The Material Adverse Change Clause

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Útdráttur

Viðfangsefni ritgerðarinnar er gjaldfellingarákvæði sem er algengt í flestum stórum fjármálasamningum, eða „Material Adverse Change clause“ skammstafað MAC. Þetta er ákvæði sem lánveitendur leggja mikla áherslu á að sé í samningunum í þeirri trú að það „grípi“ vanefndir lántaka sem önnur vanefndarákvæði í samningnum ná ekki yfir, eða einskonar „nær öllu“-ákvæði eins og það hefur verið nefnt. Með því að „ná“ viðkomandi vanefnd á lánveitandinn þann valkost að virkja MAC-ákvæðið og gjaldfella lánið eða samninginn. En grundvallarspurningin er: Virkar þetta?

Að nokkru mun ritgerðin horfa til MAC-ákvæða í LMA-stöðluðum lánasamningum en allir samningar sem innihalda MAC-ákvæði eru til umfjöllunar, þar með taldir samruna- og yfirtökusamningar (M&A). Skoðaðar verða nokkrar skilgreiningar á MAC og dæmigerðum ákvæðum, hvernig ákvæðið er samið, hvernig það er virkjað og hvernig nýleg fjármálakreppa hefur haft áhrif á ákvæðið. Var það almennt virkjað í kreppunni og ef svo var, endaði það fyrir dómstólum og hver var útkoman?

Annað markmið ritgerðarinnar var að finna út hvort hefðbundið MAC-ákvæði væri í lánasamningum sem íslensku bankarnir og stórfyrirtæki eru með á sínum lánum. Hvernig fór ákvæðið inn í samninginn og hvernig voru samningaviðræðurnar með tilliti til þeirra? Og ekki síst, virkjuðu lánveitendur MAC-ákvæðin í fjármálakreppunni á Íslandi á síðustu tveimur árum og hvernig var ferillinn?

Að lokum safnar höfundur saman lista yfir ýmsar ábendingar varðandi framtíð MAC-ákvæða í fjármálasamningum. En megin niðurstaðan er að hið dæmigerða MAC-ákvæði veitir ekki þá vörn sem lánveitendur telja að það veiti.

The Material Adverse Change Clause

Abstract

The subject of this thesis is the default clause which is common in most large financial agreements, the Material Adverse Change clause (MAC). It is a clause that lenders generally insist on including in the loan agreements believing that it will catch defaults of the borrower which are missed by all the other default provisions in the agreement, or „catch all“ clause as it has been called. By catching the default the lender has the option to activate the MAC clause and accelerate the loan or the agreement. But the fundamental question is; is it working?

The thesis will to some extent concentrate on MACs in LMA standard loan agreements but all larger agreements containing MAC clauses are under research including merger and acqusition agreements (M&A). In the process some definitions and typical samples of MAC clauses are looked at, how are they drafted, how are they activated and how has the recent financial crises affected the clause. Was it invoked all over during the crisis and if so, was it challenged in court and what was the outcome?

Another aim of the thesis was to find out if the typical MAC clause is used in loan facilities which Icelandic banks and corporations have taken. How did it get into the facilities and how was the negotiation process in regards to them? And not least, did lenders invoke the MAC clause during the financial crisis in Iceland in the last two years and what was the process?

Finally, based on the subject covered the author collects and lists some recommendations regarding the future of MAC clauses in financial facilities. But the basic conclusion is that the typical MAC clause as such does not fulfil the security function the lenders believe it does.

Contents

Introduction

The subject of this thesis is the default clause which is common in most large financial agreements, 'the Material Adverse Change clause' (MAC). The concept of the MAC clause, is commonly a part of Events of Default sections of most financial agreements in the world, especially loan agreements and merger and acquisition agreements (M&A). The first intention with this thesis was to concentrate only on MAC clauses in standardised loan agreements[1] and particularly on LMA facilities.[2] But in the research process it turned out that it would limit the scope of the thesis too much, so it was decided to look at MAC clauses in standard loan agreements in general along with M&A agreements. The fundamental question is if the Material Adverse Change clause is working as such in financial agreements and then how? The MAC clause is intentionally included in those agreements in order to catch default events that other acceleration provisions do not catch and upon default, the lenders have the option to accelerate the facility. Different types of MACs will be defined, the way they are drafted will be discussed, and various examples of different MAC clauses will be shown. Not much has been written on the usage of a MAC clause in contracts in different countries, but a few countries will be mentioned briefly and among them is Norway. The Norwegian law and court process is as close to the Icelandic legal environment as can be found, so it could be assumed that the legal effect on MAC clauses in Icelandic contracts would be similar or same.

One of the major aims of this thesis is to see if the MAC clause as such has changed one way or another during the recent years of the financial crisis. How is it possible to invoke the MAC clause, is it worth the risk and are lenders actually activating the clause? How is the clause interpreted by courts and how clear is it? What happens if it is invoked incorrectly or wrongfully and how risky is it? Does it matter what is said during the negotiating process when the case goes before a

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[1] In case of a standard loan agreement, it is a contract with fixed terms and conditions, offered almost always on 'take it or leave it' basis. Also called standard form contract. Definition from: BusinessDictionary.com. But a standard loan facility is placed somewhere between '*adhesion contracts*' (one party writes and supplies the ready contract and the other has to accept) and '*agreed document*' (a standard agreement written by both parties) as the basic form is standard but parties negotiate certain provisions.

[2] Loan Market Association, established in London 1996 as a forum for dealing first and foremost with issues relating to the syndicated loan market and in order to develop and promote standard documentations for the syndicated loan market. Involved in the project were the British Bankers´ Association and the UK Association of Corporate Treasurers and the drafting was undertaken by Clifford Chance and Allen & Overy along with leading banks and City law firms.

court? Are there any court cases on MAC clauses' disputes and what were the process and results?

Another aim of this thesis was to find out if the typical MAC clause is part of international loan facilities used by Icelandic banks and larger corporations. If so, is their wording the same as is seen elsewhere in other loan facilities. Was the clause heavily negotiated, were they able to get it changed during the negotiating process? During the recent financial crisis have the lenders activated it and accelerated loans based on the MAC clause? How do those companies see the future of MAC clauses in loan facilities? In the process of the thesis, answers were found to most of those questions though some were not very obvious.

Finally, based on the subject covered, some suggestions or recommendations on the future MAC clauses are presented at the end.

1. Loan agreements - facilities

Financial loans are commonly classified with reference to four major characteristics, on the basis of availability, on the basis of the lender's credit decision, on the basis of the purpose of the loan, and on the basis of the number of lenders. Within each category there are a number of different types of loans which will not be covered here. For each loan delivered, a loan agreement is drafted (hereafter generally referred to as a **facility**). The fundamental purpose of the facility is to ensure the lenders the necessary rights and powers they need, as the owners of the funds, to get it repaid with interests. And as they have now handed over a large sum of money, in exchange they receive the facility and some security for the repayment. The first draft of the facility usually comes from the lender (often produced by its lawyer). The structures of the facilities vary depending upon the nature or characteristic of the loan. The concentration of this thesis is mostly on standard forms of loan facilities and then the focus will be more on the LMA facilities than other standard forms. The first LMA form was introduced in 1999 and since then it has been developed further and updated, so today it is the market practice to use them as basis for loan documentation in the London market, and facility agreements produced by the major City law firms today are all based on the LMA format[3] and they are commonly used all over Europe.

[3] Clifford Chance, "Syndicated Loan Documentation", Netherland, 2005, p.6.

The aim of publishing the standard agreement is to encourage a more harmonised approach of loan documentation in order to make the primary and secondary markets more efficient.[4] There are two types of loan facilities which are commonly syndicated: revolving loan facilities and term loan facilities[5], each with different agreement. For the purpose of this thesis there is no need to distinguish between these two types of loan facilities or describe them further, but when loans or loan facilities are mentioned it is generally referring to syndicated loans. Parties to syndicated loans are basically two, the borrower and the lender. The borrower is commonly a single party but the lenders are often a group of lenders (syndicate), as mentioned before, but for the purpose of this thesis the reference to this role will be in the singular.

The provisions within the standard form of the LMA facilities can be divided into two major sets of provisions, 'hard' and 'soft'. The 'soft' provisions consist of provisions[6] that are mere starting points which require negotiation on case by case basis, while the 'hard' provisions do not generally require adjustments.[7] A typical LMA facility is divided into three basic provisions, administrative provisions,[8] business critical provisions,[9] and the boilerplate clauses.[10] The MAC clause is generally a part of the Events of Default section and therefore a part of the critical provisions which the major negotiation between the lender and borrower is usually focused on. An Event of Default clause typically provides that a breach of covenant will only become an Event of Default after a given grace period (i.e. if it can be remedied) and that period can be any number of days. An Event of Default means that the lender has the option of accelerating the facility and demand immediate repayment. Among advantages for such a standardised facility is that for many borrowers it might be more convenient for them to use a loan format which is known and familiar in the market, as it leads to a greater efficiency in the negotiation

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4 Bradley, Caroline, "Forming a view on the LMA agreement", *The Treasurer*, July/August issue, UK 2000, p.13.

5 LMA, "Guide to Syndicated Loans", *London Market Association*, p. 1.

6 Provisions such as representations, undertakings, events of defaults, financial covenants, transferability, and conditions precedents.

