Briefing

Corporate Turnaround and Insolvency

No MAC clauses - the new superhero?

No material adverse change (MAC) representations and events of default have customarily been drafted into loan agreements for many years. The final drafting is often the result of detailed negotiation about what constitutes a material adverse change and the metrics (e.g. prospects, borrower/group performance, financial condition, ability to repay the loan etc.) in respect of which a material adverse change should cause the loan to default. In practice, such clauses have rarely been relied on by lenders as the basis for demanding repayment and enforcing security due to the perceived subjectivity and therefore risk of enforcement action being challenged. Who wouldn't prefer to rely on an objective, clear cut repayment default or financial covenant breach if they could?

The recent case of *Grupo Hotelero Urvasco SA v Carey Value Added SL and another* examined the no MAC representation, together with an event of default provision triggered by an obligor beginning negotiations with another creditor to reschedule its indebtedness because of actual or anticipated financial difficulties - another little relied on provision due to its subjectivity and the difficulty to find evidence of a purported breach.

Background

The parties were two Spanish entities involved in the development of a hotel and apartments on the corner of Aldwych and the Strand in London. The site had been acquired by a subsidiary of GHU. Initially traditional bank funding was provided. However as a result of difficulties with that funding, Carey provided an additional loan to GHU to fund the development and expected to purchase the property once the development was completed. That loan was guaranteed by a third GHU group company. Carey stopped funding in June 2008 and work on the development stopped in September of the same year. GHU brought a claim for damages, alleging the fact that Carey had ceased making advances under the loan agreement was a breach of contract which caused the development to fail. The key question for the court therefore was whether there was a default under the loan agreement, giving Carey a contractual right to refuse to make further advances.

Carey's loan agreement contained a representation stating that there had been no material adverse change in the financial condition (consolidated if applicable) of GHU and its property owning subsidiary since a specified date. This representation was deemed to be repeated on each date a further tranche of the loan was drawn by reference to the circumstances existing at that time. In the normal way, if any representation made by GHU proved to have been materially untrue when it was made, an event of default under the loan agreement occurred.

The bank funding contained a provision stating that an event of default would occur if the guarantor or GHU began negotiations to reschedule their debts with any creditor due to the guarantor or GHU actually experiencing financial difficulties or anticipating them.

Carey claimed that defaults arose under both the "no MAC" representation and the "no debt rescheduling" event of default.

"No MAC" representation

When considering the "no MAC" representation given the particular facts of this case, the court set out four guidelines which will generally apply to most "no MAC" representations:

- Financial condition should be determined primarily by reference to a company's financial information although other compelling evidence may be considered.
- A change is only materially adverse if it affects a company's ability to perform its obligations under the relevant agreement.
- The lender cannot trigger an event of default on the basis of circumstances of which it was aware at the outset.
- A change must not be merely temporary.

These conclusions are common sense and are welcome. With the dearth of previous case law involving the interpretation of "material adverse change", drafting was gradually becoming more complex and time consuming to agree. It is helpful to have clarity that the common sense interpretation does not have to be painstakingly drafted into loan documents (with the attendant risks of getting the drafting failing to cover all bases).

"No debt rescheduling" event of default

The court held that the term "rescheduling" implies that there must be a degree of formality to the negotiations with creditors

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relating to the debt in question. It is more than a call or email to the lender sounding out the possibility of the borrower being given more time to pay. In this particular case, for an event of default to occur, the rescheduling was required to be "by reason of actual or anticipated financial difficulties" and this went beyond the ordinary course of business liquidity problems which the guarantor had faced for a number of years and which Carey was aware of prior to entering into its loan agreement with GHU. Changes in the general economic climate in 2007 changed the nature of the guarantor's negotiations with its creditors resulting in the occurrence of a "no debt rescheduling" event of default. Prior to this case there had been no judicial guidance on the interpretation of "rescheduling" so this is very welcome.

Practical implications

As there had been little or no previous case law concerning "no MAC" clauses and "no debt rescheduling" events of default this decision provides useful guidance on how those clauses should be interpreted and therefore when they could be relied upon by lenders. Whilst this judicial decision was arrived at in relation to particular facts and the particular drafting of the relevant loan provisions, it will be helpful for the majority of loans drafted with LMA based provisions of this nature.

This case does not make a superhero of "no MAC" or "no debt rescheduling" provisions. We won't see a run of defaults being called on the basis these provisions – the inherent subjectivity and problems in obtaining suitable evidence remain. However it may give lenders more confidence to call defaults (or at least use the threat of a default to get a borrower to the negotiating table) on the basis of "no MAC" or "no debt rescheduling" provisions, especially in relation to covenant-lite loans.

For IPs, no event of default should be "better" than any other. IPs, prior to be appointed under a security package would be wise always to obtain legal advice regarding the validity of the proposed appointment and that advice should consider, not only the validity of security documents, but also the lenders' view on the factual occurrence of the event of default. Lenders and IPs will be aligned in wanting to know a breach has occurred. Given subjectivity and evidential difficulties, lenders are unlikely to seek to rely upon where "no MAC" or "no debt rescheduling" provisions where a more clear cut event of default exists.

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