

Reprinted from the April 1998 issue

# INTERNATIONAL FINANCIAL LAW REVIEW

## **Does the crisis bring default under MAC clauses?**

*Asian crisis special*

By Richard M Gray of  
Milbank, Tweed, Hadley & McCloy, Singapore

---

Milbank, Tweed, Hadley & McCloy,  
#14-00 Caltex House,  
30 Raffles Place,  
Singapore 048622

Tel: +65 428 2400  
Fax: +65 428 2500

# Does the crisis bring default under MAC clauses?

After currency devaluation in Asia, lenders and borrowers are scrutinizing material adverse change (MAC) clauses to determine their respective positions. By Richard M Gray of Milbank, Tweed, Hadley & McCloy, Singapore

Representations by borrowers as to the absence of any material adverse change (MAC), and events of default triggered by the occurrence of any material adverse change, have a long history in cross-border financing documentation. Despite this history, the interpretation of MAC clauses remains rather indefinite. The recent currency devaluations and other macroeconomic events in parts of Asia have brought renewed attention to MAC clauses. Lenders seek to determine whether lending conditions have been satisfied; borrowers assess whether they are vulnerable to the termination or suspension of funding commitments; and all parties seek to ascertain whether an event of default exists.

## Defining the MAC clause

Because there are many variations of the MAC clause it is impossible to refer to any single standard formulation. However, two common examples of the MAC clause are:

- MAC representation — the borrower represents and warrants that there has been no material adverse change in its business, assets, operations, prospects or condition, financial or otherwise, since a specified date. By referring to factors specific to the borrower, it can test to see whether any of those factors have changed in a materially adverse way since the specific date (most often the date of the borrower's latest audited financial statements delivered before the signing of the financing documentation). Because a credit agreement typically requires as a borrowing condition that the representations made by the borrower, including the MAC representation, continue to be true, the borrower will not be entitled to borrow if a material adverse change has occurred. The MAC representation protects lenders by temporarily suspending their obligations to make additional loans as long as the adverse circumstances continue.
- MAC event of default — any event or circumstance that could reasonably be expected to materially and adversely affect the borrower's ability to perform its obligations under the financing documents. The MAC event of default can have more serious consequences for a borrower, because it permits lenders to terminate lending commitments permanently and to accelerate the maturity of loans. Unlike the MAC representation, it is not

typically drafted to focus only on factors specific to the borrower. However, the MAC event of default usually requires that the adverse event or circumstance affect the ability of the borrower to perform its obligations under the financing documents. In a project financing, these obligations may be read to include express covenants to adhere to an approved budget or to complete the project according to agreed specifications, in addition to the more obvious requirement to pay principal and interest when due.

**The recent currency devaluations and other macroeconomic events in parts of Asia have brought renewed attention to MAC clauses as all parties seek to ascertain whether an event of default exists**

The MAC clause can frequently bestow other rights on lenders and other burdens on borrowers beyond those relating to making or accelerating loans. In a project financing, for example, project completion (and the resulting termination of completion guarantees or other shareholder support, or the payment of completion-based fees to sponsors) might well be contingent on the continuing accuracy of representations and warranties and/or the absence of any event of default, including in each case any applicable MAC clause. Also, lenders would frequently be entitled to exercise remedies relating to project accounts or other collateral security if an event of default exists.

## Analyzing the language

The first step in determining whether a MAC clause applies in any specific case is to analyze the wording of the relevant provision. A poorly drafted provision or overly sparing language could have unfavourable consequences for lenders.

In *Mellon Bank v Aetna Business Credit*, 619 F2d 1001 (3rd Cir 1980), for example, Aetna's commitment to purchase a real estate construction loan stated that the borrowers "will furnish evidence satisfactory to [Aetna] at

## Asia in crisis

the date of funding that there has been no material adverse change in [the borrowers'] financial condition". After Aetna invoked the MAC clause on the basis of a decline in the real estate market, the court held Aetna liable for breach of contract, finding that the quoted provision constituted a covenant and not a condition precedent.

