COVID-19 and the related disruption have resulted in enormous pressure on society and businesses. Material adverse change (“MAC”) clauses in loan agreements present important issues that borrowers and lenders alike need to consider carefully in this environment. There are very few published decisions on enforcement of MAC clauses in the lending context and no published cases addressing a pandemic-type situation like the one we are currently facing.

A lender that invokes a MAC clause may seek to declare a default under the loan as a prelude to an enforcement action or to avoid funding, or further funding, its loan to the borrower. Lenders are often confronted with extreme time pressure when a funding request is involved, which makes these situations even more challenging.

We address herein whether COVID-19 and the resulting business disruption may be reasonably considered a MAC in a typical commercial loan.

I. MAC CLAUSES IN GENERAL.

Before discussing MAC clauses in the lending context, we briefly discuss MAC clauses generally and how they have been addressed by the courts in the mergers and acquisitions (“M&A”) context, where these disputes are vastly more common.
To determine whether a MAC clause is properly invoked in any particular case, courts generally focus on whether the asserted adverse change is “material” to the agreement as a whole, based on the intent of the parties. *Akorn, Inc. v. Fresenius Kabi AG*, 2018 WL 4719347 (Del. Ch. Oct. 1, 2018), *aff’d*, 2018 WL 6427137 (Del. Dec. 7, 2018). Adverse changes are material only to the extent they “substantially threaten” the parties’ agreement “in a durationally-significant manner.” *Id.* at *53. Accordingly, a “short-term hiccup in earnings” may not constitute an enforceable MAC.

The leading case in the M&A context is *In re IBP Shareholders Litigation*, 789 A.2d 14 (Del. Ch. 2001), which involved an acquirer that invoked a MAC clause to terminate a transaction. *IBP* establishes that traditional contract-law principles apply to MAC disputes and that courts should give “great weight to the parties’ objective manifestations of their intent in the written language of their agreement.”

Equally important, the *IBP* court concluded the entire contract must be considered, all based upon the situation and circumstances existing at the time of its creation.

In *IBP*, the buyer contended that the target’s recent declining performance and an impairment charge taken due to an internal accounting fraud issue, taken together, constituted a MAC. The buyer, however, had publicly expressed other reasons for terminating the merger and did not include in its public statements the arguments it later raised in litigation. *Id.* at 65. The court ultimately concluded that the buyer had failed to meet its burden of establishing a material adverse change under the contract.

As applied to the lending context, *IBP* stands for the proposition that the parties must understand all of their loan documents, the MAC clause at issue, and the intent of the parties at the time of execution to fully assess the risks associated with invoking a MAC clause. Any party asserting a MAC should carefully articulate why a MAC has occurred, rather than making generalized statements at the time the MAC clause is invoked and constructing *post hoc* arguments in litigation.

II. MAC CLAUSE ANALYSIS IN THE LENDING CONTEXT.

A MAC clause generally protects a lender from a material adverse effect on a borrower’s operations, business, assets, and financial condition, although a lender and borrower
may, of course, negotiate specific contract language that provides more or less protection.

Approximately a half-dozen reported decisions have addressed MAC clauses in the lending context, but we have found no reported decision addressing a MAC clause in the context of a pandemic or other kind of widespread outbreak. The extant cases, however, shed light on how courts may evaluate MAC clause enforcement based on an unexpected pandemic.

In In re Lyondell Chem. Co., 567 B.R. 55 (Bankr. S.D.N.Y. 2017), aff’d, 585 B.R. 41 (S.D.N.Y. 2018), the Bankruptcy Court for the Southern District of New York addressed (among other things) a breach of contract claim by a borrower for a lender’s refusal to fund a $750 million draw request on a revolving line of credit based on the relevant MAC clause. Applying New York law, the Lyondell court ruled that the lender breached its contract with the borrower by refusing to fund the draw request under the circumstances. Id. at 150.

Weaving the “common threads” among the key cases in this area, the Lyondell court established a general standard for evaluating MAC clauses in the lending context. Joining IBP and many other courts, the Court concluded MAC clauses are to be read “in the context of the entire agreement and in conjunction with other evidence of the parties’ intent.” The Lyondell court also considered “whether the alleged material adverse change was within the contemplation of the parties at the time they executed the agreement, whether it was within the control of the parties, and the magnitude of the impact on the relevant party’s business.” Id. at 123.

In Lyondell, the borrower was facing major challenges. The Great Recession was in full swing, and two hurricanes had occurred, along with a major industrial accident at one of the borrower’s facilities. Id. at 82-84. When the borrower made its draw request, the lender claimed the borrower’s “discussions with its lenders concerning an anticipated bankruptcy filing” and an awareness that “restructuring advisors had been retained and were hard at work” supported a refusal to fund based on a material adverse change. Id. at 86-87.

The Lyondell court made short work of the lender’s assertions. The Court observed that no legal precedent existed for the proposition that insolvency itself constitutes a MAC. Moreover, the lender required a solvency representation and warranty when the loan was originally made to the borrower, but did not require the same protection as a condition for
subsequent loan draws.  *Id.* at 123. *Cf. Kena Properties, LLC v. Merchants Bank & Trust,* 218 F. App’x 402 (6th Cir. 2007) (affirming district court’s grant of summary judgment in favor of a lender that invoked an unambiguous MAC clause).

III. MAC ANALYSIS UNDER THESE CIRCUMSTANCES.

Other than the September 11, 2001 tragedy and related fallout, we can think of no other comparison to the sudden COVID-19 crisis in modern times. The current crisis may be prolonged and may have severe and long-lasting effects on business and the global economy. Unusual situations sometimes lead to unpredictable legal results.

Although the cases discussed above provide relevant guidance, the determination of whether a MAC has occurred is extremely fact-specific. As one court has observed, there is no easy test for a MAC based on “quantitative considerations.” *Channel Medsystems, Inc. v. Boston Scientific Corp.*, No. 2018-0673, 2019 WL 6896462, at *34 (Del. Ch. Dec. 18, 2019).

The COVID-19 situation and resulting business disruption may warrant consideration of whether a MAC clause is an issue in a lending transaction. Whether a MAC clause provides a proper basis for a lender to refuse funding a loan or to declare a default under a loan will depend on the applicable loan documents and how those documents operate on an integrated basis. In the parlance of the *Lyondell* decision, the parties also will need to consider the “magnitude of the impact” on the borrower’s business.

The material adversity issue may have a number of different aspects. The particular industry is important. For example, large event-planning organizations have largely ceased doing business, and the material effect on that industry is nearly self-evident. Conversely, this issue is not necessarily applicable to other industries – certain healthcare providers, for example. There are also probably geographical aspects of this issue. A business in a “hot spot” is more likely to have a MAC issue, depending on the industry under consideration and the language in its loan documents. All of these issues will need to be considered on a case-by-case basis.

IV. CONCLUSION

COVID-19 is a global pandemic with far-reaching implications for all of us. As it relates to commercial loans in particular, borrowers and lenders will need to review the MAC
provisions in their financing agreements carefully and consult with counsel to determine how COVID-19 may affect a specific company or lending transaction.

1. MAC clauses are also commonly called “material adverse effect” or “material adverse condition” clauses. Although the exact language of the clause is always important, the cases do not turn on the label.

2. The IBP court addressed these legal principles in the context of New York and Delaware law. Of course, each agreement must be evaluated based on the law of the applicable jurisdiction, the language of the clause, and the particular facts of the case.

3. The MAC was defined as “a material adverse effect on the business operations, assets, liabilities (actual or contingent) or financial condition of the company.” Id. at 85.

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