Material Adverse Change Clauses: Protection to a Lender?

by Ong Eu Jin and Christine Chan Ee Yin

Material adverse change clauses ("MAC clauses") — sometimes referred to as "material adverse effect clauses" — have always been "carefully drafted, bitterly negotiated, yet seldom invoked"[1] in credit agreements. Lenders, however, insist that MAC clauses are necessary to protect them against:

(i) gaps in due diligence;

(ii) unforeseen changes to the borrower's financial situation;

(iii) unanticipated and drastic market fluctuations; and

(iv) anything else that could adversely affect the borrower's ability to repay the loan but may not be provided for in the agreement.[2]

Forms of MAC clauses

MAC clauses usually appear in two forms:

(i) as a continuing representation or warranty by the borrower that nothing has happened that has or will have a material adverse effect on the borrower's business, financial condition or ability to perform its obligations;

(ii) as an event of default if a material adverse change or effect occurs.

Both forms of MAC clauses will provide the lender with the option to recall the loan.

Triggering the MAC clause

Notwithstanding their insistence on having them, lenders are generally reluctant to rely on MAC clauses, leading an English lawyer to remark that "nobody ever really relies on them".[3]

If the MAC clause is invoked without proper justification, the lender will be in breach of contract and its reputation may also be affected. It is therefore unusual for MAC clauses to be the sole basis for a lender to accelerate the repayment of a loan. Almost invariably lenders will look for an alternative justification such as a separate event of default before recalling the loan.

A Malaysian case

In *Simpang Maju*,[4] the deceased had entered into an agreement with the plaintiff developer to purchase a house. The deceased had also obtained a loan from the third party bank to pay for part of the acquisition price. On 14 September 2012, the deceased had fulfilled all the conditions precedent for the loan by submitting the required documents to the bank. The deceased died 13 days after that. About one year later, the bank terminated the facility without having released the loan. When sued by the developer for payment, the deceased's estate joined the bank as third party, contending that the bank should have disbursed the loan sometime during the nine working days between the fulfilment of the conditions precedent and the death of the deceased.

The High Court held that there was no deliberate delay on the part of the bank in disbursing the loan, although it took nine working days for the documents to reach the officer in charge.[5] The Court of Appeal took a different view and

1 Franck Julien and Jean-Marc Lamontagne-Defriez, "Material Adverse Change and Syndicated Bank Financing: Part 1", Journal of International Banking Law and Regulation (2004) at 172

2 Travis Evens, "A Brief Overview of Material Adverse Change Clauses in Credit Documents", Gowling WLG (15 December 2016) <https://gowlingwlg.com/en/global/insights-resources/a-brief-overview-of-material-adverse-change-clauses-in-credit-documents> (accessed 15 October 2017)

3 Jo Windsor, "When Can a Material Adverse Change Clause be Relied On?", Journal of International Banking and Financial Law (1 September 2013) at 497

4 *Simpang Maju Enterprises Sdn Bhd v Soh Yen Ling (as administrator of the estate of Chan Yau Seng, deceased); Malayan Banking Bhd* (*Third Party*) [2017] 1 CLJ 588

5 *Ibid*

held that it was incumbent upon the bank to make sure that, once all conditions precedent were satisfied, prompt and timeous steps were taken for the disbursement of the loan. The bank had failed to account for its omission to disburse the loan during those nine working days.[6] The decision of the Court of Appeal is consistent with the axiomatic rule of law that a party cannot take advantage of its own wrong,[7] namely, the bank's internal procedural delay.

The MAC clause in *Simpang Maju* was in the following form:

> "Section 5.01 CONDITIONS PRECEDENT TO DRAWING
> The Borrower may not commence to make any Drawings on the Facility until the fulfilment in manner satisfactory to the Bank, prior to the first (1st) Drawdown date, of the following conditions precedents:
>
> ...
>
> "(e) the Bank is satisfied that as from the date when the Borrower first applied the Facility there have been no material adverse changes in the financial affairs of the Borrower which could or might adversely affect the decision of the Bank to proceed with or continue the Facility."