An ambiguous provision was also at issue in *Esplanade Oil & Gas v Templeton Energy Income*, 889 F2d 621 (5th Cir 1989), where an agreement to purchase oil and gas properties contained a condition precedent to the effect that "there shall occur no adverse material change to the Properties". After the buyer invoked the MAC clause because of a fall in world oil prices, the court applied a literal interpretation of the narrowly drafted clause. Noting that the definition of 'Properties' specified certain mineral leases and equipment, the court held that the MAC clause referred to the physical state of those properties, the validity of the leases and the seller's ownership interest in them, rather than to their value.

### **Whether or not a material adverse change has occurred is generally a factual determination. There can be no legal certainty as to whether any given set of circumstances will be determined to constitute a material adverse change**

An often-negotiated point in a MAC representation is whether it should refer to the subject company's 'prospects'. The absence of this reference may have been dispositive in *Pittsburgh Coke & Chemical v Bollo*, 421 F Supp 908 (EDNY 1976). Here, the buyer of a business sued the seller after the closing, alleging a breach of the following representation: "[Since] December 31 1967, there has been no material adverse change in the financial condition or in the business or operations of [Standard (the target of the acquisition)]." The basis of the allegation was Standard's failure to keep abreast of technological changes in the aviation industry, to which Standard was a parts distributor. Noting that technological changes had indeed occurred, the court nevertheless stated: "[To] say that these extrinsic developments constituted material adverse changes in Standard's existing business or financial condition is patently unreasonable."

Even where a MAC clause does not appear to be overly narrow, special circumstances may affect its interpretation or utility. For example, in *Wells Fargo Bank v US*, 26 Cl Ct 805 (Cl Ct 1992), the court held that the legislative policy of the government's guarantee programme to support ethanol production would be inconsistent with the application of a MAC clause to a decline in world oil prices. Another case apparently involving special circumstances is *Re JC's East*, 1995 US Dist LEXIS 13607 (SDNY 1995). Here, a lending commitment was negotiated during the pendency of the borrower's bankruptcy case. Influenced by circumstances

suggesting that the funding commitment was intended to be firm (including an affidavit from the lender), the court held that the MAC clause should not be applied to an event that could have been foreseen or guarded against. Finally, in *Sinclair Broadcast Group v Bank of Montreal*, 94 Civ 4677 (SDNY 1995), the court held that proof of the borrower's allegations that the lender knew at the time of entering into its loan commitment of the circumstances constituting a material adverse change, might be sufficient to eliminate the MAC clause as a defence to a breach of contract claim.

### **Analyzing the facts**

The second step in interpreting a MAC clause is to apply it to the facts at hand. Whether or not a material adverse change has occurred is generally a factual determination made by a jury or a judge acting as fact-finder. There can be no legal certainty as to whether any given set of circumstances will be determined to constitute a material adverse change. Hence the reluctance of most lawyers to express a legal opinion on whether or not a material adverse change has occurred. It should also be noted that whenever a material question of fact is at issue in litigation, the case will not be disposed of at an early stage by dismissal or summary judgment. Unless the parties settle the dispute, the case will advance to trial in a proceeding that may be expensive and time-consuming.

*Pan Am Corporation v Delta Air Lines Inc*, 175 BR (Bankr SDNY 1994) provides a useful guide to relevant factors in determining the occurrence of a material adverse change. During the bankruptcy case for Pan Am, Delta and Pan Am entered into negotiations for Delta's investment in Pan Am II (the proposed survivor of Pan Am following the contemplated reorganization). A condition of the investment was that there be "no material adverse change in the business, financial position, results of operations or prospects of [Pan Am or Pan Am II]". Before closing, passenger sales declined, expenses increased and revenue forecasts plummeted. The court found that these results reflected a material adverse change. The principal factors taken into account by the court were the financial projections contained in the Pan Am II business plan, which was revised to reflect increasing expenses and deteriorating sales revenues in key commercial markets. The revisions showed a funding gap of US\$75 million to reach an acceptable liquidity level.

