Why banks should look at market flex and MAC clauses

During extraordinary events banks must trust to material adverse change clauses to protect themselves from unforeseen risk. Patrick Holmes, Kevn Muzilla and Richard Gray of Milbank Tweed Hadley & McCloy examine the relative merits of these different agreements

Given the current volatility of the markets and general political uncertainties, perhaps more than ever both the commercial banks that provide underwritten commitments for commercial loans and the borrowers to which those commitments are made need to consider the clauses in commitment papers that allocate syndication risk. Underwriting banks are facing increased risks in making financing commitments because of the current disruption in the syndicated loan markets and need to mitigate those risks; borrowers, often in response to seller or stock listing requirements, need firm underwriting commitments to finance competitive bids for acquisitions or in the context of privatization transactions. The allocation of the syndication risk must achieve a balance between these conflicting needs.

This article explores the market flex clauses that give underwriting banks the flexibility to change the price, terms and/or structure of a loan commitment, potential issues relating to the ability of underwriting banks to invoke a traditional material adverse change (MAC) clause to terminate a loan commitment based on external events which indirectly affect a borrower and market MAC clauses that give underwriting banks the ability to terminate a commitment on the basis of material adverse changes in the financial markets.

The market flex clause

The market flex clause first made its appearance in late 1998 in response to the Russian debt crisis. The provision, which now has become commonplace in loan commitment letters, specifically allows underwriting banks to restructure the pricing, structure and/or terms of a committed loan to the extent necessary to ensure a successful syndication. Before the advent of the clause, underwriting banks would commit to a financing, including its pricing and its covenant package, well before closing, thereby assuming all the risk of changes in market conditions. The introduction of the market flex clause shifted this risk to the borrower.

Market flex as a tool has been used to reprice transactions in the light of investor reaction to the credit. It has thus brought the loan market closer to the underwritten bond market where the bond underwriters commit to bring an issuer to market on the basis of the pricing (and often the covenants and structure) prevailing in the market for comparable credits on the date of issue. The use of the clause is now prevalent across all debt products, although perhaps with more focus in relation to lower grade credits or structured transactions where market reaction is less easily predicted.

The following is an example of the sort of market flex clause that an underwriting bank might include in its loan documentation:

"Before the close of syndication, the underwriting banks shall be entitled to change the pricing, structure, tranches or terms of the facilities (otherwise than by reducing the total amount of the facilities) if, having regard to the then prevailing conditions in the domestic and/or international financial markets, they determine that such changes are advisable in order to ensure a successful syndication of the facilities."

Because what a court may determine is, in the final analysis, unpredictable, it can be difficult to be certain whether a specific set of circumstances will in fact constitute a material adverse change

The clause itself will not necessarily be found in the commitment or underwriting letter, sometimes being included in the fee letter. Moreover, the provision will often survive the signing of the definitive credit documentation as syndication may well be planned to continue for a period after the signing.

In negotiating market flex clauses, a borrower will want both to preserve the optimal structure for its loan and to minimize the risk of an increase in pricing. Limiting the scope of the clause so that the underwriting banks can only increase the margin and/or their fees (and capping the amount of any such increase) clearly achieves both these objectives but is unlikely to provide the underwriting banks with the flexibility which they require. If this is the case, the solution may be to exclude changes to certain elements of the structure or covenant package or limit changes to particular items, for example by defining the extent to which

tranches may be increased or reduced or by specifying the particular covenants which are subject to change (and then limiting the extent of those changes).

In highly leveraged transactions, where there is likely to be a need for more extensive structural changes, misunderstandings between the borrower and the underwriting banks can be avoided by ensuring that the market flex clauses are more specific in describing the way in which the transaction might be restructured, for example by reference to the inclusion of different pricing options such as call protection and rate floors or the introduction of subordinated or senior levels of debt and securitizations.

A general market MAC clause may not provide the banks with sufficient protection. Banks should be considering amplifying their market MAC clauses to make reference to the specific external events which are of current concern to them

The extent to which successful syndication needs to be defined will depend on the particular transaction, but some degree of objectivity (for example, by reference to a final hold position for the underwriting banks and a specific period of time) will be helpful in all cases. However, although a test that is triggered if a loan does not achieve a minimum credit rating or if there are too many competing syndications in the relevant market may suit some transactions, a better approach in others may be simply to call for a pre-agreed period of consultation with the borrower before changes are introduced.

Issues with traditional MACs

There may be events of such significance that the flexibility to reopen key terms does not provide the underwriting banks with the protection that they need, that protection being the right to terminate their commitments completely. Lenders have long relied on traditional MAC clauses allowing cancellation of their commitments if, for example, after a particular date "there is a material adverse change in the condition (financial or otherwise), results, prospects, operations, liabilities or business of the borrower".

Although there is ample legal support for the proposition that the traditional MAC is enforceable under New York and English law, the authority suggests that there can be problems when they are applied to external or political events. The question of whether a material adverse change such as contemplated by the language quoted in the preceding paragraph has occurred is a question of fact that ultimately must be determined by a court. Further, even where a clause appears to give the underwriting banks an absolute discretion to determine whether a material adverse change has occurred, a court would be unlikely to uphold a determination made otherwise than in demonstrable good faith and may even go so far as to require that the determination be a reasonable one. Because what a court may determine is, in the final analysis, unpredictable, it can be difficult to be certain whether a specific set of circumstances will in fact constitute a material adverse change.

