financial condition to a review of its financial statements and was prepared to consider other factors related to the borrower's financial condition that might suggest a different conclusion. However, the fact that the Court initially focused on the borrower's financial statements suggests that a court is likely to take a similar approach in applying agreements that contain financial covenants and other provisions that refer to a borrower's financial position.

Second, the Court found that materiality should be determined with reference to a borrower's ability to meet its obligations to the lender. The Court concluded that "unless the adverse change in its financial condition significantly affects the borrower's ability to perform its obligations, and in particular its ability to repay the loan, it is not a material change."[13] By referring to a "significant" effect, the Court deliberately set a high bar in determining materiality: "I would emphasize the word 'significant'. Unless the clause is read in this way, a lender may be in a position to suspend lending and/or call a default at a time when the borrower's financial condition does not fully justify it, thereby propelling it towards insolvency."[14]

Third, the Court found that a lender's knowledge of pre-existing circumstances is relevant and that a lender should be precluded from relying on facts and circumstances known to the lender at the time the loan is made. Fourth, the Court found that the change in circumstances giving rise to the lender's concern must not be temporary if it is to be considered material. Lastly, the Court found that the onus is on the lender to demonstrate that the borrower has breached the agreement.

The differences between the decisions in *Doman* and *Grupo Hotelero* with respect to their interpretations of MAC clauses, the English Court being less willing to consider the overall health of the borrower and construing the MAC clause narrowly to limit its application, can largely be explained by the differences in the wording and scope of the MAC clauses in the two cases. Nevertheless, the narrow reading of "financial condition" and the other limitations imposed by the English Court on the effective use of a MAC clause should give lenders some pause. It may be quite difficult to determine with any certainty whether an event or circumstance affecting a borrower is "significant" or "temporary". Furthermore, the Court's narrow interpretation of materiality could call into question the utility of broadly drafted MAC clauses, if in the end, all that is relevant is the impact on the ability of the borrower to meet its obligations to the lender. In most cases it is not readily apparent what the immediate impact of such an event or circumstance on the borrower's ability to repay might be, especially where the MAC clause by its wording requires a consideration of events or circumstances based on their possible rather than probable consequences.

In both cases courts were willing to enforce a MAC clause if there were material changes in a borrower's condition that were considered carefully by a lender acting in a reasonable manner. A decision by a lender to rely on a MAC clause to reject a funding request or to demand repayment of outstanding

advances is one that should be taken with due consideration of the terms of the credit agreement and all other relevant factors, including any objective measures of the borrower's business and financial condition, the facts and circumstances giving rise to the material adverse change, the impact of the decision on the borrower and other external data and facts that are available to the lender at the time the determination is made.

If a lender can show that it has undertaken a thorough analysis in determining that a material adverse change has occurred, in the absence of any other criteria in the credit documents to measure the health and status of the borrower, a court is likely to give effect to the rights of the lender seeking to rely on the MAC clause as a means to terminate funding commitments and to demand repayment. ■

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1. *Grupo Hotelero Urvasco SA v. Carey Value Added SL*, [2013] EWHC 1039 (Comm), at para 334 [*Grupo Hotelero*].
2. MAC clauses are sometimes also used in qualifying representations, warranties and covenants generally but the focus of this article is on the use of MAC clauses in their own right as a material term of financing documents.
3. *Securities Act* (Ontario), Section 97.3(1); see section 2.27 of Multilateral Instrument MI 62-104 for similar requirements in other provinces and territories.
4. *Securities Act* (Ontario), Section 97.3(2); see section 2.27 of Multilateral Instrument MI 62-104 for similar requirements in other provinces and territories.
5. In financing the acquisition of a regulated business, lenders may wish to include a Market Out financing condition, given the length of time required to obtain regulatory consent to complete the acquisition. This will almost certainly dictate including the same condition as a bid condition, given that the satisfaction of this condition is completely outside the offeror's control.
6. 2005 BCSC 774 [*Doman*].
7. *Doman*, at para 28.
8. *Doman*, at paras 135-140.
9. *Doman*, at para 159.
10. See Note 1 above.
11. *Grupo Hotelero*, at para 351.
12. Note that the MAC representation in the *Grupo Hotelero* credit agreement was given on a retrospective basis. Query whether the Court's view might have been affected if the MAC clause was used prospectively.
13. *Grupo Hotelero*, at para 357. Note that this approach differs somewhat from that suggested by the Judicial Committee of the Privy Counsel in *Cukurova Finance International Limited v. Alfa Telecom Turkey Ltd.*, [2013] UKPC 2, where the Court found that "an event need not objectively have such an adverse effect: All that is required is that [ATT] believes that it has such an effect." (at para 45).
14. *Grupo Hotelero*, at para 357

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