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MAE in loan agreements: A framework for lenders and borrowers during the current crisis

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Projections of the full impact of COVID-19 (more commonly known as the coronavirus) on the economy remain extremely uncertain and continue to reflect a variety of outcomes.

As a result of this uncertainty, businesses who have remaining borrowing capacity under existing loan facilities are considering whether to draw down some or all of any remaining borrowing capacity they may have under their credit facilities.

Indeed, as has been widely reported, many business have already decided to do just that and draw down on all or most of any of their available borrowing capacity.

Interestingly, there is not a significant amount of case precedent on interpreting MAE clauses in the context of loan agreements.

For some businesses these considerations were motivated by a general fear that a run on the bank by other borrowers may cause a liquidity crisis for lenders and perhaps make funding unavailable if/when it becomes necessary.

For businesses in sectors that have already been directly impacted by COVID-19, including as a result of mandated or voluntary shutdowns of most or all of their business activities (such as movie theaters, restaurants and retailers), these considerations also include a real and practical overlay, namely, the need to counter the negative impact on cash flows they are already experiencing.

These business already impacted by COVID-19 which have not yet drawn on available borrowing capacity are facing a growing anxiety about whether their lenders will choose to not fund a borrowing request by exercising material adverse effect (MAE) clauses in the applicable loan agreements.

Loan agreements typically include a representation that no MAE exists, provide for an MAE to constitute a default, or both.

Most commonly, an MAE in loan agreements is defined to cover a material adverse effect on (1) the business, assets, operations or financial condition of the borrower or (2) on the borrower's ability to perform its payment obligations under the loan agreement.

Loan agreements typically require lenders to fund financing obligations so long as that at the time such funding is requested by the borrower (1) no defaults have occurred or would occur as a result of the financing and (2) the representations and warranties made by the borrower in the loan agreements remain true in all material respects.

However, unlike mergers and acquisitions (M&A) agreements, MAE clauses in loan agreements are not modified by well-crafted and customarily agreed-upon exceptions to the terms, as lenders are focused on the borrowers' ability to service the loan.

Historically, court cases deciding whether an MAE clause has been validly exercised have been predominantly litigated between buyers and sellers in the M&A context.

Since the governing law of a majority of M&A agreements is Delaware law, the bulk of these court cases over the applicability of MAE clauses have been litigated in Delaware.

However, New York law is the most common governing law of many commercial agreements (including loan agreements). Interestingly, there is not a significant amount of case precedent on interpreting MAE clauses in the context of loan agreements.

We offer the following important considerations based on existing case law in Delaware and New York that can assist you during this period.

As mentioned, the bulk of the case law on MAE provisions comes from Delaware courts, which have established the "IBP approach" (in the IBP/Tyson Foods cases) that views MAE provisions as protecting "*the acquirer from…events that substantially threaten the overall earnings potential of the target in a durationally significant manner*."

At the same time, the court acknowledged that it was required "to engage in an exercise that is quite imprecise" in order to determine whether an MAE has occurred since "[t]he simplicity of the words in the [MAE clause] is deceptive because the application of those words is dauntingly complex."

The court there focused what information was available to parties at the time a determination needs to be made.

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In the first Delaware case upholding a buyer's right to terminate an M&A agreement on the basis of invoking an MAE provision (*Akorn v. Fresenius Kabi AG*), the Delaware Supreme Court reached that conclusion applying the IBP approach.

Notably, in *Akorn*, the Delaware courts considered evidence relating to the motives of the terminating party invoking the MAE provision and made the determination that such party was not invoking the MAE provision merely looking to get out of its contractual obligations on account of "buyer's remorse."

This is consistent with existing Delaware precedent on this issue.

In reaching its determination, the court in *Akorn* pointed to the fact that the terminating party was in substantial compliance with its contractual obligations, including with respect to its obligations to expend efforts on getting the deal closed, and that the terminating party was in constant communication with the target about its findings and the concerns they raised well before the drop in the target's stock price.

> The duration of the COVID-19 pandemic is currently unknowable. This may make it challenging to establish whether the materially adverse effect caused by COVID-19 threatens the overall earnings potential of the borrower in a durationally significant manner.

It should be noted that the business and operations of Akorn incurred significant and identifiable losses for significant duration that aligned with the MAE construct established by IBP.

Most decisions by New York courts relating to MAE provisions seem consistent with the IBP approach. It has therefore become generally accepted among academics and practitioners that New York courts would continue to approach MAE provisions in a manner consistent with the IBP approach.

However, the fact remains that New York cases on this subject are very sparse, and there are some cases (including some decided by federal courts sitting in New York) that seem to be at odds with the IBP approach.