7 Wright, Sue, *International Loan Documentation*, New York, 2006, p.8.

8 Dealing with mechanics of advances, calculation of interest, repayment etc., usually in LMA Term Loan clauses 1-17.

9 Dealing with representations, undertakings, and events of default, usually in LMA Term Loan clauses 18-23, and where most negotiating is focused on between the lender and borrower.

10 Dealing with notices, indemnities, jurisdictions, changes in circumstances, and relationship between lenders, usually in LMA clauses 24-38.

process, and might even lead to a lower cost for the borrower. On the other hand, it can be harder for the borrower to negotiate a loan draft presented by the lender as a market standard, instead of a draft form of a law firm.[11] The LMA standard loan agreement formats are generally understood as being more favourable to the lender, and even sometimes more favourable to him than many standard forms prepared by banks.[12]

Finally, there are two documents prepared in the process of forming any syndicated loan and which will be mentioned here in regards to the MAC clause. The Mandate letter (or Commitment Letter), is a letter where the borrower appoints the Arranger, and among other items it includes conditions to lenders obligations, syndication issues (such as clear market provisions, market flex provisions and syndication strategy) and cost cover and indemnity clauses.[13] Attached to the signed Mandate letter is a Term Sheet which normally sets out, among other items, most of the key commercial terms and the facilities major legal clauses such as the financial covenants, representations and warranties, transfer of rights and obligations and events of defaults (which includes the MAC clause).[14] Those terms need to be agreed between the borrower and the lender (bank), arranging the facility, prior to announcing the new loan to the market.

2. What is a MAC?

The major focus of this thesis is on the concept of the Material Adverse Change clause, or the MAC clause. As mentioned before, the MAC clause is usually located in the Event of Default section of loan facilities (in LMA and other loan agreements). It can be highly contentious and is sometimes referred to as the "catch all" clause, meaning if a default of the borrower is not caught by any other provision of the facility, this clause will catch it. The major concentration will be on MAC clauses within financing agreements and loan facilities (special attention on LMA facilities), but MAC is also commonly found in Merger and Acquisition agreements (M&A)[15] and in some other types of contracts. The basic fundamentals of the MAC clauses in

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[11] Bradley, "Forming a view on the LMA agreement", p.14.
[12] Mehta, Subrud, "Material Adverse Change Clauses in Adverse Markets", *Milbank*, UK 2008, p.2.
[13] LMA, *Guide to Syndicated Loans*, p. 4.
[14] Clifford Chance, "Syndicated Loan Documentation", p.2.
[15] According to a survey by Nixon Peabody LLP, Eighth Annual MAC Survey, October 2009, 434 out of 523 M&A agreements in value over $ 100 million included a MAC clause.

those agreements are very similar, so for the purpose of this thesis there will not be made a general distinction between the clauses in those agreements (except in the discussion of case laws). In M&A the MAC clause gives the buyer the option to walk away from the agreement before completion, or to provide a basis for re-negotiating the transaction, if something occurs that is detrimental to the target company (seller). It is the same effect in the loan facility where the MAC clause gives the lender the right or option to accelerate the loan or even walk away from his commitment to lend. This means that a MAC event of default gives the lender the right to call a default under the loan if events occur which have or may have, a prejudicial effect on the borrower's ability to perform its obligations under the facility.[16] Commercial lenders often include MAC clauses in their loan facility, especially when the loan involves the release of funds over a time such as in revolving a line of credits. The MAC clause commonly sets the requirement for activating it in case any event or circumstances occur and "Majority Lenders" (usually requires at least 66%) reasonably believe, or is reasonably likely to have a material adverse effect.

What distinguishes MAC clauses from other clauses in the facility is the kind of risk these clauses allocate. A typical MAC clause aims at allocating extraneous, supervening, unknown and therefore unforeseeable risk related to the borrower's business. In other words, it can be said that MAC clauses aim at allocating whatever risks that are left and have not been covered by all the other, more specific conditions and warranties in the facility ("catch-all" as mentioned before). To name a few risks which the MAC clauses commonly are supposed to cover are non-fulfilment of financial targets, general decline in the borrower's market, not previously known circumstances which lead to a loss in the borrower's assets, and drastic loss of the borrower's market shares. And this is at the same time what differentiates the MAC clauses from all the other clauses of the facility. Its task to cover unforeseeable risk is a difficult if not impossible task, and therefore requires very wide, open and vague ranging clauses.

On the other hand, this vagueness generally comes at the expense of the predictability of what degree of protection the clauses provide. A MAC clause is therefore typically broad and provides that the occurrence of a MAC constitutes an event of default from the borrower's side under the facility. So, the MAC is defined to

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[16] Hooley, Richard, "Material Adverse Change Clauses After 9/11" *Commercial Law & Commercial Practice,* edited by Sarah Worthington, USA 2003, p. 306.

cover some material change in business, financial conditions or the operations of the borrower (for example, a large and negative change shown in successive financial statements of the borrower). In that way it provides the lender with the necessary protection against certain risks he cannot foresee. On the other hand, it exposes the borrower to the potentially and costly situation if the lender decides to back out of the loan after the borrower has committed himself to the deal.[17] Such clauses are tough to get through the negotiation process between the lender and the borrower and they tend to create uncertainty when it comes to interpreting the clause, while one of the major purposes of the MAC clauses is to reduce uncertainty, not to increase it. One way to make it less uncertain is to make the clause more specific, but that will be discussed further at a later stage. As said before, most MAC clauses relate to the financial condition, business, assets and liabilities or some operation results of the borrower, while some MAC clauses relate to external conditions of the borrowers business or the economic environment, and some facilities distinguish between those two MACs (will be discussed further later).

Sometimes the MAC clause is used as a qualifier to certain covenants or representations and in some cases drafters distinguish between Material Adverse Change (MAC) and Material Adverse Effect (MAE), where they use MAE as qualifier to covenants and representations while they use MAC for Events of Defaults. Generally both concepts are used interchangeably, but if both are used they should mirror each other. In most loan facilities there is some form of a MAC clause. Lenders insert it and argue that they cannot be expected to see in advance every circumstance which may arise, while borrowers often object to the MAC clause as it tends to be very wide, uncertain and subjective. While the MAC clauses are a common feature of loan facilities and are usually heavily negotiated, it seems that those clauses are not commonly used to default a borrower as can be seen later in this thesis.

2.1. Definition

The LMA standard facility generally contains no definition of MAC clauses and is usually left to negotiation between the lender and borrower, but they are often considered as sweep-up protection clauses ("catch-all") for the lender. Borrowers

[17] Garry, Thomas, "Lenders, borrowers screening MAC closes carefully", *Midwest Real Estate News*, Illionis, volume 24, July 2008.

should not take it as a fact to accept a MAC Event of Default in addition to a MAC (or MAE) representation. But in the European leverage market, a MAC Event of Default is fairly usual, although, the 'covenant-lite'[18] and 'covenant-loose'[19] transactions seen in early 2007 often did not include a MAC and the LMA User Guide acknowledges that this provision is just a suggestion.[20] It is tended to cover other circumstances likely to lead to actual default and not covered elsewhere in the facility. Depending on other provisions of the facility in question, the occurrence of a MAC could mean any of the following points:[21]

- The lender is actually relieved from his obligation to provide further funding.
- The lender has the option to demand a cure of the default.
- The lender is entitled to accelerate the loan.

The aim of the clause is to cover a significant deterioration without reaching insolvency, but in practice, the lender is often hindered by lack of up to date information and proof and circumstances will have to reach a stage of catastrophic before the lender can be certain that the MAC test is satisfied.[22] The MAC clauses are normally a part of the Event of Default sections of the facility, as mentioned before, and in cases when the loan requires multiple draw downs, the lender usually requires the MAC representation and warranty to be repeated whenever drawdown takes place. So, it gives the lender an exit opportunity if something material occurs to the borrower's business or which has been more practical and just as important, it provides leverage for re-negotiations of the terms of the facility. Most MAC clauses contain the following three points:[23]

- Material adverse effect on the business, condition (financial or otherwise), operations, performance, prospects or properties of any Obligor.
- Material adverse effect on the rights and remedies of the Lender or on the validity or enforceability of the facility.
- Material adverse effect on the ability of any Obligor to perform its obligations under the facility.

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18 Loan agreements with rather few restrictions on the borrower.

19 Meaning that the lenders have very little control over these businesses until they are in a situation where covenants are already being breached.

20 Slaughter and May, *"The ACT Borrower´s Guide to the LMA Facilities Agreement for Leveraged Transactions"*, *ACT*, UK, Sept. 2008, p. 177.

21 Clyde & Co., "MAC clauses post August 2007", *Banking Litigation, Review of 2009*, UK, 2009, p. 6.

22 Montagu, Gerald, and Paul, Colin, *Banking and Capital Markets Companion*, UK, 2003, p.86.

23 Clifford Chance, "Syndicated Loan Documentation", p.21.

While MAC as such is not defined in the LMA standard facility, the MAE clause generally is, and although those two concepts will be handled as the same in the thesis the MAE definition will be looked at as well. As mentioned before the MAE clause, if used, is generally used as a qualification to various provisions of the facility, especially many of the representations, undertakings and Events of Default.

