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COVID-19—Evaluating Material Adverse Change Clauses in Loan Agreements

Access to credit is a question of paramount importance to borrowers navigating uncertain times, and as market participants work to assess the impact of COVID-19 on the broader economy, the question has arisen as to whether the pandemic has already triggered, or will soon be grounds for invoking, a Material Adverse Effect ("MAE") clause or Material Adverse Change ("MAC") clause.

MAE or MAC definitions in loan agreements are typically used (i) to qualify or provide a threshold for certain representations and warranties, (ii) as a condition to the extension of revolving credit and (iii) as an Event of Default (although this final usage is far from what would be considered market). MAC or MAE as a condition to extensions of revolving credit is the focus of this memorandum.

Contract Language

A typical MAE or MAC definition in a loan agreement will have multiple prongs; this memorandum will address the business impact prong of the MAE or MAC definition in loan agreements (the "Financing MAC"). A customary Financing MAC definition will read, in part, as follows:

"Material Adverse Change" means a material adverse change in, or a material adverse effect upon, the financial condition, operations, [prospects], assets, business, or properties of the Loan Parties taken as a whole …"

MAC in M&A versus MAC in Finance

In addition to the extension of revolving credit, the MAE or MAC concept is common in two other scenarios:

i. the buyer in a merger or acquisition ("M&A") transaction has the ability to refuse to consummate the transaction by arguing that an MAE or MAC exists ("M&A MAC"), and

ii. the Lender in an acquisition finance transaction has the ability to refuse to finance the acquisition by arguing that an MAE or MAC exists (the "Acquisition Finance MAC" and, together with the M&A MAC, collectively the "Acquisition MAC").

MAE or MAC language in the M&A MAC and the Acquisition Finance MAC contexts is typically very similar. That is because it is in the best interest of a buyer in an M&A transaction that its M&A MAC and its Acquisition Finance MAC closely parallel each other; a buyer wants both tests to be triggered simultaneously.

Acquisition Finance MAC language is fundamentally different from Finance MAC language. Broadly speaking, the

Acquisition MAC has a number of seller-friendly exceptions (for example, force majeure, terrorism, acts of God, acts of war, and changes in general economic conditions that do not disproportionately affect the target company) that prevent a buyer and its financing source from invoking an Acquisition MAC and refusing to close the transaction. The Financing MAC in a loan agreement does not have these carve-outs.

There is a relatively robust body of case law on the circumstances triggering an Acquisition MAC. While these cases are not directly on point for understanding whether a Financing MAC has occurred, these cases in the Acquisition MAC context are helpful analogs in the Financing MAC context.

Existing Case Law: Durational Significance and Severity Tests

As mentioned, commercial finance practitioners can turn to the existing Acquisition MAC case law for guidance in evaluating how a court might decide an issue involving a Financing MAC. The real question is how a court determines what "material" is. Almost all of the existing case law is in Delaware courts, applying Delaware law, due to the fact that Delaware is identified as the governing law in most acquisition agreements. However, courts in Colorado and New York would likely follow these cases due to the lack of binding precedent from courts in their own jurisdictions.

Determining Materiality—Durational Significance and Severity

Delaware courts, when left with no clear guidance from the contract or a bright-line, easy to apply quantitative rule, have arrived at the following formulation when determining materiality:

A material adverse effect is "an unexpected event or series of events that threatens a business's overall earnings 'in a durationally-significant manner.'" *3M Co. v. Neology, Inc*., NO.: N18C-07-089 AML CCLD, 2019 Del. Super. LEXIS 312, at *30–31 (Del. Sup. Ct. June 28, 2019). That said, "[w]hether a material adverse effect exists ultimately is a factual issue[.]" *Id*.

Durational Significance

The durational-significance test lays out the first guiding principle; however, this too is somewhat amorphous. As a currently relevant example, the duration of the impact of COVID-19 is unknown, which complicates the matter of analyzing Finance MAC in the context of this pandemic. However, to the extent a Finance MAC does not make reference to impacts on the "prospects" of a company, a company may take the position that the analysis of whether the duration of the adverse impact is material is backwards looking.

Furthermore, Delaware courts have determined that context matters, meaning the durational significance test can change depending on the length of a contract. The lifecycle of an acquisition transaction (or the length of time that the buyer will hold the acquired company) can be indefinite, so a court would be looking at a longer period of time in order to determine if there is durational significance. Generally, in the Acquisition MAC context, an acquirer must expect reduced earnings to "persist significantly into the future." *Hexion Specialty Chems., Inc. v. Hunstsman Corp.*, 965 A.2d 715, 738 (Del. Ch. Ct. 2008) (also stating this is usually measured in years). A loan agreement, on the other hand, has a set maturity date of typically between three and seven years (with the most common term being five years). As such, courts might take into account the relatively short-term nature of the loan agreement contract when determining whether there is durational significance with respect to adverse impacts on the borrower; that is, shorter-term adverse impacts might be determined to be durationally significant.

