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CORONAVIRUS: IMPLICATIONS FOR MATERIAL ADVERSE EFFECT CLAUSES IN NY LAW-GOVERNED CREDIT AGREEMENTS

A Material Adverse Effect (or an "MAE")[1] clause permits the parties to a contract to void it if an event occurs which changes the fundamental underpinning on which the contract was entered. In the lending context, lenders and borrowers will heavily negotiate what constitutes a "material adverse effect" and will qualify certain representations and covenants in a credit agreement by reference to whether or not a breach of such representation or covenant could or would result (or has resulted) in a material adverse effect. Similarly, credit agreements will often include events of default that are triggered if a material adverse effect occurs. The COVID-19 pandemic and the related precautionary measures being taken globally to try to contain the disease have led various borrowers and lenders to question whether an MAE provision has been triggered under existing credit facilities.

What is an MAE under NY State Law?

The determination of whether or not an MAE has occurred is highly dependent on many factors, including (1) the specific wording of the MAE clause in question, (2) the applicable law of the agreement containing such MAE clause and the interpretation of such applicable law by the relevant courts, (3) the particular facts that have given rise to the assertion that an MAE clause has been triggered, (4) whether or not the event that gave rise to the alleged MAE was a risk that could have been foreseen by the parties at the time the relevant agreement was entered into, and (5) the duration of the event that gave rise to the alleged MAE.

In the context of New York ("NY") law-governed credit agreements, though the definition of "material adverse effect" will vary from deal to deal, most definitions

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1 References to "Material Adverse Effect", "Material Adverse Change", "MAE" and "MAC" are used interchangeably throughout this article,.

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will focus on whether or not an event has occurred that could or would have (or, in some instances, has had or could or would reasonably be expected to have) a material adverse effect on (1) the business, operations, property, financial condition or prospects of the borrower (and/or its subsidiaries), (2) the borrower or its subsidiaries' ability to perform its or their obligations (or certain of them) under the credit agreement and related loan documents, or (3) the validity, enforceability, effectiveness or ranking of any security granted in connection with the credit agreement or the rights or remedies of a lender. NY law-governed credit agreements typically do not include carve-outs in the definition of MAE for "acts of God", pandemics or industry-wide specific risks.

The generality and broadness with which most MAE definitions in NY law-governed credit agreements are drafted means that lenders are theoretically able to invoke such broad and general MAE clauses to declare defaults or refuse to fund whenever an event that the lenders deem material and detrimental to the borrower and its ability to service its debt to the lender occurs. However, in practice, lenders have been wary of invoking the occurrence of an MAE unless there is clear and convincing evidence that such an event has indeed occurred. A lender that does not fulfil its obligations under a credit agreement faces the risk of litigation by the borrower for breach of contract and, equally important, potential reputational damage.

MAE Case Law

Though rare, court decisions on whether or not an MAE clause has been breached focus on whether there has been an adverse change that is material enough to have substantially and fundamentally threatened the purpose of the agreement in a durationally significant manner. In fact, a court specifically held that it is possible that "short-term hiccups in earnings" may not constitute an enforceable MAE.[2] And most courts seem to agree that whether or not an MAE has occurred is extremely fact-specific.

An opinion in *In re Lyondell Chem. Co*.[3] is one of the few written decisions that applies a NY law analysis to an MAE clause in a credit agreement. In that case, a borrower brought suit against its pre-bankruptcy lender because the lender refused to fund the borrower's $750 million funding request made pursuant to a revolving credit agreement. The lender refused to fund on the grounds that an MAE had occurred. The definition of MAE in the agreement in question included, among other things, “a material adverse effect on the business, operations, assets, liabilities (actual or contingent) or financial condition" of the borrower. Specifically, the lender asserted that it invoked the MAE clause on the basis that the borrower had many financial issues, was discussing a possible bankruptcy filing with its lenders, and the lenders knew that the borrower had retained restructuring advisors. The parties did not dispute that the MAE clause at issue did <u>*not*</u> explicitly provide for an ongoing solvency requirement. The *Lyondell* court, applying NY law, refused to infer a solvency requirement where none was drafted by the parties and rejected the lender's assertion that the borrower's impending bankruptcy filing alone constituted an MAE, noting that there was no legal precedent for inferring a solvency requirement from an MAE clause similar to the