The typical MAE clause definition in the LMA facility reads as follows:

> '**Material Adverse Effect**' means a material adverse effect on
>
> (a) the business, condition (financial or otherwise), operations, performance, prospects or properties of any Obligor [or any Group member] [or of the Group taken as a whole]
> (b) the rights and remedies of the Lender; or
> (c) the ability of the Borrower to perform its [payment] obligations under this Agreement.[24]

As the definition is written, it is obviously very lender-friendly and therefore sometimes negotiated down to something quite direct and narrow. The borrowers try to delete the subjective element of the definition, so it is rare to see an "opinion of the Majority Lenders" referred to in it. Borrowers should try to have paragraph (a) deleted completely or at least to have it merged with paragraph (b), so there will only be a MAE if there is a MAE on the business, operations etc. of the Group which affects the ability of the borrower to perform his payment obligation under the facility or, possibly, to comply with the financial covenants.[25] Lenders often resist the deletion of paragraph (c) when borrowers argue that the invalidity or unenforceability should be required to have an impact on the lenders being repaid in order to qualify as having MAE. Some compromise is usually found there.

2.2. Different types of MACs

Earlier it was mentioned that in many loan facilities both MAC clause and MAE clause are listed and the MAC clause in Events of Default section then refers to the MAE clause which generally is a part of the Representation and/or Warranty sections, but sometimes they function as one and together are referred to as MAC provisions. One broad issue traditionally addressed when drafting and/or interpreting MAC clauses, is whether a deterioration in overall economic or market

[24] Wright, *International Loan Documentation*, p.48.
[25] Slaughter and May, "The ACT Borrower´s Guide to the LMA Facilities Agreement...", p.31.

conditions should constitute a MAC. Lenders may want to have the option to have a way out or re-negotiate in the event of a major disruption of overall market conditions. This view has led to the fact that MAC clauses are commonly divided into two different types. One is a MAC clause which is tied to the borrower's internal business and operation, Business MAC (or Company MAC), and the other one is a MAC clause which is broader and is related to the external part of the borrower's business and picks up adverse changes in the overall surrounding economy, in the business sector, or relevant markets and is referred to as the Market MAC.

2.2.1. The Business MAC

There is not a big difference between the general MAC clause in the facility agreement and the typical Business MAC clause, as it reserves the right to terminate the Mandate letter in case there is a MAC in the borrower's operation or financial conditions prior to signing the Mandate letter. The clause is of course open for negotiation as other provisions of the facility. However, in some cases the wording can be quite specific (although probably more common in M&A agreements) and as an example some per cent in revenues or certain per cent drop in equity value could be listed. The ideal situation for the lender is to protect himself and he would want to have certain specific business MAC protections along with the more general and extensive business MAC language.[26] A common definition of a Business MAC is: "*Any event, condition or change that materially and adversely affects or could reasonably be expected to materially and adversely affect the assets, liabilities, business, financial condition or results of operation of the company*."[27] Business MAC clause has been a common feature through the years in USA Mandate letters, but has to some extent lost some of its emphasis due, in part, to some drafting concessions made by lenders during strong credit markets as lenders were relying solely on heavily qualified Business MAC conditions.[28]

26 Hooley, *Commercial Law & Commercial Practice,* p. 321.
27 Dykema, "Market Adverse Change Clauses During Market Turmoil", *Corporate and Commercial Finance*, Alert III, November 5. 2008.
28 Linklaters, "Commitment letters: Lessons from recent US litigation", *Banking Update*, USA, Feb. 2009.

2.2.2. The Market MAC

The Market MAC provisions are a familiar concept in the sector of syndicated loans. In short it looks at the external part of the borrower's business and looks at changes and events or circumstances which are related to the domestic as well as the international lending and capital markets. The major attention those provisions have received historically have been in the context of Mandate letter documentation. In the letter it is often provided that there will be no Market MAC during the period between signing the Mandate letter to the date of signing the loan agreement and this can be seen in the LMA form of the Mandate letter. This could also mean that in the absence of language to the contrary, Market MAC will fall away at the time of signing the loan agreement.[29] These Market MAC clauses have historically been used only occasionally in the Mandate letter for syndicated loans.[30] But the development, as the loan market continues to show signs of dislocation, has indicated that underwriters and arrangers seem to be placing increased attention on the Market MACs. And Market MAC clauses have though rarely been used in US commitment letters since the 1990s, but this might change after the recent historic market shift, as lenders will probably be more inclined to include Market MAC clauses in their Mandate letters.[31] Following the financial crises, tightening of the credit markets and related decrease in borrower leverage, Market MACs are more and more becoming a norm. This will mean that lenders will continue to utilise Market MACs to allocate market risk to potential borrowers and their emphasis will probably be (among other items):[32]

(i) Require broader language to be able to trigger a Market MAC.

(ii) Insist on shorter term commitments.

(iii) In order to enable parties to re-negotiate terms in order to reflect market expectations one should expect further use of 'market out' and 'market flex.'

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[29] Clifford Chance, "Market MACs and Market Disruption", *Client briefing*, October 2008.

[30] Pinsent Masons, "Downturn Survival: Material Adverse Change Clauses – Fact or Fiction?", *Update*, December 2008.

[31] Linklaters, "Commitment letters: Lessons from recent US litigation".

[32] Dykema, "Market Adverse Change Clauses During Market Turmoil".

2.3. What to consider when drafting – negotiating MAC?

As the lender usually makes the first draft of the facility it is up to the borrower to respond and there are some typical areas of negotiation and points for him to consider in regards to the MAC clause:[33]

(i) Take out 'prospects' and limit the scope further as to 'business, financial conditions or assets'.

(ii) Limit the scope to payment obligation only if possible and other 'material' obligation 'taken as a whole' under the facility.

(iii) A rare subject to negotiation is 'market standard.'

Most facilities include the MAC clause in some form and from the lender's point of view the clause is considered almost a must, if the Financial Ratios are limited, or possibly none in the facility, then the MAC clause might be the major protection against financial changes or decline in the business of the borrower. The MAC clause is, as mentioned before, most often listed in the Event of Default section of the facility. It is also not uncommon to include it as a representation but the negotiation points to consider are the same. It is known that MAC clauses have inbuilt a certain degree of "uncertainty factor", meaning that the circumstances under which it can possibly be activated is far from obvious or clear. A situation which the borrowers are very concerned about and the lenders should be also, is any uncertainty in the clause which makes it highly risky for them to activate the clause and possibly face a liability claim from the borrower on the basis that he had acted prematurely and by it breached his obligation to the borrower. In practice, a MAC clause is more likely to be activated in order to stop a drawing (as in revolving loan) and force re-negotiation of the loan instead of accelerating it as lenders tend to use other Event of Default provisions before they look at the MAC clause.

The major objections of the borrower toward a MAC clause and points for him to consider in the negotiating process can be divided into four arguments:[34]

(i) The uncertainty of the circumstances in which it may be used.

It is very important for the borrower to exclude any uncertainty from the facility as the importance is to be able to rely on the funding. The lenders on the other

[33] Clifford Chance, "Syndicated Loan Documentation", p. 22.
[34] Wright, *International Loan Documentation,* p. 179.

hand state that it is unlikely it will be used except in most extreme circumstances and in practise rely on the objective events of default.

(ii) Lenders do not seemingly use it so why include it?

It seems to be rarely used as such, but activating the clause leads to discussions between the lender and the borrower if there is a cause for concern and that again often leads to renegotiation of the loan.

(iii) The fragility it imposes on the borrower's overall business.

The fact that such a provision in the loan contract can be a threat to the overall business as if activated, it can cause the loan to be accelerated and therefore endanger the business.

(iv) It gives the lenders excessive power and discretion.

The clause in some very vague forms give the lenders a huge discretion, but on the other hand, and this is most often the case, if the clause is drafted so wide and open, then it is very difficult for the lenders to enforce it as they will risk a liability claim. This is likely if a court decides that there was no ground for the lender to activate the clause. So the power is not as promising as it looks.

In the past, lenders have preferred rather broadly and vaguely drafted MAC clauses convinced that the broader language will provide greater protection against the unforeseen and therefore expand the field of eligible. This intention is also to avoid potential deal breaking and also time consuming negotiations covering what is "material" on each and every loan. The opposite approach is to draft a narrowly defined MAC clause with some quantitative measures. The major problem here is that parties tend to have difficulties reaching an agreement on what method or quantitative figure is to be used as the threshold. But jurisprudence interpreting MACs have suggested that both approaches can expose the parties involved to unintended results. Courts have been generally unwilling to interpret narrowly written MACs which are not in the basic interest of the lender (seller in case of M&A) which is to obtain protection against unforeseen events. And as courts tend to examine MACs (M&A clauses in USA) with a strong emphasis on the particular facts of the case involved, a formulaic approach in writing the MACs is not chosen. [35]

[35] Alexander, Joseph B., "The Material Adverse Change Clause (With Simple Language)", The *Practical Lawyer*, Vol. 51, Number 5, October 2005, p. 12.

But if the MAC clause will be included in the facility, how should it be drafted? As will be discussed later, it has become more important that the clause is rather narrow and more direct instead of wide and open. But generally it should address three points:[36]

(i) How likely must the MAC be?

Depending on the likelihood from the lender's side that a MAC will happen he chooses the wording between '*may occur*', '*will have'*, '*has had*', '*which could have*', or '*which could reasonably be expected to'*.

(ii) Whose is it to decide?

Is it in the opinion of the lender such as in the sentence: '*an event occurs which the Lenders reasonably expect to have a MAC*'. As opinion of the fact becomes more unreasonable the harder it is for them to prove they had that opinion.

