DOES THE MAC HAVE YOUR BACK? THE USE OF MATERIAL ADVERSE CHANGE CLAUSES IN CANADIAN LOAN AGREEMENTS

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Material adverse change ("**MAC**") clauses are routinely inserted into loan agreements by lenders. However, the practical effects of enforcing a MAC clause in the context of a loan financing remain uncertain. In this bulletin, we summarize the current case law with respect to MAC clauses, borrowing from developments in the United States and the United Kingdom, and provide some practice pointers for drafting MAC clauses in loan agreements.

1. What is a MAC Clause?

In loan agreements, a standard MAC clause describes an event, whether general or particular, that prevents the borrower from being able to meet its obligations. In a typical loan agreement, a MAC can be stated as (i) a condition precedent to closing, or (ii) an event of default, in each case, the MAC being determined at the lender's discretion, and/or (iii) a representation of the borrower, which is determined by the borrower. Declaring a MAC gives the lender certain rights, which can include demanding repayment of the loan. As a result, MAC clauses have the potential to offer significant protection to lenders and are carefully negotiated during the drafting phase of most loan agreements. While lenders tend to prefer broadly-worded MAC clauses, borrowers try to negotiate narrowly-worded MAC clauses with many exclusions. Case law with respect to MAC clauses, however, is sparse and sometimes conflicting, which raises concerns for lenders about their ability to rely on MAC clauses to protect their interests. As discussed below, the way a MAC clause is phrased can have a profound effect on a court's interpretation of whether a MAC has actually occurred.

2. Canadian Case Law

The British Columbia Supreme Court's decision in *Doman Forest Products Ltd. v. GMAC Commercial Credit Corp. ("**Doman Forest**")*[1] is the only Canadian case that has interpreted a MAC clause in the financing context. In this case, a MAC, in relation to an event of default, was defined as:

> [A] material adverse effect, as determined by Lender in its sole discretion, on, as the case may be, (a) the condition (financial or otherwise), operations, assets, business or prospects of [Doman Industries Limited] on a consolidated basis, (b) Borrower's ability to pay the Obligations in accordance with the terms

thereof, (c) the Collateral, the Liens on the Collateral or the priority of any such Liens, or (d) the practical realization of the benefits of Lender's rights and remedies under this Agreement and/or the Ancillary Agreements.[2]

The court considered whether the borrower's serious financial setbacks, which worsened after the US government imposed a softwood lumber duty, constituted a MAC, despite the cyclical nature of the borrower's business. In finding that it was open for the lender to declare a MAC, the court provided certain guiding principles for analyzing and drafting MAC clauses.

First, the court stated that because the MAC clause left the determination of a MAC to the lender, in its sole discretion, the standard of materiality is that of the particular lender in its discretion rather than "the objective standard of a reasonable lender in [the same] circumstances."[3] However, the court did note that the lender's discretion has to be "exercised reasonably and be based on *bona fide* considerations."[4] Second, the court held that prior knowledge of the borrower's financial problems (which were known to the lender before execution of the loan agreement and supported through the financial covenant to provide future financial statements) does not preclude a MAC because what matters is whether the financial problems accumulate over time, until they become "material".[5] The court noted that the definition of material adverse effect was broadly defined to include the financial condition of the borrower and looked to the financial results, in particular the earnings before interest, taxes, depreciation and amortization ("EBITDA"), of the borrower to determine its financial condition, despite the fact that the loan was secured by accounts receivables and did not contain a financial covenant requiring the borrower to maintain a certain EBITDA ratio. Thus, the court found that the financial results of a borrower can be an "important indicator"[6] of the borrower's financial condition, even where the advance of a loan itself does not rely on them. Lastly, as the imposition of a softwood lumber duty on the borrower was a major contributing factor in its deteriorating financial condition, the case suggests that events not within the borrower's control can constitute a MAC.