Interestingly, the IBP approach was articulated by the Delaware Chancery Court in a case where it applied New York law.

Also as mentioned, the MAE jurisprudence has mostly been decided in the M&A context, Delaware and New York courts have decided MAE cases outside of the M&A context.

As examples, in one of the seminal New York MAE cases, *Pan Am Corp. v Delta Air Lines, Inc.*) the court upheld a lender's termination of a loan agreement on the basis of a MAE.

Similarly, as recent as 2017, the Delaware Chancery Court (in *The Mrs. Fields Brand Inc. v. Interbake Foods LLC*) decided that "the same factors underlying [IBP's] approach — knowledge, magnitude and duration — are relevant to" MAE provisions outside of the M&A context (in this case, a license agreement).

Notably, in the *Pan Am* case, the New York court found an MAE to have occurred over a period of three months as a result of a "rapid deterioration" of the borrower's revenue.

Similarly, in applying the IBP approach to a license agreement in the *Fields* case, the Delaware Chancery Court acknowledged that "the reasonable expectations of licensees and licensors would not necessarily be the same for buyers and sellers of a business insofar as the durational factor is concerned" and concluded that "the period of time that would be "commercially reasonable" in determining whether…a consequential decline in earnings has had a material adverse effect on the license presumably would be shorter than the period of time relevant to the acquisition of business" (where a "commercially reasonable" period "would be measured in years rather than months").

In reading the applicable case law, a common and repeated theme is that, as with every position based on a contractual provisions, careful consideration needs to be given the overall context of the transactions contemplated by the applicable contract and the general context in which the applicable contract seeks to apply the MAE clauses contained therein as well as the specific language and wording of the MAE clauses themselves.

As examples, a loan agreement may apply MAE provisions as forward-looking or just based on current effects or it may provide for carve outs of certain systemic risks and allocate them to the lenders or, as noted above, may lack any such carve outs.

Applying the above takeaways to the current COVID-19 situation, we note the following:

- Special attention should be given to the specific wording of MAE clauses and how the wording compares to the available facts. In each case, a determination needs to be made whether the applicable MAE provision is based on effects that have already occurred or on effects that could be reasonably expected to occur in the future. While many businesses may suffer substantial deterioration of earnings if the COVID-19 pandemic continues, many such businesses have not yet experienced an actual deterioration. If an MAE provisions contains any carveouts, a determinations needs to be made about the intent and meaning of such carveouts and the applicability to

the current facts of the COVID-19 pandemic. As such, depending on the specific wording, carveouts for systemic risks may provide a serious challenge to lenders seeking to invoke the MAE provision as grounds for not funding.

- As mentioned above, the duration of the COVID-19 pandemic is currently unknowable. This may make it challenging to establish whether the materially adverse effect caused by COVID-19 *threatens the overall earnings potential of the borrower in a durationally significant manner*.

- It will also be important to establish the correct durational period that is relevant for the measuring of adverse impact. Any determination will need to be based on the reasonable expectation of the lenders and the borrowers in the applicable context. The applicable durational period may be different for loans contemplated to be made pursuant to a financing commitment in connection with the closing of an acquisition than for loans that have a five-year or longer term from the time of funding. The durational period may also depend on the use of proceeds and whether there is any paydown period associated with such loan.

- If the MAE provision in the applicable loan agreement includes a prong focused on the borrowers' ability to pay their obligations as they become due, the MAE analysis may be relevant for this prong, and if there is uncertainty about the borrowers' ability to pay their obligations as they become due, then, depending on the specific wording, the application of the more generic prong of the MAE provision may be moot for those borrowers, and they may not be in a position to expect the lenders to fund any loans.

- Prior to invoking an MAE clause as the basis for refusing to fund any loans, lenders should ensure they are clearly communicating any concerns they may have with the borrowers in a timely manner and remain willing to engage with borrowers in order to provide support to their business while balancing the lenders' desires to protect their exposure and risk to the extent feasible. As with each of the cases cited above, the burden of proof is on the party invoking the MAE to demonstrate the evidence of the impact or the potential impact on the business and operations.

Finally, we expect that the dearth of case law in the loan agreement context (other than financing commitments in connection with the closing of an acquisition) may be a result that unlike a potential buyer in the M&A context, lenders already have a financial interest in the borrowers' business and they may be incentivized to protect their existing interest.

As such, we expect lenders and borrowers to engage with each other and seek common ground on each party's contribution to support the applicable business survive the COVID-19 pandemic in order to preserve the value of the business for the expected economic recovery.

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