(iii) MAC on what?

It should also include the following three options. (1) Changes in the market or the surroundings of the borrowers company (the market conditions, the industry the company operates within, the general economy and such). This is of major concern to borrowers as this is looking forward and at the surrounding of the borrowers which he has no control over. And a negative change in the surroundings generally means that the borrower is in more need of stable finances. (2) The internal business activities of the borrower (such as financial conditions and the ability to repay the loan). Reference to financial conditions can be included in the MAC clause regardless of the financial covenants, and the lender's argument is that this is done in order to catch financial changes not yet caught by the financial ratios (which are often only tested twice or four times a year). But if the MAC clause includes financial conditions they need to be related to the financial covenants in the facility (mirror imagine of them). (3) The facility and related documents (its validity and enforceability). It is rather common to include in the MAC clauses a relation to validity and enforceability of the documents and the right of the lender to respond accordingly.[37]

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[36] Wright, *International Loan Documentation*, p. 181.
[37] Ibid., p. 182-183.

Why are the MAC clauses so universal but on the other hand so unpredictable? David Morley gave in short the following explanation to this question:[38]

> The simple answer is that they are intended to cover risks that people cannot anticipate. In a financing commitment, for example, they may cover an unforeseen change of circumstances affecting the borrower's credit standing or the ability of the lender to spread the risk bringing in other banks into the deal.
>
> But the real reason most MAC clauses lack predictability is clear: to get deals done. The more explicitly the MAC is defined – by linking it to the specific fall in the FTSE 100, say, or a credit rating downgrade – the more effective and predictable is the clause.
>
> The snag is that insisting on such specific terms can be a deal-breaker. When people buy or sell businesses, or borrowers raise finance, they want to be certain the other side will stick to the deal – specific conditions that weaken this commitment are often negotiated out to get the deal done. What is left tends to follow a basic formula, but with infinite variations that affect the MAC clause's impact.

Some writers say that MAC clauses can even be "potentially toxic clauses" and borrowers should be very much aware of them, especially in the current financial environment. Three questions or points should be mentioned in this regards which are related to the MAC clause and should be taken into consideration when drafting the MAC clauses:[39]

(i) Does the MAC clause include a look-forward test which considers future compliance with financial covenants?

If that is a case the borrower could be in compliance with its financial covenants at a certain time, but could still be in a default if a performance change could possibly result in a future breach of the financial covenants. From the lender's point of view this is risk coverage while this might be toxic for the borrower.

(ii) What actually constitutes a MAC in a borrower's condition and who is to determine?

This has been answered earlier, but generally an occurrence of an event which might have a MAC on the borrower's financial status or his ability to comply with certain obligations covered by the facility, can constitute a default. And whether this constitutes a default or not is determined exclusively by the lender. A very solid position for the lender, but the borrower should try to negotiate it such that the position is determined objectively instead of subjectively by the lender and exclude all forward elements.

(iii) Are there repeating representations given on a regular basis?

[38] Morley, David, "Clauses with potent effects", *Financial Times*, 4 March, 2002.
[39] Smith, Travers, "Looking beyond financial covenants", *Legal Briefings*, 9 June, 2009, p. 1.

If that is the case the borrower should make sure that those representations are limited only to technical legal matters, not a statement such as '*no MAC has occurred'* since the last date representations were delivered.

Yet another point for the drafter of a MAC clause to consider is whether it shall be drafted as a warranty or as a condition precedent. Drafting it as a warranty, it is a warranty that no MAC has or will occur and if it happens it gives the lender the option to claim a breach of warranty and he can therefore accelerate the loan if he so chooses. When drafted as a condition precedent, the duty to perform under the facility does not happen until a defined time period has passed and no MAC event occurred. This means that the conditioned obligation will not become effective unless the condition precedent is satisfied, and if not satisfied, there is no obligation to perform.[40]

Finally, it is worth mentioning that general rating agencies commonly view MAC clauses in major loan facilities as unfavourable and recommend to companies to which they have given credit rating, that they should limit the scope of the MAC clause as much as possible.[41]

2.4. Samples of typical MAC clauses

Following are some samples of typical MAC and MAE clauses, mostly ones in loan facilities, but MACs in M&A agreements are also shown as they are very similar and hard to distinguish. Samples of MAC clauses in the Icelandic loan facilities will be given in chapter 10. It is very common that MAC clauses consist of an operative clause (the real MAC clause) and a definition of the MAC event (which could be the MAE clause). Sometimes those two parts are mixed together and in such a case, is part of the operative clause.

A common example of the operative part of a MAC clause is as follows:[42]

Conditions precedent to Closing:

> Since the date of [the Agreement], there has not been any Material Adverse Change in the condition (financial or otherwise), business, assets, liabilities or results of operations of [the Party and its Subsidiaries taken as a whole…].

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[40] Sikkeland, Lars Ole, "(NO) Material Adverse Change Clauses – Norwegian Law with a Comparative Perspective", UiO Dept. of Private Law, Oslo 2006, p.4.

[41] Clifford Chance, "Syndicated Loan Documentation", p. 22.

[42] Sikkeland, "(No) Material Adverse Change Clauses – Norwegian Law with...", p. 5.

In this agreement, what was to be regarded as a “material adverse change” (a MAC event) was defined as follows:

> “Material Adverse Change” means any result, occurrence, condition, fact, change, violation, event or effect that, individually or in the aggregate with any such other results, occurrences, conditions, facts, changes, violations, events or effects, is materially adverse to:
> (A) the financial condition, business, assets, liabilities or results of operations of the Company and its Subsidiaries, taken as a whole,
> (B) the ability of the Company to perform its obligations under this Agreement or
> (C) the ability of the Company to consummate the Merger; provided, however, that in no event shall any of the following constitute a Company Material Adverse Change:
> (1) any change or effect resulting from changes in general economic, regulatory or political conditions, conditions in the United States or worldwide capital markets;
> (2) any change or effect that affects the oil and gas exploration and development industry generally (including changes in commodity prices, general market prices and regulatory changes affecting the oil and gas industry generally);
> (3) any effect, change, event, occurrence or circumstance relating to fluctuations in the value of currencies;
> (4) the outbreak or escalation of hostilities involving the United States, the declaration by the United States of a national emergency or war or the occurrence of any other calamity or crisis, including acts of terrorism; […]
> (14) any of the matters referred to in Schedule 3.1(a)…

This is a very long and detailed MAC and not common as such. Even though the LMA standard form of loan agreements does not give any standard format of an MAC clause there are some LMA forms of MAC clauses mentioned elsewhere. Here is a typical sample of a LMA form of a Market MAC clause:

> The absence, in the Mandated Lead Arranger’s opinion, of any event(s), development(s) or circumstance(s) (including any material adverse change or the continuation or worsening of existing circumstance(s) or any combination thereof) which in its opinion, has (have) adversely affected or could adversely affect the international or any relevant domestic syndicated loan, debt, bank or capital market(s) and which in the opinion of the Mandated Lead Arranger could prejudice syndication of the Facilities, during the period from the date of this letter to the date of signing of the Facility Documents.[43]

A standard form clause like this one, commonly used by lenders (banks), is drafted in such a way that the MAC condition is possible to invoke based on existing market conditions, but borrowers might resist it.

The MAC clauses are generally more in favour of the lender, which is probably normal as it is in the nature of the MAC clause to be a safety clause for him more than the borrower, and it is also normally the lender who is supplying the first draft of the facility. So, finally here are two typical MAC clauses, one in favour of the lender and the other one more favourable to the borrower (which is not common).

[43] Mehta, “Material Adverse Change Clauses in Adverse Markets“, p. 4.

(i) More favourable to lender:

> There not having occurred or become known to us [i.e. the lender] any material adverse condition or material adverse change in or affecting the business, operations, properties, condition (financial or otherwise) or prospects of the Target and its subsidiaries, taken as a whole, since December 31, 200X.[44]

(ii) More favourable to borrower (very rare):

> There not having occurred and be continuing any material adverse change in the business, operations, properties or financial condition of the Target or any of its subsidiaries since December 31, 200X.[45]

2.4.1. MAC as a part of Representation or Warranty

In the absence of any material adverse change, MAC clauses are usually a part of the Representation and Warranty sections and in the Event of Default section, triggered by a MAC. And in case of a revolving loan (multiple draw downs) the lender usually requires that the MAC representation and warranty is repeated each time there is a draw down and they might also require to insert a MAC clause as a separate condition precedent to draw down.

MAC (or MAE) as a Condition precedent:[46]

> A Financier is not obliged to provide any drawdown until the Facility Agent is satisfied that there has been no change in: – the commercial, operational or economic viability of the Project from that contemplated in the Plan or Feasibility Study; or – the business, condition (financial or otherwise), operations, performance or assets of the Company, which is, or is likely to be, a **Material Adverse Event.**

2.4.2. MAC (or MAE) in M&A

Commonly the MAC clauses in M&A agreements take the form of conditions to completion or a warranty that no MAC has occurred since the last test date. And as mentioned before, the buyer (lender in case of loans) will want to keep it such that the warranty is repeated at the date of completion and wants to have the option to terminate the agreement if the warranty has not been satisfied.