Canadian courts have also considered MAC clauses in the context of mergers and acquisitions ("M&As").[7] In these cases, the MAC clause generally states that, as of a certain date, there has been no material adverse change in the financial condition of the target company. These clauses are representations of the target company and so are not stipulated to be at the purchaser/lender's discretion, unlike in *Doman Forest*.

Nevertheless, certain key principles can be extracted from the Canadian M&A cases. First, materiality should be assessed by analyzing the context of the "particular circumstances" reasonably expected to influence the decision of the particular purchaser to complete the purchase.[8] This is similar to *Doman Forest*. Second, in transactions between sophisticated parties, such parties may want to proceed with a transaction despite knowing of problems in a target's financial condition, in which case such knowledge would preclude a finding of a material adverse change.[9] This is not consistent with *Doman Forest*, but should nevertheless be taken as

a warning that knowledge of the borrower's financial problems at the time that the loan agreement is signed may make it more difficult for a lender to prove a MAC. Third, external events not within a target's control can be MACs, so long as the MAC clause is not specifically limited to internal events, which is consistent with Doman Forest.[10]

3. US Case Law

The leading cases on MAC clauses in the US appear in the context of M&As. Unlike in Canada, the courts in the US have adopted a very high standard of materiality. Purchasers face "a nearly insurmountable burden" in persuading the court that a MAC has occurred.[11]

In *IBP, Inc. v. Tyson Foods Inc. ("**IBP**")*,[12] which dealt with the acquisition of a beef and pork distributor, the target company gave a representation that there was no MAC, which was defined as "any event, occurrence or development of circumstances or facts which has had or reasonably could be expected to have a Material Adverse Effect…on the condition (financial or otherwise), business, assets, liabilities or results of operations of [IBP] and [its] Subsidiaries taken as a whole."[13] In denying the acquirer's claim, the court held that although the target had failed to meet its projected earnings for a quarter, its business was subject to the cyclical nature of the beef industry and thus a more long term standard of materiality was required. The court adopted a standard of materiality that only considered "the longer-term perspective of a reasonable acquirer."[14] The court held that a MAC clause protects the acquirer from unknown events and not events that are known to it. It specifically referenced the fact that while some MAC clauses refer to "declines in the overall economy or the relevant industry sector" the one in this instance did not.[15] One of the factors that the court considered in making its decision was that the acquirer, in its public statements with respect to the termination of the purchase agreement, did not state that a MAC had occurred. The court's decision in *IBP* was affirmed in three subsequent cases in the US.[16]

4. UK Case Law

There are two leading cases in the UK on MAC clauses in the financing context. In the first case, *Grupo Hotelero Urvasco SA v. Carey Value Added SL and Another ("**Grupo**")*,[17] the UK court used reasoning similar to that of the US courts described above, citing IBP in its decision, and therefore, applied a high standard of materiality when interpreting a MAC clause. The MAC clause was a representation of the borrower which stated that "there has been no material adverse change in [the borrower's] financial condition (consolidated if applicable)" since an applicable date. [18] The court identified several guiding principles for analyzing MAC clauses: (i) to find a MAC, there must be a significant effect on the borrower's ability to perform its obligations, and "in particular its ability to repay the loan";[19] (ii) the term "financial condition" is in itself limited in time and scope, and excludes the borrower's prospects and "external economic or market changes";[20] (iii) if the lender has

knowledge of circumstances relating to the MAC at the time the loan is made, it should not be able to rely on the MAC clause; and (iv) any material adverse changes must be long-term and not temporary. The court carefully examined the structure of the MAC clause and pointed out that the insertion of the words "consolidated if applicable" is a direct reference to the borrower's financial statements. Accordingly, the financial condition of the borrower should be determined from the financial statements – otherwise, the enquiry "becomes wide ranging and imprecise."[21] The court, however, noted that there are other factors to consider as well, such as the borrower's inability to pay its debts.