A licensing dispute between a cookie producer and a licensee of the producer's cookies presents an interesting example that may shed light on durational significance in the Finance MAC context. *Mrs. Fields Brand, Inc. v. Interbanke Foods*, LLC, No. 12201-CB, 2017 Del. Ch. LEXIS 113 (Del. Ct. Ch. Mar. 2, 2017). Shortly after entering into a five-year licensing agreement with the plaintiff, the defendant extinguished the licensing agreement, arguing, in part, that certain aspects of the plaintiff's business were a materially adverse condition such that its performance was

excused. *Id*. at *56–59. The court noted:

In an acquisition, where the buyer acquires the assets of a business outright and the cash flows they generate in perpetuity, 'one would think' that a commercially reasonable period 'would be measured in years rather than months.' The License Agreement is different. [Plaintiff] retained ownership of the brand and [defendant's] interest in the business only extends until the license expires, which occurs after a five-year term, subject to an option to renew the license for another five years. Thus, given the limited duration of the License Agreement, 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. *Id*. at *60.

The court ultimately ruled that the supposed changes in the plaintiff's business were not material, and did not address the durational question head on. *Id*. at *63–66.

Like a licensing agreement, a loan agreement has a set duration. It is reasonable to assume that a court, when evaluating a Finance MAC in a loan agreement, would take a similar approach. While it is not entirely clear how a court would interpret the issue, a bank might argue that the period of time that would be "commercially reasonable" is the remaining period prior to maturity (or the remaining period prior to the next interest or principal payment).

<u>Evaluating Severity</u>

As with duration, the magnitude of the required impact is fact-specific and no bright-line, easy to apply quantitative rule exists. Delaware courts have addressed the severity issue in the Acquisition MAC context and have arrived at different suggested thresholds based on the specific facts of the case.

In *Akorn, Inc. v. Fresenius Kabi AG*, No. 2018-0300-JTL, 2018 Del. Ch. LEXIS 325, *123–24 (Del. Ch. Ct. Oct. 1, 2018), the court posited "[i]n their influential treatise, Lou R. Kling and Eileen T. Nugent observe that most courts which have considered decreases in profits in the 40% or higher range found a material adverse effect to have occurred." In Akorn, the plaintiff suffered a loss in [profits] of 51% over a five-quarter period, which the court found to be material. Id. at *125. Delaware courts had not previously been willing to hold that a material adverse effect had occurred. *See, e.g., Raskin v. Birmingham Steel Corp.*, No. 11365, 1990 Del. Ch. LEXIS 194, at *5 (Del. Ch. Dec. 4, 1990) (suggesting in dicta that a 50% decline in earnings over two consecutive quarters would constitute a materially adverse event). The rule is not absolute and is context specific. For instance, in *In Re IBP S'Holder Litig. v. Tyson Foods*, 789 A.2d 14, 22 (Del. Ch. Ct. 2001), the court held that a 64% drop in quarterly earnings was not a materially adverse event because the seller—a beef producer—suffered the decline due to an unseasonably harsh winter. After the bad quarter, the seller began to perform more in line with its typical performance from the previous five years. *Id*. at 66–71. The court found that the buyer failed to offer sufficient proof at trial this event was materially adverse such that it excused its performance under the merger agreement; in this instance, a 64% drop in quarterly earnings was not enough to be considered "material." *Id*.

The *IBP* case, and the court's observation as to duration, may be important to the analysis of Finance MACs in the COVID-19 context.

<u>Burden of Proof</u>

Delaware courts have been clear that the burden of proof lies with the party invoking the MAC, which in the Financing MAC context would be the lender in connection with a refusal to extend credit: "… absent clear language to the contrary," a party invoking a MAC clause bears a "heavy burden" to show the clause has been breached. *See Hexion Specialty Chemicals, Inc*., 965 A.2d at 738–39.

Conclusion

A Financing MAC determination will be a fact-specific inquiry. As the consequences from COVID-19 work through the financial markets, determinations made using the existing guidance might come into tighter focus.

Existing case law gives some shape to the analysis, but ultimately a determination will center on the business itself and the impact of COVID-19 on that business.

For the time being, given the lack of clear guidance from courts as to the treatment of Finance MACs, borrowers and their lenders are in all likelihood better served by working together to craft a practical, extrajudicial solution to a potential MAE or MAC occurrence.

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