MAC (or MAE) clause reflecting the above:

> Completion of this agreement is conditional on the Investors jointly completing due diligence investigation of the Company and that investigation not revealing any fact or matter that would have a **Material Adverse Effect** on the Company.[47]

[44] Widen, William H., “Sample Material Adverse Change Clauses“, *e-Presentations*, UCC, Miami, March, 2001.
[45] William H. Widen, “Sample Material Adverse Change Clauses“.
[46] Mallesons Stephen Jaques, “Material Adverse Change Clauses“, *Mallesons´ Publications*, August 2002.

And the definition of this MAE clause was as follows:

> **Material Adverse Effect** means any event, condition or change which materially and adversely affects or could reasonably be expected to materially and adversely affect the assets, liabilities, financial results of operations, financial conditions, Business or prospects of the Company.[48]

Finally, a typical sample of a MAC clause in a common M&A agreement (with certain standard variations bracketed):

> Material Adverse Change [Effect] means [a material adverse change in or] any event, occurrence, fact or circumstance which has had [or is reasonably expected to have] a material adverse effect on the business, assets, condition (financial or otherwise), liabilities [, or] results of operations [or prospects] of Target and its subsidiaries taken as a whole.

Even though this is a typical clause, they can vary and are commonly negotiated, and indeed, there often are serious negotiations over whether to include certain of the bracketed or other language.[49]

3. MAC in various countries

It is interesting to look at a few different countries and see how the MAC clause as such is treated there and enforced. The author had great difficulties in finding any writings on MAC clauses in other countries than UK and USA, so the countries are only five and the text is limited. The countries are the USA, the UK, Belgium, Italy and Norway. The USA and the UK will more and less be taken together as their legal systems are very similar, and the content of this thesis, in relation to the concept of the MAC clauses, is in general reflecting the way it is treated in the UK (and in some instances in the USA), except where otherwise mentioned.

3.1. MAC in UK and USA

The MAC clauses originated in M&A agreements in the USA in the early 1940s.[50] It was then first seen in syndicated loans to sovereign borrowers in the 1970s as it was complicated to devise workable covenants in financial agreements for loans to governments, so a MAC clause was drafted in order to provide the lending banks

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47 Mallesons Stephen Jaques, “Material Adverse Change Clauses“.
48 Ibid.
49 West, Glenn D. and Parel, S. Scott, “Revisiting Material Adverse Change Clauses“, *The Metropolitan Corporate Council*, USA, September 1. 2006, p. 1.
50 Schwartz, Andrew A. “A ´Standard Clause Analysis´ of the Frustration Doctrine and the Material Adverse Change Clause*“*, UCLA Law Review, September 2009, p. 28.

with more comfort.[51] It is not clear when it was first used in financial facilities in Europe or UK, but one would assume it was as early as in the 1970s in the UK.

Both the UK and the USA contract law, like in most western countries, are founded on the principle of freedom to contract and sanctity of contract. Based on that, parties have the right to freely make agreements between them in harmony to their intentions, and they can rely on the principle that agreements should be held between them in accordance with their agreed content. In regards to MAC clauses and the principle of sanctity, the parties involved must decide exactly what is agreed and whether or not the contract should be upheld no matter what their content or their legal effects. This refers to the question of absolute contracts. Both USA and English contract law are known for giving full effect to the wording of commercial contracts and this has been expressed through the '*Parole evidence rule'* or the '*Plain meaning rule'.* Courts in both countries have referred to this rule in courts' ruling:

> ...construe a written document […] according to the ordinary grammatical meaning of the words used therein, and without reference to anything which has previously passed between the parties to it."[52]

One should therefore assume that parties in both the UK and the USA involved in a contract which includes a MAC clause could rely on the MAC clauses as such. But that is not the fact, especially as the English contract law has through the years shifted slowly from the 'Plain meaning rule' in interpretation toward a more moderate interpretive theory, which includes to a larger extent some subjective elements than were traditionally accepted.[53] Similar development has been happening in the USA, as subjective elements have increasingly been admitted in case laws on contract law, so in a way UK and USA contract law have during the past decades been moving closer to each other. There have been several instances through the years where MAC clauses have been applied and interpreted by the USA courts (almost all related to M&A agreements) and a few major case laws will be covered at a later stage in this thesis. On the other hand, there are hardly any case laws on MAC clauses in the UK and the reason is believed to be two folded. One is the outcome of USA case laws where courts are now likely to consider all

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51 Coyle, Brian, *Bank Finance*, UK, 2002, p. 74.

52 Expression of this rule in English case law can be seen in: Lovell and Christmas Ltd v Wall (1911) 104 LT 85

53 Sikkeland, "(No) Material Adverse Change Clauses – Norwegian Law with...", p.8.

relevant facts of the case (not following blindly the Plain meaning rule), including subjective elements, in their process of deciding whether a MAC has actually occurred, and the other one is the fact that MAC clauses originated in the USA, so UK courts will most likely look to USA examples when interpreting MAC clauses. [54]

Today, MAC is very common in the UK both in financial facilities as well as in M&A agreements. It has already been covered how they are reflected in standard loan facilities, but in M&A agreements their structure and content differ some, depending on the form of the company, public or private. In private M&A companies the MAC clause often takes the form of either a condition to completion or a warranty that no MAC has occurred for a specified date. Those MACs usually contain similar exceptions as private company MACs do in the USA (events such as general economic, political or regulatory conditions or charges, and financial market fluctuations). On the other hand, in M&A agreements (offer documents) in UK public companies, it is a standard practice to contain a standardised MAC clause: "[save as publicly disclosed] no adverse change or deterioration having occurred in the business, assets, financial or trading position or profits or prospects or operational performance of any member of the Group which in any case is material in the context of the wider Group taken as a whole".[55] But as UK regulation prescribes under what circumstances a condition may or may not be invoked, there are no negotiated exceptions events in the private company context. UK case laws covering MACs cases are very few in the UK, but one of the most important regarding a MAC clause in the context of a public company was when the Takeover Panel ruled on WPP plc's offer for Tempus Group plc, on the subject of a MAC condition (2001) and held WPP to its offer.[56]

[54] Sikkeland, "(No) Material Adverse Change Clauses – Norwegian Law with...", p. 8.
[55] Rothschild, Jeffrey, Nick Azis, Patrice Corbiau, Dennis White and Abigail Reed, "Drafting material adverse change clauses", *Financier Worldwide´s 2008 International M&A e-book*, McDermott Will & Emery, 2008, p. 3.
[56] Offer by WPP Group plc for Tempus Group plc (Takeover Panel Ruling, 6 November 2001), para 18.

3.2. MAC in Belgium

MAC clauses were only recently introduced in Belgium[57] and are now rather common, but because of the short time in usage and such contractual provisions were classified as MAC clauses only recently, it is premature to generalise anything about its developments or trends. But similarly as in the USA (and actually all over), in Belgium, parties involved claim a MAC in order to establish a ground for re-negotiation of the contract instead of an immediate termination. Under Belgian law, parties are generally free to enter a contract and subject it to conditions and they may be conditions precedent or conditions subsequent. But a contract is only valid if four elements are included: consent, capacity, an object and a cause.[58] The challenge facing a writer of a MAC clause is to fulfil the object requirement, so the more determined the language of the MAC clause is, the more likely it will satisfy the requirements of the Belgium contract law. And finally, if one party to the contract wants to protect itself from a specific event, one should not rely on a general MAC clause but instead use a separate clause in such a case.[59]

3.3. MAC in Italy

MAC clauses are well known in various corporate transactions in Italy, such as finance agreements, M&A agreements, initial public offering documents and general contractual agreements, and have been for years. But as in other countries, MAC clauses are not statutorily regulated directly under Italian law, even though they are so common, and no case law have dealt with their enforcement in the country.[60] According to Italian law there is a general principle of freedom to contract, meaning the MAC clauses in contracts are valid and enforceable. But under Italian law validity and enforceability also depend upon the wording and intention of each and every MAC clause being enforced. And the evaluation is different between MAC clauses being enforced as a contractual condition and another one enforced to terminate a contract. In regards to the condition, a MAC clause should not be unlawful,

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[57] Corbiau, Patrice and Dierickx, Geert, "Drafting MAC clauses in light of Delaware case law, Inside M&A," *Inside M&A*, November/December 2007, p. 5. Was introduced by the Anglo-Saxon approach of negotiating corporate and financial transactions.

[58] Corbiau, Patrice, "Use of Material Adverse Change Clauses in Belgium", *Mondag Business Briefing*, Washington, January 17, 2008.

[59] Rothschild, et.al. "Drafting material adverse change clauses", p. 4.

[60] Mazza, Filippo, "Material Adverse Change Clauses Under Italian Law", *Mondag Business Briefing, Washington*, January 17, 2008.

impossible, contrary to law or to the public order. When it comes to the enforceability of a contractual termination right clause, such as a MAC clause in a contract being enforced as a termination clause will be deemed enforceable if it is overly generic or unspecific. This means the drafters of MAC clauses must bear in mind what the clause is generally designed to protect or remedy, and as higher degree of protection as a termination clause the drafter seeks the more carefully the clause should be drafted. But if the clause is only meant as a contractual condition and condition subsequent is the outcome, parties involved should specify how and when the unwinding of the contract takes place.[61]

3.4. MAC in Norway

MAC clauses are frequently used in contracts in Norway, but so far there have not been any case laws where a MAC clause has been in involved in a dispute, either interpretation or application of it. In his paper on MAC clauses under Norwegian law, Lars Ole Sikkeland, [62] examines the legal effects that MAC clauses may be expected to have under Norwegian law, but he does not address the issue of interpretation of contracts drafted in the English language or between foreign parties. As Icelandic laws are very much based on the same principles as the Norwegian ones it might be assumed that the process in regards to court disputes would be very much the same in Iceland.

