MARCH 23, 2020

COVID-19: Material Adverse Change and Material Adverse Effect

Authors: Matthew Milne-Smith and Chenyang Li

The COVID-19 pandemic has had, and is likely to continue to have, a major impact on the global economy as countries implement various levels of "social distancing" and other restrictions on normal activities. In these uncertain times, many businesses may find themselves reviewing their contracts for material adverse change (MAC) or material adverse effect (MAE) clauses – or struggling to negotiate such clauses.

These clauses most commonly appear in credit agreements and acquisition agreements. While there are some general principles that apply to all MAC clauses, the applicability of any particular MAC clause to COVID-19's economic impacts will depend on the wording of the clause and the nature of COVID-19's impact on the particular business.

The Facts and the Wording of the Clause

MAC clauses can take many different forms and vary in wording, but usually focus on changes to the borrower's or acquisition target's financial condition, assets or (in the case of credit agreements) ability to meet its obligations. However, whether a MAC clause has been triggered will turn on both the wording of the clause and the particular circumstances of the borrower or target.

For example, a clause in a credit agreement that gives the lender sole discretion to determine whether a MAC has occurred may be triggered more easily than a clause that requires the borrower to represent and warrant that no MAC has occurred. A clause that explicitly excludes macroeconomic effects or issues affecting an entire industry may be interpreted more narrowly than an open-ended clause that includes any kind of MAE on the target. A clause that applies to the borrower's business generally may be interpreted more broadly than a clause that applies specifically to the lender's collateral.

To date, there is very little jurisprudence in Canada on MAC clauses, which may indicate that parties have typically been able to find a negotiated solution to issues over whether a MAC clause has been triggered, even during times of economic disruption such as the 2008 financial crisis. In the United States, the jurisprudence is somewhat more extensive and has typically required the party claiming a MAC to prove a substantial and lasting adverse change in order to successfully invoke a MAC clause.

Applying MAC Clauses to COVID-19

Whether a MAC clause can be triggered as a result of COVID-19's economic impacts will depend on the ability of the party seeking to rely on it to prove that COVID-19 has caused an adverse change of sufficient significance to the condition of the borrower or target that fits within the wording of the specific MAC clause. Both the magnitude of impairment to the borrower or target, and the reasonably expected period of time that the impairment may persist, are important factors in analyzing whether a MAC clause may be invoked.

The express allocation of risk in the wording of each MAC clause will also be important in assessing whether the MAC clause may be invoked. For example, a MAC clause that expressly provides that the occurrence of "natural disasters" may constitute an adverse change or event is more likely to be successfully invoked because of COVID-19 than a MAC clause that refers solely to changes in the borrower's or target's financial condition. One of the differences between MAC clauses in a mergers and acquisitions (M&A) context versus a lending context is that, in the M&A context, there are often many highly negotiated exceptions and restrictions to the scope of MAC clauses. Lending agreements, however, typically contain fewer MAC clause carve-outs than M&A agreements. In light of the evolving situation with respect to the COVID-19 pandemic, parties that are negotiating new contracts in both the lending and M&A contexts may wish to

consider specifically addressing how the business or economic impacts caused by COVID-19, or other outbreaks of sickness, epidemics, and pandemics, will be treated in new MAC clauses.

Finally, the factual matrix surrounding the agreement, including such matters as the term of the agreement compared to the anticipated duration of disruption from COVID-19, will be relevant in assessing whether the COVID-19 pandemic may trigger the MAC clause. Certain industries and businesses, like the tourism and hospitality industries, are more vulnerable than others to business impacts caused by COVID-19. Consequently, a relatively narrow MAC clause, even based solely on the borrower's or target's financial condition, may be triggered when the business in question is unusually susceptible to restrictions being placed on the movement of people, goods and services. Conversely, even a relatively broad MAC clause may not be triggered when the business in question is less likely to be adversely affected to a material extent by the COVID-19 pandemic.

Key Contacts: Matthew Milne-Smith and Louis-Martin O'Neill

This information and comments herein are for the general information of the reader and are not intended as advice or opinions to be relied upon in relation to any particular circumstances. For particular applications of the law to specific situations the reader should seek professional advice.

© 2024 DAVIES WARD PHILLIPS & VINEBERG LLP