[2] *See, e.g., Akorn, Inc. v. Fresenius Kabi AG,* No. CV 2018-0300-JTL, 2018 WL 4719347, at *47 (Del. Ch. Oct. 1, 2018).
[3] 567 B.R. 55 (Bankr. S.D.N.Y. 2017).

one at issue.[4] The court also noted that, while the lender had required that the borrower make a solvency representation at closing, there was no bring-down of such representation for subsequent borrowings—which made it less likely that the parties had intended for an ongoing solvency requirement.[5] Therefore, the court held that the lender had breached the credit agreement with the borrower by refusing to fund the requested borrowing.[6]

Lessons Learned

In light of current case law, whether or not lenders can successfully invoke an MAE breach as a result of the COVID-19 pandemic will largely depend on the specific facts of the relevant transaction and on the specific drafting of the MAE clause in question. For example, whether a provision in a credit agreement refers to events that "could reasonably be expected to result in an MAE" as compared to events that "have resulted in an MAE" should be meaningfully considered by a lender. Similarly, whether a definition of MAE refers to "prospects" or not is an important component, as for some businesses, the effect of the COVID-19 pandemic may be impactful on a more protracted timeline.

Courts have held that, in order for the relevant event to be material the effects of such event must be long-lasting, thus it may be too early to safely determine whether a specific borrower group has suffered an MAE as a result of the COVID-19 pandemic. However, this argument is weakened as time continues to pass without borrowers being able to avoid adverse effects on their businesses or their ability to service debt as a result of the COVID-19 pandemic.

Similarly, lenders need to carefully determine whether it was foreseeable that a borrower's business could have been affected by the COVID-19 pandemic at the time the agreement was entered into. As noted above, one of the key considerations that a court makes in evaluating whether an MAE occurred is whether the event in question fundamentally alters the spirit of the agreement. One of the elements that a court evaluates in determining whether the spirit of the agreement has been altered fundamentally is whether the event in question was foreseeable to the parties at the time the agreement was entered into. Therefore, a court may be less inclined to rule that material adverse effects on a particular borrower caused by the COVID-19 pandemic fundamentally altered the underlying spirit of the deal if, for example, the lenders entered into the relevant agreement after it was known that the COVID-19 virus could result in a pandemic and could affect the business of the particular borrower in question.

With respect to existing credit agreements, lenders should consider actions taken by them under such credit agreements after December 2019, which is when information about COVID-19 started becoming broadly available. For example, if lenders funded a borrowing request under an existing credit agreement after December 2019, such lenders' actions could also weaken the argument that such lenders were not aware that COVID-19 may adversely affect the relevant transaction at hand and therefore that the underlying spirit of the agreement is being altered in a fundamental manner.

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[4] *Id.* at 150.
[5] *Id.* at 149-50.
[6] *Id.* at 150.

Further, lenders need to consider whether potential borrowers have made disclosures in public filings about the possible impacts that COVID-19 may have on their businesses. For example, Fox Corporation disclosed on March 31, 2020 in an 8-K filing with the Securities and Exchange Commission that it could suffer material adverse effects as a result of the COVID-19 pandemic. If a borrower has made such disclosures and a lender enters into a new credit agreement with such borrower (or funds a borrowing request under an existing credit agreement with such borrower) after such disclosure is made but prior to such lender invoking the occurrence of an MAE, it may be more difficult to assert that the risk of COVID-19 was unforeseeable which may, in turn, weaken the argument that the event in question fundamentally alters the underlying spirit of the agreement. As a result, the claim that an MAE has occurred may be weakened as well.

Finally, the current legislative environment should be evaluated prior to invoking an MAE clause. Lenders should be mindful of the focus by the US federal government to inject liquidity into the markets. A lender invoking an MAE clause as the basis for refusing to fund under an existing credit agreement is definitionally depriving a borrower of presumably-needed liquidity. It remains to be seen whether courts will inform their determination that an MAE has or has not occurred by reference to the general efforts by the federal government to ensure that financial liquidity is available to those who need it as a result of the COVID-19 pandemic. Short of judicial scrutiny, the court of public or "corporate" opinion may react to such invocation, and when the world of lending approaches a sense of pre-COVID-19 normalcy, such a lender may be criticized for its actions during a time of main street crisis.

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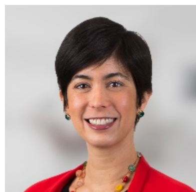

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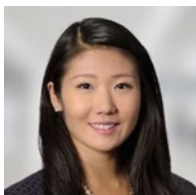

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