3.4.1. Is the MAC clause unnecessary due to default rules in Norwegian law?

The fundamental reason for MAC clauses is to make it possible for a party (lender or buyer in M&A) to get out of a contract in case the deal turns out to become unsound for reasons of unforeseen or unexpected material change. Under Norwegian law the right to terminate a contract due to material breach is based upon the general principle of contract law, and that is actually in contrast with UK and USA general principles of contract law. So if some warranty regarding the other party's financial strength is included in the contract and some material change occurs in that area,

[61] Mazza, "Material Adverse Change Clauses Under Italian Law", p. 7.
[62] Sikkeland, Lars Ole, "Material Adverse Change klausuler som suspensive betingelser - Norsk rett i et komparativt perspektiv", Oslo, 2006, and a shorter version of it in English issued the same year, "(No) material Adverse Change Clauses – Norwegian Law with Comparative Perspective", Oslo, 2006. This chapter is more and less based on those Sikkeland´s papers.

the other party (lender or buyer) could terminate the contract due to material breach based upon general principles of contract law. In such a case there would be no need for a special MAC clause. But if there is no warranty covering a particular adverse change, the change will not constitute a breach of an obligation and the right of termination. The same applies if both positive and negative changes occur to the party (borrower or seller) involved, the court looks at the changes as a whole (the negative against the positive) and from that makes an assessment of wether there is a cause to terminate the contract.

Is there a possibility of a discharge due to material events? In Norwegian law, just as in both UK and USA contract law, each party to a contract must be responsible and carry his own risk according to the development of the contracted obligations. Under Norwegian law, if a material event leads to totally unfair and unreasonable results, predictability may be outweighed by reasonableness. Two principles can affect this result. One is the doctrine of failed assumption and the other one is the mandatory rule prescribed by 1918 Contract Act § 36 stating that an contract can be declared void or amended by the courts if its effects upon one of the involved parties can be considered “unfair”.[63] There are three conditions that must be in place so that the doctrine of failed assumption can set aside a contract, (i) the failed assumption must be significant, (ii) it must be relevant (fair and reasonable), and it must be recognisable to the other party involved in the contract. Usually the threshold for the application of the doctrine of failed assumption which leads to a discharge of contractual obligations are very high for commercial contracts and even higher if the involved parties are professionals and the degree of the risk involved is known in advance.[64] This could mean that the consideration of predictability and the principle of each party carrying his own risk might not be considered outweighed. In practice a claim for discharge based on the principle of failed assumption in case of material circumstances rarely succeed as the court finds that a risk actually has been allocated through the contract between the parties involved. The result is that the Contract Act § 36 or the doctrine of failed assumption allocate much less risk than a

[63] Same clause is in the Icelandic Contract law, *Lög um samingsgerð, umboð og ógilda löggerninga*, 1936 no. 7, Act 36

[64] This has been shown in relevant court cases in Norway such as in Rt 2000 p. 806 where the court found that the party involved as a professional party must carry the rish for the development in dispute (major change in the energy market), as the contract did not expressly allocate it.

typical MAC clause, so relying on such default rules will probably mean much less predictability than relying on a typical MAC clause.

3.4.2. Why MAC clauses cannot fulfil its legal effect under Norwegian law?

The basic function of the general MAC clause is to give a party to a contract (lender in loan facilities or a buyer in case of M&A) a required assurance against unforeseeable event (risk) so that the party has the option to get out of its obligation. So is this possible under Norwegian law? As a MAC clause has never been tried by a Norwegian court it is difficult to give an answer to such a question. But Sikkeland is convinced that MAC clauses cannot be relied upon under Norwegian law and following are his major reasons for this assumption.

First, there is one fundamental difference between interpretation principles of UK and USA contract law on one hand and Norwegian law on the other hand, where the Norwegian law can and will take into consideration *all relevant evidence* and have no limit on the evidence that can be taken into consideration. And one major consideration in Norwegian contract interpretation is taking into consideration the fairness of the result. But if the wording of the MAC clause is clear direct, it can be expected that the MAC clause will be applied according to its wording and that is supported by case law.

Secondly, courts are likely to choose an alternative which is seen as the most fair and reasonable, when faced with ambiguous and vague contractual obligations. But the court will always look at the circumstances of each case and take into consideration the amount of risk involved each time and raise the threshold in accordance. The scope of the Mac clause is another consideration for the court to look at and the Norwegian court will likely take similar stand as The Delaware court took in the Tyson case in USA[65] where the scope of the MAC clause was very wide and gave much room for interpretation by the court. This means that the bigger the transfer of risk given by the MAC clause, the more likely the interpretation will be narrower in order to balance between the parties involved.

[65] IBP Inc. v Tyson Foods Inc, 789 A.2d 14 (Del. Ch. June 18, 2001)

3.4.3. How would 'material' be defined by Norwegian courts?

A MAC must be "material", but what does it mean and how to apply the materiality requirement, or what will be regarded as a "material" adverse change under Norwegian law? It is complicated to decide actually what "material" is, but in this context two points are important: (i) in general it can be assumed that Norwegian courts will probably interpret the concept "material" on a case to case basis and look at different sides, how big is the claimed loss compared to the risk taken in the contract etc.

(ii) Courts will probably look at similar cases for guidance which again is complicated as there are no direct MAC cases available, so they must look at cases dealing with similar criteria occurring in similar circumstances. Assessment of material breach and MAC will generally rely on the same set of facts, but does not need to be the same. Two reasons can be mentioned why actual assessment might be different from MAC:

(i) the two clauses to some degree serve different functions, and

(ii) there might be some other differences between the two clauses. The difference between the clauses can be due to different considerations upon which the clauses are built and some element of one is not relevant to the other one.

3.4.4. Other items related to MAC clauses under Norwegian law.

Yet another factor which may limit the use of MAC clauses under Norwegian law is that Norwegian courts might find that the clauses could lead to unfair results, even though it is probably not likely as the threshold for such a result is very high as mentioned before. The term "condition" (precedent) does have a particular legal effect under Norwegian law, and is a condition that needs to be performed before the contract becomes finalised and binding or something which needs to be fulfilled before the duty to perform a defined obligation arises. This means that the legal effects of a condition apply automatically but when a MAC event occurs, the obligation to close the contract does not rise. The Norwegian Supreme Court[66] has accepted the doctrine of conditions as it had been developed in legal theory, but it added an additional element of assessment, element of fairness and reasonability

66 In the court case Rt. 1969 p. 222.

with reference to “good faith”. By this the court was not strictly following the doctrine as it seems to be uncomfortable with the result. But Sikkeland believes that the court would have come to a different conclusion regarding assessment of a MAC clause, because parties involved in a MAC clause would be professionals (which parties in the above case were not) so the “fairness” of the result would not weight as much. His conclusion is that an application of the MAC clause under Norwegian law will be similar as under USA contract law. This is supported by the fact that USA courts have increasingly given higher weight to similar consideration as Norwegian courts can be expected to do. Those considerations include, as mentioned before, fairness and reasonableness. Bearing in mind the similarities between Icelandic and Norwegian law and practise[67] one could assume that similar results would be if disputes over MAC clauses would be taken to court in Iceland (see chapter 10.9.).

4. How has the financial crisis affected the operation of MAC clauses?

Since the middle of 2007 the general commercial climate has changed dramatically in many ways, and brought with it much greater uncertainty, and a lot of financial institutions have been facing financial difficulties and many of a larger scale than have been seen before. This has led to a market that is less borrower-friendly and banks all over are wary of advancing funds and have shown a tendency to reduce their existing commitments and many simply because of lack of funds. Lenders have been reviewing their positions and status and have been forced to rethink their commitments toward their borrowers. Many existing financial agreements are on terms which most lenders would probably not be prepared to offer today and many of the assets that secured the older loans are worth much less than they were when the loans were given. The tightening of the credit market because of the crisis has also affected the M&A market which has realised an increase in the number of “busted” or re-negotiated deals during the period of the financial crisis.[68]

[67] The Icelandic Contract law “*Lög um samningsgerð, umboð og ógilda löggerninga nr. 7/1936*“ or “*Samningalögin*“ from 1936 were mostly based on Nordic contract laws, but not a complete translation or harmony as it took into consideration special Icelandic conditions. In 1986 some changes were made on chapter III, based on changes that the Nordic countries had done on their contract law few years earlier. Páll Sigurðsson, *Samningaréttur*, Reykjavík, 2004, p. 34.

[68] White & Case, “Material Adverse Change Clauses in the Current Credit Environment“, *Client Alert*, New York, October 2008.

