

# CLIENT UPDATE

## ENGLISH HIGH COURT INTERPRETS MEANING OF MATERIAL ADVERSE CHANGE

### LONDON

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Recently, the English High Court considered<sup>1</sup> how to interpret a material adverse change (“MAC”) clause, which is a provision that routinely appears, in various forms, in loan 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. This may be of some comfort to borrowers in the current economic climate. Conversely, the case serves as a warning to lenders to consider carefully how future MAC clauses should be drafted.

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.

The court held that:

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

- 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 lender 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 the 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, 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

- Lenders in English-law finance documentation should, following this case, consider carefully the intended scope of a MAC clause and of any similar provision, such as a Material Adverse Effect definition. We note that the LMA standard form loan agreements for both leveraged and investment grade borrowers include in the MAC representation a reference to the borrower's business as well as financial condition. This has in the past often been omitted, but we expect lenders will be more likely to insist on it following this case.
- Lenders should take particular note that they will likely not be able to successfully invoke a MAC clause in respect of circumstances of which they were aware when they entered into the relevant agreement.
- Borrowers may wish to cite the Grupo Hotelero decision in any dispute with their lenders as authority for the proposition that a MAC clause relating only to financial condition should be construed narrowly.

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Please do not hesitate to contact us with any questions.

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