

CLIENT UPDATE

ENGLISH HIGH COURT INTERPRETS MATERIAL ADVERSE CHANGE CLAUSE

LONDON

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Recently, the English High Court considered¹ how to interpret a material adverse change (“MAC”) clause, which is a provision that routinely appears, in various forms, in both acquisition and finance agreements but on which there is limited case law. The court found in this case that there had been no MAC in the financial condition of a borrower. In the absence of much case law on MAC clauses, the case is notable for the detailed general guidance given by the court on how to interpret a MAC clause, and more specifically, the narrow interpretation given to a MAC clause which is based only on the financial condition of a borrower. While the case considered a MAC clause in the context of a loan agreement, the court drew on M&A precedents and it is likely that the decision will have a wider impact on the interpretation of MAC clauses in the context of acquisitions, both public and private. The narrow interpretation of the MAC clause in this case may be of some comfort to sellers and borrowers in the current economic climate. Conversely, the case serves as a warning to buyers and lenders to consider carefully how to draft MAC clauses in the future.

The MAC clause in question was a representation that “there has been no material adverse change in [the obligors’] financial condition (consolidated if applicable)” since a particular date.

¹ *Grupo Hotelero Uroasco SA v Carey Value Added SL and another* [2013] EWHC 1039 (Comm) (26 April 2013)

The court held that:

- The assessment of the financial condition of an obligor should begin with its financial information at the relevant time and it is for the lender seeking to demonstrate a MAC to show an adverse change over the period in question by reference to that information. However, other compelling evidence may be considered as to the obligor's business, if applicable.
- An adverse change will be material if it significantly affects the company's ability to perform its obligations under the relevant agreement.
- A party to an agreement cannot trigger a MAC clause on the basis of circumstances of which it was aware at the time of the agreement.
- In order to be material, a change must not be merely temporary.

In this case, a Spanish property finance fund (the "Lender"), claimed that Grupo Hotelero Urvasco S.A., a property developer (the "Borrower"), was in default under a loan agreement because, among other things, there had been a breach of the representation that there had been no material adverse change in the financial condition (consolidated if applicable) of the Borrower since the date of the loan agreement.

Although the loan agreement was governed by Spanish law, the court applied the English rules as to the interpretation of contracts in its reading of the MAC clause as it noted there was no difference between English and Spanish law in this respect.

FINANCIAL CONDITION

The Lender argued that the term "financial condition" is a general phrase with no inherent limitations. It asserted that it is not, for example, limited to particular parts of the company's accounts such as net current assets or profits, and should relate to all aspects of the company's finances as well as the state of the markets in which the company operates.

The court preferred the Borrower's view that any consideration of a company's financial condition should start with an assessment of its financial statements. A lender seeking to demonstrate a MAC should show an adverse change over the period in question by reference to the relevant financial statements. Where a MAC clause is intended to extend to broader matters, the clause should refer to "a material adverse effect on the business or financial condition" of an obligor. It is, in our experience, common for representations as to a MAC and definitions of Material Adverse Effect to refer to "business or financial condition" and not just financial condition. That was not, however, the position in this case.

The court further held that, while the financial information is the starting point, there may be compelling evidence to show that an adverse change sufficient to satisfy a MAC clause has occurred, even if an analysis limited to the company's financial information might suggest otherwise. The parent guarantor in this case had ceased to pay its bank debts, and the court noted that this was compelling evidence that a MAC had occurred in respect of the guarantor, even though it was not reflected in the guarantor's financial information.

MATERIALITY

To be material, the court held that an adverse change must affect **significantly** the obligor's ability to perform its obligations under the loan agreement, and in particular its ability to repay the loan. The court held that the purpose of a MAC clause in a loan agreement is ultimately to protect the rights of the lender to payment of interest and repayment of principal. Accordingly, a material adverse change in the financial condition of an obligor should be assessed by reference to those changes which are relevant to the obligor's ability to meet its payment obligations. Unless the clause is read in this way, the court stated, a lender may be in a position to suspend lending and/ or call a default at a time when the obligor's financial condition may not fully justify it, thereby propelling the obligor toward insolvency.

PRE-EXISTING CIRCUMSTANCES

The court held that a lender cannot trigger a MAC clause on the basis of circumstances of which it was aware at the date of the loan agreement since the parties intended to enter into the agreement in spite of those circumstances. An event which is continuing between the two dates by definition will not constitute a change in financial condition between the two dates. This applies equally to a state of affairs which is likely to occur when the agreement is entered into. The court cited approvingly the 2001 Delaware *Tyson Foods* case, in which it was held that the MAC clause in the relevant agreement was "best read as a backstop protecting the acquiror from the occurrence of **unknown events** that substantially threaten the overall earnings potential of the target in a durationally significant manner".

DURATION OF CHANGE

The court's final construction point in its interpretation of the MAC clause was that, in order to be material, a change must not be merely temporary. This is consistent with the approach which both English and Delaware courts have taken in relation to MAC clauses in the context of acquisition agreements.

IMPLICATIONS

- We note that, in contrast to United States practice, until recently, English-law private acquisition agreements had very rarely included a MAC condition to an acquisition. Although such provisions are more common in an English public bid context, the Takeover Panel has traditionally set a high bar to offerors invoking a MAC condition to an offer. Thus, in this decision, the High Court is consistent with the Takeover Panel's approach of limiting use of a MAC clause. Following this case, parties to English-law agreements should consider carefully the intended scope of a MAC clause or any similar provision, such as a Material Adverse Effect definition. In our experience, when such provisions are included in an English-law agreement they often include a reference to a company's business as well as financial condition, and we expect this reference to be more regularly insisted on in the future.
- Parties should take particular note that they are unlikely, following this case, to be able to invoke a MAC clause successfully in respect of circumstances of which they were aware when they entered into the relevant agreement.

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Please do not hesitate to contact us with any questions.

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