It is worth mentioning that there is an extended difference between credit agreements and term sheets in USA and Europe deals. That is partly because in the USA there is no generally accepted standardised financial documentation equivalent to the Loan Markets Association (LMA) precedent documentation, as the European market commonly uses, especially for mid-market deals.[69]

With those developments in mind lenders have been closely scrutinising their loan agreements, going through their Mandate letters to analyse whether the closing conditions have been satisfied by their borrowers. Among the conditions that probably have been receiving serious attention are MAC clauses, and participants in syndicated loan markets are paying increased attention especially to the Market MACs clauses. From the borrowers' point of view, the economic downturn in the last two or three years has meant that many borrowers have found it increasingly challenging to fulfil their financial covenants in their financial loan facilities. As the financial performance is probably in many cases not meeting expectations and the focus is on financial covenants, hard work is definitely in process on how to fulfil the requirements of those provisions. But there are a few other provisions in loan facilities that borrowers need to pay close attention to as they can cause them problems even though they are complying with the financial covenants. Of course, the nature and the size of their problem is to some extent based on the nature of their facility, like if it is lender-friendly (such as LMA facilities generally are) or if it is not a standardised document. Some writers refer to some of those provisions as "toxic clauses" and the MAC clause is defined as one of them[70]. And if borrowers become default to any of those "toxic clauses" that would have the same consequence as a financial covenant breach has. This could mean that the control over the business might be shifted over to potentially hostile creditors with serious consequences for the borrower.

The last couple of years have meant new committed financings, a spike in defaults and lender-negotiations to avoid them. There have been attempts by issuers to use flexible credit agreement terms, borrower buy-backs of term loans, and unfortunately we have seen numerous bankruptcies and restructurings all over. This will probably mean that lenders will take a more conservative 'back-to-basics'

[69] Baker, Michael, "The loose US. The different impact of the credit crunch on leveraged lending terms in the US and in Europe", *Interntional Financial Law Review*, New York, January 2008, p.14.
[70] Smith, "Looking beyond financial covenants".

approach in extending new loans. Credit committees of banks and financial institutions will be cautious of assuming the warehousing risk of failed syndications which led to unprecedented write downs of arrangers' balance sheets.[71] This means that both banks and borrowers will be paying closer attention to the MAC provisions in the underwriting Mandate letters. The discussion will probably focus on whether the test should be objective (a question of fact) or subjective (the determination is in the sole discretion of the banks). Subjective and more discretionary tests are currently being required by commercial banks so that they will not have to negotiate with borrowers if a MAC has occurred or not.

One question is, whether the Market MAC conditions will again become a standard feature in commitment papers? Recent transactions and ensuing litigation have implied a certain limited usefulness of this condition for lenders. The court case *Solutia Inc. v. Citigroup Global Markets, Inc.* from 2008[72] which was then settled later that year highlighted the issues facing both arrangers (in M&A), in relying on Market MAC provisions, and buyers in challenging them.[73] The financing commitment in *Solutia* was underwritten in October 2007, and the lenders withdrew the commitment in January 2008 referring to Market MAC condition in the commitment letter. The fundament of the argument between the parties involved was: when is a market event sufficiently 'material' to qualify as a 'material adverse change'? Does it measure in a situation when there is a general economic downturn? The question of 'materiality' is always relative and should be considered in the context of the market conditions in existence. But the most likely result in the near future of this is that lenders will probably tend to tighten lending terms in general and especially the language of the Market MAC clauses. A recent survey supports this, as it reveals that there is a trend among lenders to tighten the MAC clauses and give more discretion to the creditors to determine whether there has been an adverse change in the borrower's financial condition.[74] On the other hand, borrowers will probably be reluctant to accept a commitment which is based on and subject to a Market MAC, but while market and economic conditions remain as they are, lenders will likely

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[71] Ridealgh, Damian, "Recent Trends in Committed Financings", *The M&A Lawyer*, New York, September 2009, p. 1.

[72] Solutia Inc. V Citigroup Global Markets Inc. (Case no. 03-17949(PCB)) (Feb 2008). The case is covered in more detail in chapter 9 and in Appendix III.

[73] Ridealgh, "Recent Trends in Committed Financings", p. 3.

[74] Allen & Overy, "Life after Lehman, analysis of changes in market practice", London, September 2009, p. 8.

insist on them. And, at the same time, borrowers probably have little bargaining power to get rid of them.

Another problem that lenders were facing during the credit crunch, was that because of the structure of the covenant provisions in the pre-credit loan documents the borrower could suffer a large financial deterioration before he was facing a default, meaning that the lender could not react by exit, restructure his risk and/or force a re-negotiation. This meant that the lender potentially suffered a much greater loss on a bankruptcy of the borrower, than if he had been able to intervene earlier. So again, the financial crisis has influenced lenders to review and re-negotiate loan documentation in more detail than before and MAC clauses are a part of that negotiation process.

5. Invoking a MAC clause

The recent financial markets crisis has again brought renewed focus on MAC clauses. MAC clauses are presently in many loan agreements and the majority of merger and stock purchase agreements, and as mentioned before, are sometimes a central focus in negotiations between the involved parties. Typically, if a MAC occurs it allows either party to cancel the transaction. The provisions of the facility then often enumerate various exceptions to this potential possibility.

In the years prior to the crisis, the MAC clauses have been marked by ambiguity, and courts in general have largely refrained from clarifying the precise boundaries of their use, except to put the limit to invoking a MAC very high. This was proven by a relatively new court case in the USA where Hexion Specialty Chemicals Inc. tried to walk away from a very big acquisition of Huntsman Corporation, but was rejected on September 29th 2008 in an opinion from the Delaware Chancery Court, and is only the latest example in a few cases where companies have tried to invoke a MAC clause without success. [75]

In trying to address the increased risks related to the credit crunch, lenders and acquirers have tried to use a variety of contractual approaches to get out of problematic transactions, with varying degrees of success. The most commonly used, but probably least legally certain, is the invocation of a MAC. In the Hexion case, one of the principal arguments used by Hexion as justification for getting out of

[75] Hexion Specialty Chem. Inc. v Huntsman Corp., C.A. No. 3841-VCL (Del. Ch. Sept. 29, 2008). The case is covered in more detail in chapter 9 and Appendix IV.

the Huntsman's deal was the claim that Huntsman had experienced a material adverse change of terms in the agreements. A MAC clause, either in a loan or M&A agreements, permits a lender or buyer (acquirer) to walk away from a transaction upon the occurrence of some major changes which fundamentally impairs the value of the target (in case of M&A which this litigation concerns). Most MAC clauses relate directly to the financial condition, business, assets, liabilities or results of operations of the target entity (or borrower), and to external environment of the company.

Experience has therefore proven that MAC clauses are extremely difficult to enforce, and the party seeking to invoke it is bearing the burden of proving that a MAC has actually occurred. Courts have, when evaluating the scope of a MAC clause, been concerned with four factors: (i) analysis based upon facts related to the written text of the clause itself, (ii) available details of the negotiation and interpretation of the clause between the parties involved, (iii) the commercial context in which the transaction took place (in case of M&A), and (iv) the general purpose of the agreement involving the MAC clause in dispute. In the process the following factors are commonly examined by the court (special M&A factors marked):

- Financial benchmarks or criteria included in the MAC.
- Whether the MAC claim is reasonable and in good faith in the light of circumstances.
- What are the motivations for exiting the agreement?
- The buyer's general purpose in acquiring the target entity (M&A).
- The commercial context of the losses suffered (M&A).
- Absolute and proportionate amount of the losses realised (M&A).
- Was it possible for the acquirer to protect himself through specific warranties from the target? (M&A). [76]

Such MAC clause cases are rarely decided on a motion to dismiss as courts (in USA) cannot grant such a motion where there are material facts in dispute as is the case in these litigations, but the fact is, however, that MAC cases are often settled before determination is reached.[77] In the following chapters the process, reasons behind it, and the consequences of invoking MAC clauses will be discussed in details and in most cases a distinction is not made between MAC clauses in loan agreements and in M&A agreements as the fundaments are very much the same.

[76] White & Case, "Material Adverse Change Clauses in the Current Credit Environment", p. 2.
[77] Ibid., p. 2.

5.1. Thorough assessment before calling a MAC

Invoking a MAC is a very serious action as already has been pointed out, the burden of proof is substantial and the consequences could be enormous if not correct. So it is very important for the party considering this action (the lender or the buyer in M&A cases) to go through all the underlying details in order to be sure that the decision is correct. Alexander Hewitt[78] suggests that before such a decision to invoke a MAC is made one should go through given 15 questions.[79] One should be aware of the borrower's financial status, if he has become insolvent in the past or is heading there. As there is only one UK court case where a lender has successfully called a MAC event of default and that was related to the debtor insolvency,[80] it is important to be aware. Was it possible for the lender to see what was coming (this is important as USA case law suggests one might not pass such a test). It is important to have good evidence at hand as the involved event will significantly reduce the borrower's ability to pay in medium or long term. The evidences on changes in the borrower's factors, such as his business or financial conditions, must be strong if the court is to accept it.

And how strong are the information covenants or other related sources? As Hewitt points out, most litigation is won on facts, not the law. He also points out that the most valid accelerations of international credit agreements are based upon breaches of financial ratios, which are objective facts, so it is important to consider if one shall not wait until the next testing date and let the loan default on it. Another important issue to consider is which should be done, accelerating a loan, or planning to refuse to accept further drawing on it? It is important which one is chosen, as the borrower has a better chance of suing back for a breach of lending commitment than for wrongful acceleration. And instead of taking the case to court it might work just to declare that a MAC has happened and force the borrower to the table for re-negotiation of the agreement and terms. It does matter where in the world the jurisdiction is, which covers the agreement, as in some countries it might be more difficult to rely on the MAC clause than in others. In some countries one could not

[78] Alexander Hewitt is a legal counsel at the international law firm DentonWildeSapte... and a writer on the MAC clause.