In the second case, *Cukurova Finance International Limited and Another v. Alfa Telecom Turkey Limited*,[22] a facility agreement provided that an event of default was "any event or circumstance which in the opinion of [the lender] has had or is reasonably likely to have a material adverse effect on the financial condition, assets or business of [the borrower]."[23] A large arbitration award was made against the borrower and the lender sought to enforce the MAC clause. The court held that a lender has to believe there to be an adverse effect, however, there does not actually have to be such an adverse effect. According to the court, the MAC clause entitled the lender "to be a judge in its own cause on the issue of whether the MAC clause is satisfied."[24] Nevertheless, the court has to be convinced that the lender did in fact form such an opinion and that this opinion was "honest and rational".[25] This mirrors the court's findings in *Doman Forest*.

5. A Specific Example of a MAC: Economic Downturns and the Vote for Brexit – Do these Constitute a MAC?

The controversial nature of MAC clauses is highlighted by recent events in Great Britain: the vote in support of "Brexit" reopened a discussion about whether a volatile economy or profound economic event could constitute a MAC. In general terms, legal practitioners in the UK appear to be largely of the view that the vote for Brexit does not represent a MAC. In the context of M&As, one US scholar has argued that an economic crisis should not constitute a MAC; instead, MAC clauses should specifically exclude economic downturns.[26] Moreover, he argues that (i) courts in the US rightly interpret MAC clauses in favour of the seller of a company, rather than the purchaser and (ii) this trend is supported by risk allocation considerations and the other options that purchasers have to end the deal.[27] This view is further supported in Grupo, in which the court specifically stated that the term "financial condition" in a MAC clause does not include an economic crisis (see discussion of this case in Part 4 above).[28] Therefore, an economic crisis in and of itself is unlikely to sway a court any more than other factors the court will consider when interpreting a MAC clause. In our view, in the Canadian context, the focus of a MAC clause should rather be on the specific effects of an economic crisis on the borrower, such as a change in the financial condition or results of operation of the borrower. Specifically including (rather than excluding, as is normally done) economic downturns in MAC clauses is another strategy,

albeit one that (i) has not been tested in the courts and (ii) may be difficult to negotiate.

6. Does a MAC Clause Protect Lenders' Interests?

While there is a paucity of case law with respect to MAC clauses,[29] general principles gleaned from existing cases offer insight as to how parties to loan agreements can best protect their respective interests. Keeping in mind that MAC clauses are context-dependent and that there is no one ideal MAC clause for every loan agreement, the following are a few pointers for lenders to consider when drafting a MAC clause: (i) lenders should carefully consider whether to include a MAC as an event of default or as a representation of the borrower (or both), as the case law points to higher success for lenders in defending a MAC when the MAC is an event of default rather than a representation; (ii) lenders should incorporate language to the effect that a MAC which results in an event of default is determined at the discretion of the lenders; (iii) a MAC should be broadly defined and if there are certain changes or events that lenders want to constitute a MAC, these should be specified; (iv) courts may interpret the term financial condition broadly or narrowly, therefore, if a lender would like the court to rely on a specific item to determine the financial condition of the borrower, the term "financial condition" should be defined in the loan agreement; caution is advised, however, against drafting such definition too narrowly; and (v) lenders should consider including in a MAC clause short-term effects on the borrower's business and financial condition, to avoid a court finding that the MAC clause only applies to long-term effects, especially where the borrower's business is subject to cyclical changes.

Additionally, when deciding to declare a MAC, lenders should keep detailed records about how they came to their decision. Moreover, if the borrower discloses information, such as financial information related to its business operations and results, the lender needs to carefully analyze such information. Otherwise, a court may find that the lender had knowledge of a certain condition, which could preclude the finding of a MAC.

We await further clarification on MAC clauses by the Canadian, US and UK courts. In the meantime, lenders should use caution when relying or planning to rely on MAC clauses to demand the repayment of a loan. MAC clauses and the events leading up to the MAC are carefully scrutinized by the courts. Lenders should therefore take care to have other robust protections built into loan agreements[30] so as to ensure that their right to declare an event of default and to accelerate a loan is protected.