In addition, case law underscores the additional risks to which underwriting banks are subject when they rely on a traditional MAC clause in the context of external events. One oft-negotiated point in a traditional MAC clause is whether it should refer to the borrower's prospects. The absence of such a reference may be conclusive where a traditional MAC clause is being relied upon because of the impact of external or political events. For example, in the 1976 case of *Pittsburgh Coke & Chemical v Bollo*, a dispute involving a traditional MAC provision in an acquisition context, the buyer of the business sued the seller, 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 buyer's allegation was that Standard, a parts distributor to the aviation industry, had failed to keep abreast of technological changes in the aviation industry and by such failure had impaired its future trading prospects. Although the court noted that technological changes had indeed occurred, it nevertheless went on to state: "[To] say that these extrinsic developments constituted material adverse changes in Standard's existing business or financial condition is patently unreasonable".

It is also the case that, if a borrower has disclosed the potential ramifications of a particular event, an underwriting bank concerned about the event may have trouble relying on a traditional MAC clause to terminate its commitment even where the clause contemplates changes to the borrower's prospects. In the 2001 *IBP, Shareholders Litigation v Tyson Foods* case, the court held that a MAC clause included in proposed merger transaction documents was not triggered by an SEC requirement for a restatement of IBP's financial statements because IBP had disclosed the problem that gave rise to the requirement. The Tyson case makes it clear that an underwriting bank concerned about a particular event or problem should ensure that it is specifically dealt with in the MAC clause or in the definition of material adverse change.

Similarly, it may be difficult for an underwriting bank to rely on a traditional MAC clause to terminate a loan commitment if external economic or political events were likely to occur (or had begun to occur) at the time the commitment was undertaken. In the 1995 case of *Re JC's East*, 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, the court held that the traditional MAC clause should not be applied to an event that could have been foreseen or guarded against. In much the same vein, the court in the 1994 case of *Sinclair Broadcast Group v Bank of Montreal* held that proof that a lender had knowledge of the circumstances constituting a material adverse change at the time of the lender's commitment might be sufficient to preclude it from relying on a traditional MAC clause as a defence to a claim for breach of contract.

Similar conclusions were reached in England when the Panel on Takeovers and Mergers of the London Stock Exchange, in a panel statement issued in November 2001, reviewed whether the

terrorist events which had occurred in the United States on September 11 2001 were sufficient to invoke a traditional MAC clause in connection with a proposed acquisition by WPP Group of Tempus Group. Tempus claimed that the events of September 11 were exceptional and unforeseeable and had a material adverse effect on WPP's prospects. After analysing the traditional MAC clause, the Panel concluded that the events did not meet the degree of materiality required to constitute a material adverse change in WPP's longer term prospects.

The primary risk to the underwriting banks in incorrectly invoking a traditional MAC clause is being held liable for damages suffered by the borrower as a result. The fact that in invoking the clause the underwriting banks acted with a good faith belief that a material adverse change had occurred may not of itself be a defence. It is thus incumbent on underwriting banks deciding whether to invoke the clause in uncertain circumstances to consider the impact of their decision on the borrower (and therefore their potential liability).

In the worst case, if the funds committed by an underwriting bank were necessary to maintain a borrower's operations, termination of a commitment to lend could result in a borrower's bankruptcy or the failure of a particular business enterprise, giving rise to potential liability for the loss of its going–concern value. However, in such a situation a borrower would have a duty to mitigate its losses (for example by using cash in hand, reducing expenses, deferring activities, curtailing capital expenditures and seeking other sources of funds) with the result that the underwriting bank's might be liable for foregone business opportunities or the increased cost of alternative funding.

The market MAC clause

Underwriting banks wishing to reduce the risk that they will be unable to syndicate their commitments even after pricing and other changes have been introduced may want to consider a market MAC clause. A recent example of a general market MAC clause is:

"Prior to the completion of the syndication, the underwriting banks may terminate their commitment, if, in the sole judgment of the underwriting banks, there is a material adverse change in the domestic or international money, debt or capital markets which might, in the opinion of the underwriting banks, materially and adversely affect their ability to syndicate the facility."

The issues relevant in the analysis of traditional MAC clauses will also be relevant to the analysis of such a market MAC clause. In the current context of substantial market dislocation and rapidly unfolding geo-political events, the lesson to be taken from Tyson and WPP is of particular relevance because underwriting banks run the risk that a court could conclude that the consequences of those events are foreseeable, with the result that a general market MAC clause may not provide the banks with sufficient protection. Banks should thus be considering amplifying their market MAC clauses to make reference to the specific external events which are of current concern to them. At the same time, and bearing in mind the needs of their borrowers, they should also be seeking to ensure that upon the occurrence of those events their market MAC clauses lead to the most appropriate consequence, whether that be an entitlement to cancel their commitments altogether or merely a right to invoke a market flex provision.

The negotiation of market flex and MAC clauses will naturally be troubling to both parties. Given the extraordinary economic and political changes affecting the environment in which underwriting banks operate, the availability of market flex and market MAC clauses may provide an attractive alternative to both parties to manage the risks that flow from extraordinary events and ensure that underwriting banks are able to continue to approve the extension of commitments in uncertain times. It is too early to see how the market for these type of clauses will develop. In the meantime, both underwriting banks and borrowers need to go into transactions with their eyes open. ▮