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COVID-19 and MAC in Financing Agreements

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The Mac Provision*

A material adverse change ("MAC") provision (depending on where or how it is used) typically references a material adverse change in the business, assets, properties, liabilities, operations, condition or prospects of the relevant obligor (referred to as a "Business MAC" provision). MAC provisions may also refer to events that have a material adverse effect on the financial, banking or capital markets as a whole (referred to as a "Market MAC" clause). This discussion will largely focus on Business MAC provisions.

MAC provisions are often found as:

- a qualifier to events of default, representations and warranties, covenants and other terms in both loan and lease documents;
- a condition precedent to funding in commitment letters and loan agreements, and in some cases as a stand-alone event of default.

While the COVID-19 global pandemic can already be seen to be sparking events of default (without reference to stand-alone MAC events of default), a growing discussion point in the aviation finance market is whether the effects of COVID-19 will enable lenders to refuse to fund under a loan agreement or commitment letter on the basis that a MAC has occurred.

The Law

Much of the case law dealing with MAC provisions has been generated by decisions in Delaware and New York relating to M&A deals (and focusing in particular on Business MAC provisions). In general, a Business MAC must "substantially threaten the overall earning potential of the company" and do so in a "durationally-significant manner" (Akorn Inc. v. Fresenius Kabi AG, No. 2018-0300, 2018 WL 4719347 (Del. Ch. Oct. 1, 2018) citing In re IBP, Inc. Shareholders Litig., 789 A.2d 14, 40 (Del. Ch. 2001) at 68). Furthermore, the party seeking to invoke a MAC provision "faces a heavy burden when it attempts to invoke a material adverse effect clause" (Hexion Specialty Chemicals, Inc. v. Huntsman Corp., C.A. No. 3841-VCL, 2008 WL 4457544 (Del. Ch. Sept. 29, 2008)).

Unfortunately, there is no bright-line rule as to whether the above tests are met—a court will draw from various benchmarks, as well as the MAC provision in question, in order to make such a determination. For instance, courts have considered a decline in earnings of 50% over two consecutive quarters (Raskin v. Birmingham Steel Corp., No. 11365, 1990 WL 193326 (Del. Ch. Dec. 4, 1990)), and decreases in profits in the 40% range (Kling & Nugent, supra, § 11.04[9], at 11-66 as cited in Akorn Inc. v. Fresenius Kabi AG, No. 2018-0300, 2018 WL 4719347 (Del. Ch. Oct. 1, 2018)), as showing evidence of a Business MAC. In other decisions, a 64% drop in quarterly earnings did not constitute a material adverse effect (in this case on the basis that the company was a consistently but erratically profitable company struggling to implement a strategy that would reduce the cyclicality of its earnings) (In re IBP, Inc. Shareholders Litig., 789 A.2d 14, 40 (Del. Ch. 2001)). The late 2018 decision by the Delaware Court of Chancery in Akorn marked the first Delaware state court case upholding a buyer's right to terminate a merger agreement on the basis of a Business MAC. In this case, a fall in EBITDA of 86% together with adjusted EBITDA of 51% from the prior year along with other evidence showing a "dramatic decline on a year-over-year basis" was determinative.

The Delaware and New York courts appear generally consistent in their MAC analysis—the New York courts considering in their analysis "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" (In re Lyondell Chem. Co., 567 B.R. 55, 122 (Bankr. S.D.N.Y. 2017)).

While the case law is more sparse, the principles applied to MAC provisions in M&A deals are similarly applied in financing transactions (and it would be expected that the same would apply to a similar provision in an operating or finance lease). The decision in Capitol Justice LLC v. Wachovia Bank, N.A., 706 F. Supp. 2d 23 (D.D.C. 2009) is helpful in showing that the principles applied to MAC provisions in M&A deals are similarly applied in financing transactions—in this specific case, the borrower alleged that Wachovia Bank breached a loan commitment agreement ("LCA") when it invoked the LCA's Market MAC clause to terminate the LCA. The Court concluded that "the party seeking to excuse its performance under the contract because of a MAC, has the burden to prove that a MAC occurred" and that "it is for the fact-finder to decide whether a MAC is any meaningful or significant adverse change, or whether a MAC is an unforeseeable adverse change," i.e., determining whether a MAC has occurred is a question of fact based on the circumstances in question and the relevant MAC provision.

The Takeaways

In light of the above, a lender looking to invoke COVID-19 as a trigger to a MAC provision under a loan agreement or commitment letter is likely to face the following three key challenges:

(1) Lender Burden of Proof. The lender would need to show that (i) the material adverse change caused by COVID-19 was neither within the contemplation nor control of the parties at the time they executed the credit agreement or commitment letter and (ii) there was a significant impact on the borrower's business.

(2) There Is No Bright Line Test. There is no clear threshold for determining the materiality of the impact/change to the borrower's business.

(3) The Determination in Relation to Each Case Is Highly Fact-Specific. The analysis of whether a MAC has occurred is always highly fact-specific and will be determined on a case-by-case basis by reference to the facts in question and the specific MAC provision itself. The MAC provision itself will be key to determining the risk allocation between the parties—in particular, the party bearing "general market risks" such as force majeure events and pandemics such as COVID-19.

As such, it seems more likely that lenders will be seeking to invoke provisions requiring no default and/or payment arrears as a condition precedent to funding rather than a MAC itself. Only time will tell as to whether this remains the case.

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**Note that for the purposes of this discussion, material adverse change and material adverse effect provisions are treated interchangeably.*

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