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[1] 2005 BCSC 774, aff'd 2007 BCCA 88, 2007.[ps2id id='1' target='/]
[2] *Ibid*. at para. 28.[ps2id id='2' target='/]
[3] *Ibid*. at para. 159.[ps2id id='3' target='/]
[4] *Ibid*.[ps2id id='4' target='/]
[5] *Ibid*. at para. 140.[ps2id id='5' target='/]

[6] *Ibid*. at para. 132.[ps2id id='6' target='/]
[7] See: *Consumers Glass Co. v. D'Aragon*, 1979 CarswellOnt 151, 6 B.L.R. 114 (Ont. SC) ["***Consumers Glass***"]; *Cariboo Redi-Mix & Contracting Ltd. v. Barcelo*, 1991 CarswellBC 2263, [1991] B.C.J. No. 2038 (BCSC) ["Cariboo"]; *Mull v. Dynacare Inc*., [1998] O.J. No. 4006, 77 O.T.C. 81 (OCJ) ["***Dynacare***"]; and *Inmet Mining Corporation v. Homestake Canada Inc*., 2002 BCSC 61, 2002 CarswellBC 53, revers'd on other grounds 2003 BCCA 610, 2003 CarswellBC 2792 ["***Inmet***"].[ps2id id='7' target='/]
[8] Consumers Glass, *ibid*. at para 60.[ps2id id='8' target='/]
[9] See *Consumers Glass*, *Cariboo* and *Inmet, supra*. note 7.[ps2id id='9' target='/]
[10] See *Dynacare, supra*, note 7.[ps2id id='10' target='/]
[11] Lindsay Edelstein, "Big Macs: Not-So-Happy Deals and the Eurozone Crisis," Cardozo J. Int'l & Comp. L. 595 2013-2014 at 598.[ps2id id='11' target='/]
[12] 789 A.2d 14 (2001).[ps2id id='12' target='/]
[13] *Ibid*. at para. 65.[ps2id id='13' target='/]
[14] *Ibid*. at para. 68.[ps2id id='14' target='/]
[15] *Ibid*. at para. 66.[ps2id id='15' target='/]
[16] See *Frontier Oil Corp. v. Holly Corp*., 2005 WL 1039027; *Hexion Specialty Chemicals, Inc. v. Huntsman Corp*., 965 A.2d 715 (2008); *Luxco, Inc. v. Jim Beam Brands, Co*., 2016 WL 3136917.[ps2id id='16' target='/]
[17] [2013] EWHC 1039.[ps2id id='17' target='/]
[18] *Ibid*. at para. 326.[ps2id id='18' target='/]
[19] *Ibid*. at para. 357.[ps2id id='19' target='/]
[20] *Ibid*. at para 348.[ps2id id='20' target='/]
[21] *Ibid*. at para. 351.[ps2id id='21' target='/]
[22] [2013] UKPC 2.[ps2id id='22' target='/]
[23] *Ibid*. at para. 12.[ps2id id='23' target='/]
[24] *Ibid*. at para. 55.[ps2id id='24' target='/]
[25] *Ibid*.[ps2id id='25' target='/]
[26] David Cheng, "Interpretation of Material Adverse Change Clauses in an Adverse Economy," at 2009 Colum. Bus. L. Rev. 564 at 567.[ps2id id='26' target='/]
[27] *Supra*. at 584 and 599-603.[ps2id id='27' target='/]
[28] *Supra*. note 17 at para. 348.[ps2id id='28' target='/]
[29] Note that the sparse case law may actually point to the success of MAC clauses, since the majority may be settled out of court. See discussion in David Cheng's article "Interpretation of Material Adverse Change Clauses in an Adverse Economy," supra, note 26, at 604.[ps2id id='29' target='/]
[30] See, for example, Michelle Shenker Garrett's article arguing for the use of reverse termination fees in place

of MAC clauses in the M&A context, given the uncertainty of MAC clauses: “Efficiency and Certainty in Uncertain Times: The Material Adverse Change Clause Revisited,” at 2010 Colum. Journal of Law and Social Problems v. 43 No. 3.[ps2id id='30' target='/]

A Cautionary Note

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.