The High Court appears to have construed the death of the deceased primarily as an event of default and only secondarily as a material adverse change without further elaboration as to how it could amount to material adverse change:

> "Now, from these contractual clauses it is quite evident that the death of the deceased, the borrower, is an event of default. And in the event of a default occurring the third party is at liberty to withdraw and/or cancel the facility. Additionally, the death of the deceased is definitely a material adverse change in circumstances and in such an event it is open to the third party consider whether it wishes to continue with the agreement or to cancel it."[8]

The issue whether or not there was a material adverse change was not raised nor deliberated on appeal. In reversing the High Court's decision, the Court of Appeal ruled, *inter alia*, that:

(i) all conditions precedent having been satisfied prior to the death of the deceased, the loan should have been disbursed; and

(ii) the termination of the loan on the basis of the deceased death as an event of default was invalid since an event of default could not occur without the loan being first disbursed.

An English case

In the leading case in England on the subject, *Grupo*,[9] the defendant bank had lent monies to the plaintiff borrower to fund the completion of a hotel development project in London. The plaintiff had represented in the loan agreement that there has been no material adverse change in its financial condition since the date of the loan agreement. The defendant withheld funding on the basis that there had been such a change in respect of the plaintiff's financial condition as to amount to a material adverse change.

The defendant bank failed to establish that there was a material adverse change and the court held that:

6 *Soh Yen Ling (disaman sebagai Pentadbir harta pusaka Chan Yau Seng) v Malayan Banking Bhd* [2017] MLJU 842
7 *PL AR Arunasalan Chettiar & Ors v AR PL Palaniappa Chettiar* [1969] 1 MLJ 55
8 [2017] 1 CLJ 605
9 *Grupo Hotelero Urvasco SA v Carey Value Added SL and another* [2013] EWHC 1039 (Comm)

- The burden of proof lies on the lender to show that a material adverse change event has occurred;[10]

- The assessment of 'financial condition' should begin with financial information for the relevant period, but it is not limited to it if there are other compelling evidence such as the borrower's failure to meet other significant indebtedness;[11]

- Behavioural, economic and political conditions should not be considered unless expressly incorporated in the terms of the MAC clause;

- A change in financial condition is material only if it significantly affects the borrower's ability to repay the loan, or more generally, significantly increases the risk assumed by the lender;

- MAC clauses ought to protect the lender from unknown changes and, hence, those circumstances or events which are known to the lender when the loan agreement is entered into cannot lead to a material adverse change;[12]

- A material adverse change must not merely be temporary.[13]

Some drafting considerations

It is quite common to encounter MAC clauses that have been drafted subjectively, defining a material adverse change as a matter "in the sole opinion of the lender". It is unclear what effect can be given to such words as courts will be reluctant to accept an opinion of a lender which is not reasonably held or justifiable.

Many lenders would extend the scope of the material adverse change to include matters such as the borrower's "prospects" of the business. This may introduce such level of uncertainty that lenders would lack the confidence to rely on the clause and the court would be reluctant to uphold its validity.

Conclusion

The enforceability and the effectiveness of MAC clauses will depend on the facts of the particular case and also the scope of the clause. A well-drafted MAC clause may protect the lender from unanticipated adverse changes in the borrower's situation. However, due to the uncertainty associated with the validity and applicability of MAC clauses, most lenders will not exercise their rights to recall the loan solely on the basis of the MAC clause. It may be that MAC clauses continue to exist because "the main impact of the inclusion of such limitations is psychological as much as legal, reinforcing the belief that it is risky to rely on a material adverse change".[14] **LH-AG**

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10 *Ibid* at para 364
11 *Ibid*
12 *Ibid*
13 *Ibid* at para 363
14 Jo Windsor, *supra* n 3 at 499