The court's recognition of the distinction between actual results and revised projections contrasts with the analysis of the court in the *Pittsburgh Coke* case, and underscores the importance to lenders of including (and the desire of debtors to exclude) in a MAC clause forward-looking language, such as a reference to a borrower's 'prospects' or a borrower's ability to perform future obligations.

In interpreting a MAC clause in the context of the Asian financial crisis, a distinction needs to be drawn

between external events and circumstances that have a material adverse effect on an industry or a local economy generally, and those that have a material adverse effect on a borrower specifically. An external force like a currency crisis is unlikely to be regarded as resulting in a material adverse change unless it can be shown that the crisis directly affects a borrower, as reflected in income statements, balance sheets, business plans and expense, sales and revenue projections. For these reasons, analysis of whether a material adverse change has occurred may well vary from one company to another, even within the same country.

For example, the impact of these macroeconomic events may be different for:

- a telecommunications company with primarily foreign currency debt and local currency, consumer-based revenues;
- a mining venture that produces minerals to be sold for US dollars in the international markets; and
- a power project with US dollar debt and US dollar revenues where there is uncertainty about whether the local offtaker will comply with its obligations under the power purchase agreement.

#### Applying the MAC clause in uncertain circumstances

The primary risk borne by lenders who incorrectly invoke a MAC clause is liability for damages suffered by the borrower. Whether or not they acted in the good faith belief that a material adverse change had occurred may not be a defence. It is thus incumbent on lenders deciding whether to invoke a MAC clause in uncertain circumstances to consider the impact on the borrower, and therefore their potential liability.

The most potentially serious remedy is terminating lending commitments and accelerating loans. These actions could trigger cross-default provisions in other financings and result in a bankruptcy of the borrower, with potential liability for the loss of its going-concern value. Suspending loans temporarily could also result in the failure of a business enterprise if funds were necessary to maintain operations. However, in light of a borrower's legal obligation to mitigate damages, this is unlikely to happen where there are remedies such as using cash in hand, reducing expenses, deferring construction activities, curtailing capital expenditures and seeking other sources of funds. In this case, damages might be foregone business opportunities or the increased cost of alternative funding. The above remedies, arising for instance from failure of project completion, might result in less liability. For example, the refusal to terminate a completion guarantee might simply result in the guarantee being declared invalid in an enforcement proceeding, and the refusal to release a completion-based fee to a sponsor might result in liability for the time-value of money until the fee is released.

Uncertainty as to whether a material adverse change has occurred is more often than not a strong incentive for borrowers and lenders to reach an understanding rather than to seek judicial redress. A protracted legal proceeding is not in the borrower's interests, who may have difficulty maintaining its operations while funding is held up and/or its debts have been accelerated. For the lenders, an incorrect determination under some circumstances could result in a large damage award.

#### **The primary risk borne by lenders who incorrectly invoke a MAC clause is liability for damages suffered by the borrower. Whether or not they acted in good faith may not be a defence**

However, when a mutual understanding cannot be achieved, lenders would be advised to take the following steps before acting on their determination that a material adverse change has occurred:

- consider whether the same result can be achieved by identifying a more certain breach of representation or event of default;
- if a more certain breach of representation or event of default cannot be identified, analyze the wording of the MAC clause to determine whether it is sufficiently broad to cover the perceived material adverse change. See whether it includes a reference to the borrower's 'prospects' or contains other forward-looking language;
- consider whether the lenders have engaged in any misconduct that a borrower could successfully argue should stop them from relying on the MAC clause. For example, the lenders' knowledge of the material adverse change when making the lending commitment or the lenders' wrongful contribution to the occurrence of the material adverse change;
- analyze and document the determination that a material adverse change has occurred. In the case of macroeconomic events in certain parts of Asia, the currency devaluation and the resulting increase in debt and imported goods and supply costs, coupled with the declining purchasing power of a borrower's customer base, should be reflected in expense, sales and revenue projections forming the basis of a revised business plan. Revision of these indicators can undermine a borrower's future prospects and jeopardize its performance of obligations under financing documents, constituting the kind of change considered likely to have material adverse effect;
- consider the possible liability of an incorrect determination by reference to the anticipated damages suffered by the borrower as a result of the action taken by the lenders. □