

The recent coronavirus disease 2019 (COVID-19) outbreak has sent shockwaves through global financial markets, leaving numerous industry sectors and market participants scrambling in its wake.

The government-enforced lockdown in the UK has placed certain services-based industries under immediate pressure to evolve or suffer. For some businesses, they are, or soon enough may be, unable to trade full stop, thereby crippling their revenue streams and ability to service loans. This has prompted borrowers and lenders alike to assess their protections, vulnerabilities and ability to mitigate risks under existing and pending contractual arrangements.

For borrowers, the immediate concern is the impact of the pandemic on revenues and cash flow, compliance with financial covenants and, in certain instances, servicing debt. Lenders, on the other hand, will be actively considering their potential exposure to borrowers' liquidity problems alongside credit risk – assessing various contractual mechanisms, such as *force majeure*, draw stop rights and debt acceleration, to mitigate these risks.

Pending financing is also similarly facing risks. With the duration of the outbreak presently unknown, lenders and arrangers will undoubtedly need to undertake enhanced due diligence on a borrower's business. Of critical importance will be the negotiation and careful drafting of the agreement – in particular, carefully constructed objective covenants, together with representations and warranties that there has not been (or is not expected to be) a material adverse change (MAC) to the borrower's assets, business or financial condition since a specified prior date (often the most recent financial statements).

As the current crisis worsens, MAC provisions in loan agreements may provide refuge to lenders. In circumstances that could be considered a "material" change to the borrower's ability to repay the loan, MAC clauses may be called upon by lenders to demand early repayment or the cessation of lending – even where there has not been a non-payment or event of default. However, for the reasons explained below, lenders need to ensure that these provisions are carefully drafted. In this regard, consideration must be paid to the specific language used – notably the scope and temporal application. Provisions should be specifically adapted to the contract in question, rather than being based on any "boilerplate" precedents used in other, and perhaps different, contractual settings. Unsurprisingly, disputes are already emerging as to whether MAC clauses can be invoked to combat the effects of the pandemic.

As far as English law is concerned, the answers to these questions will be a matter of contractual interpretation on a case-by-case basis. It follows that for parties seeking to rely on MAC provisions at this time, a strong understanding of their contractual portfolio is of paramount importance.

MAC Clauses Under English Law

The question that many lenders with exposure to the hardest-hit industry sectors – presently, retail, leisure and hospitality – will be asking right now is, "does COVID-19 demonstrate a MAC in a borrower's ability to perform its obligations under the relevant contract?"

Regrettably, the interpretation of MAC provisions under English law is limited and far from clear. The leading authority remains the 2013 case of *Grupo Hotelero Urvasco SA v Carey Value Added SL (formerly Losan Hotels World Value Added I SL)*¹ (*Carey*). The case turned on a Spanish lender's purported right to refuse the advance of further funding to its Spanish hotel borrower as a result of the 2008 financial crisis' impact on the Spanish property market. In particular, the lender argued that the severe downturn in the Spanish property market had caused a material change in the hotel's ability to repay the loan. The court rejected Carey's arguments on the basis that it had failed to prove an adverse change in the financial position of Grupo that was significant enough to impact its ability to repay the loan.

While the lender was ultimately unsuccessful, the observations made in Blair J's judgment offer some very helpful guidance to lenders presently considering the meaning, and possible invocation, of their MAC provisions. This guidance should be read alongside established English law principles of contractual construction, whereby the meaning of a contract is derived from the intention of the parties to a contract, viewed objectively. The ultimate aim of interpreting a provision in a contract is to determine what the parties meant objectively by reference to the language they used. This involves ascertaining what a "reasonable person," having all the background knowledge that would reasonably have been available to the parties in the situation in which they were at the time of the contract, would have understood the parties to have meant.

In the context of construing a MAC provision, the following points bear emphasising:

The Adverse Change Must Be Material

Materiality of the relevant change is critical. Specifically, the adverse change must substantially affect the borrower's ability to perform its obligations under the relevant agreement, principally its ability to repay and satisfy the loan. Given the dramatic consequence of an effective invocation of a MAC clause (suspension/cessation of lending and/or acceleration of the debt), the "change" in question must be severe, not trivial. Thus, causation will be key. In the context of COVID-19, lenders should carefully consider whether the pandemic has actually caused a MAC to its counterparty borrower, drawing accurate causative links between the pandemic and the purported MAC – such as evidence of the borrower's financial condition deteriorating by way of missed debt payments. It follows that relying on generic economic changes in the markets (such as in *Carey* and other authorities) would likely fall short of the required threshold to constitute a MAC.

The Adverse Change Must Be of Non-transient Effect

The change in question cannot be fleeting or transient. In other words, it must have an enduring impact on the borrower's capacity to meet its obligations under the contract. At present, the likely duration of the COVID-19 pandemic remains uncertain – some experts argue it will be months, while others suggest the negative consequences will affect businesses for years. As such, lenders may wish to pause and exercise caution before aggressively seeking to invoke such clauses prematurely. This being said, unlike the 2008 financial crisis and 9/11 before that, COVID-19 may still create new legal precedent. While the MAC must not be temporary, there may be a good argument in due course that for certain business in the worst hit sectors – in which many businesses will not recover quickly (or at all) from the crisis – the MAC will bite and be enforceable in accordance with its terms.

Clear and Unambiguous Language

Giving words their plain and ordinary meaning is the cornerstone of English law contractual construction. Therefore, it is necessary to consider the specific language of the MAC clause. Is it couched in mandatory or discretionary language – i.e., whether the event or circumstance "may", "will" or "is likely" to constitute or cause a MAC? Is the determination of materiality at the sole discretion of the lender? What is the extent of the express evidential requirement on the borrower's financial standing and is it pro lender or pro borrower? The clarity of the language used will either aid or hinder a lender's ability to call effectively upon the provision.

Conclusion

The analysis of MAC provisions must be undertaken on a contract-by-contract basis. Each party has a different set of objectives and each contract has different obligations that may be affected in different ways. While English law has shown to be quite restrictive on what constitutes a MAC, it may be that the pandemic brings to bear novel consequences causing the courts to consider broader interpretations of these provisions. However, as yet, this remains unknown and, thus, caution should be exercised.

Closer to home, to the extent the relevant contract involves a UK bank, recent government instructions should also be carefully adhered to. As recently as last week, the UK government confirmed that the actions of lenders are under review at this difficult time. It follows that, despite having robust legal grounds to call on a MAC, in the current situation, the decision by a lender to actually refuse or withdraw funding would be a brave one. As the crisis matures, and it becomes clear which businesses are either able to bridge the crisis or are in long-term structural trouble, those in the latter category will face an increased risk of lenders losing patience. While we wait to see how the marketplace evolves to face present and future issues, the invocation of MACs may be used tactically to (i) gain leverage to extract information; or (ii) mandate an independent business review, rather than collapse credit lines. If, of course, the crisis worsens dramatically over time, there may well be more objectively-evidenced defaults occurring, such as the insolvency of a group company or payment defaults, which lenders will surely want to rely on.

Parties to affected agreements should, therefore, take all the appropriate steps to review their contractual obligations now to mitigate against the risk of unsuccessful invocations of their MAC clauses, which could bring about potential reputational damage in the market and the requirement to pay compensation to an incorrectly defaulted counterparty.

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