[79] Hewitt, Alexander, "Material adverse change – 15 questions to ask before you call a MAC event of default", *Bank Notes*, London, January 2008. Only few are covered here, but all the 15 questions are listed in Appendix II.

[80] National Westminster Bank plc v Halesowen Pressworks Assembles Ltd. (1972) AC 785 HL.

rely on a MAC if the court finds it might give the lender too much power, or it could make one's lending commitment too uncertain (like in Norway and Iceland). The result is that it is very important that the lender makes as thorough preliminary assessment of his case as possible before he takes his MAC clause default to court.

5.2. Use as a base to re-negotiate

As mentioned before, instead of taking a MAC clause default to court it might be better to use it to force the borrower to the negotiating table in order to re-negotiate the agreement and terms. This can be the result of a MAC default where the declaration of a MAC has cancelled a transaction (M&A) and the dispute never even went to trial, which seems to be more common in cases related to M&A agreements than loan agreements. A recent and a very well known and closely watched case in the USA was the so called "Sallie Mae case" in USA 2007.[81] It involved a merger agreement of the sale of Sallie Mae to investors led by J.C. Flowers II L.P. and they stated that a reduction in federal subsidies to student lenders and its impact upon Sallie Mae's earnings amounted to a MAC and the buyers should be allowed to terminate the contract without paying a defined break-up fee.[82] Sallie Mae did not accept this and sued claiming that no MAC had occurred and the merger agreement had been unlawfully terminated. The dispute was settled before it went to trial. Same happened when Kohlberg, Kravis, Roberts & Co. and Goldman Sachs pulled out of buyout of Harman Int. Industries claiming that a MAC had occurred as their financial conditions were not as agreed upon. This dispute never went to court, the acquisition was cancelled and settlement reached.[83]

5.3. What to consider

In the case of a syndicated loan facility, invoking a MAC clause is not the sole decision of the bank's agent, but rather a pool of banks involved in the syndicate (usually requires at least 66 percent). Their view on the matter and assessment should be based not only on legal judgement on the MAC involved, but also political calculations and commercial judgements. In cases where there has not been

[81] SLM Corporation v. J.C. Flowers II L.P., et al., Verified Complaint C.A. No. 3279-VCS (Del. Ch. Oct. 8, 2007)
[82] Rothschild, et.al. "Drafting material adverse change clauses," p. 2.
[83] Ibid., p. 2.

concrete accuracy, English courts have put in great efforts to analyse what happened before the transaction was concluded to find out the intent of the leading banks, while judges in the USA refer to what a reasonable debtor in a similar situation would do.[84] Considering invoking a MAC clause, it would be advisable to analyse seriously the following three factors: (i) How harmful are the events? (ii) How predictable were the events? (iii) What is the scope of the event?

5.3.1. How harmful are the events?

In order to understand the seriousness of the event involved, in the invocation of a MAC, it is necessary to look at a few case laws that have been defining this matter. In one UK case[85] the judges decided that the fact that a borrower declared voluntary liquidation shortly after withdrawing on his loan constituted a material change in his condition and could therefore invoke the MAC clause. In another UK case, Levison v Farin[86] which regarded M&A, the judge declared that a 20 percent decrease in the asset's value in only four months, between the date of the last test and the completion date, was a material change in its business and therefore justified MAC clause invoking. In a very well known UK Takeover Panel's ruling from 2001 WPP/Tempus[87] the result was that the change needed to invoke a MAC clause would require a substantial change which needed to be a part of the transaction (M&A) or: *"...an adverse change of very considerable significance striking at the heart of the purpose of the transaction in question, analogous to something that would justify frustration of a legal contract."*[88] The importance here is that the change in the target business needs to have an effect for a reasonably long time and this factor was also emphasised in a USA court case[89] a few months earlier from the UK Takeover Panel's result (they might have had the IBP-Tyson case result at hand even though it is not mentioned). In the IBP-Tyson case, the judges reflected on the IBP seasonal differences in its business, the decline in its income over two seasons

[84] Julien, Franck and Lamontagne-Defriez, Jean-Marc, "Material Adverse Change and Syndicated Bank Financing: Part II", *Journal of International Banking Law and Regulation*, 19 May, 2004, p. 193, and here they are referring to the IBP Inc. v Tyson Foods Inc. case.

[85] National Westminster Bank plc v Halesowen Pressworks Assembles Ltd. (1972) AC 785 HL.

[86] Levison v Farin (1978) 2 All ER 1149, Queen´s Bench Division.

[87] Offer by WPP Group plc for Tempus Group plc (Takeover Panel Ruling, 6 November 2001), para 18.

[88] Julien, and Lamontagne-Defriez, "Material Adverse Change and Syndicated Bank Financing: Part II," p. 193 and the quotation is from the WPP/Tempus ruling.

[89] IBP Inc. v Tyson Foods Inc, 789 A.2d 14 (Del. Ch. June 18, 2001).

could have been predicted and was therefore not a base to invoke a MAC clause; the focus should be on the long term.

5.4. Could it be predicted?

One major purpose of the MAC clause is to bring a certain security against the materialisation of unknown risk. And this is the fundamental reason why the drafters of the MAC clauses at the time of negotiating the facility, draft them broadly in order to cover what is yet unknown. Is it possible that a MAC clause is applied to situations which by no means could have been foreseen or predicted or the lenders should have suspected? The concept of precedent under English laws illustrates this up to a point, and this is supported by the Levison v Farin case, but to some account is contradicted by USA case laws.[90] In this context it is helpful to use the concept of '*frustration*'[91] under English law, which implies that occurrence of unforeseen or unexpected events can justify cancelling an agreement. But involved parties must then be ready to accept the consequences of the events which they should have been aware of at the time when they entered into the agreement.[92] So, if a bank has signed a Mandate letter which includes a MAC clause and the bank had been aware of certain circumstances which could entitle it to invoke MAC based upon it, it would be very difficult for the bank to do so, based of those circumstances.[93] This has been supported by several USA case laws.[94] But if the adverse circumstances are obvious during the time when the Mandate letter is being negotiated, it is necessary for the contracting parties to have it clear in the Mandate letter that they intended to have the MAC clause refer to that certain pre-existing and known circumstances which may be the base for invoking a MAC. Such a clear drafting establishing this intention is unlikely to be ignored by an English court. [95]

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90 Julien, and Lamontagne-Defriez, "Material Adverse Change and Syndicated Bank Financing: Part II," p. 194.

91 The theory and the concept of '*frustration*' will be covered in more detail in chapter 6.1.

92 Julien, and Lamontagne-Defriez, "Material Adverse Change and Syndicated Bank Financing: Part II," p. 195.

93 Mehta, "Material Adverse Change Clauses in Adverse Markets", p. 2.

94 Two USA cases could be pointed out as good examples on this matter: Sinclair Broadcast Group v Bank of Monteal and SLM Corporation v JC Flowers.

95 Mehta, "Material Adverse Change Clauses in Adverse Markets", p. 2.

6. Interpretation

The option of the lender to accelerate a loan, or in case of M&A the buyer to walk away from a transaction if the borrower or the target company experience a material adverse change in its business or its environment, is the fundamental function of the MAC clause. The consequences of its invocations can be enormous for both parties (in most cases probably more serious for the borrower/seller). As the clause is most often rather open it must be interpreted and unfortunately there is a lack of case laws directly covering it, so various interpreting methods are used. In the following chapters some of the most common interpreting methods and related case laws are covered.

6.1. Sanctity of contracts and the doctrine of frustration

As mentioned before, both UK and USA contract laws are based on the two principles of contract law, the freedom of contract and the sanctity of contract. The latter principle is the one which is involved in the interpreting process of MAC clauses. Several case laws in USA have covered the interpretation of MAC clauses. One of the best known, and actually a landmark decision in this field, is the case which has been mentioned already, IBP Inc. v Tyson Food Inc.[96] from 2001. This was a dispute over a MAC in an M&A agreement where the buyer (Tyson Food Inc.) claimed that a significant loss in the operation of the target company (IBP Inc.) constituted a MAC. In interpreting the MAC clause the court considered all available evidence and stated it was: *"best read as a backstop protecting the acquirer from occurrence of unknown events that substantially threaten the overall earnings potential of the target in a durationally-significant manner."*[97] This meant that Tyson Inc. could not use the MAC to get out of the acquisition and had to go through with it. When referring to this case as a "landmark decision in this field" the reason is that it is generally seen as a sample because following it USA courts have hesitated to apply a broadly written MAC clause at its literal meaning, but instead take into account all relevant facts of a case, including subjective elements, when considering if a MAC has occurred.[98] This has lead to less certainty for including MAC clauses in a facility and probably the believed potential of its ability to cover unexpected and

[96] IBP Inc. v Tyson Foods Inc, 789 A.2d 14 (Del. Ch. June 18, 2001).
[97] Sikkeland, "(No) Material Adverse Change Clauses – Norwegian Law with...", p. 8, in re IBP at 68.
[98] Ibid., p. 8.

unforeseen events. As mentioned before, there are few to none direct case laws in the UK on MAC clauses, and therefore UK courts are expected to take notes of the USA examples when interpreting MAC clauses. [99]

In accordance with the doctrine of frustration, 'frustration' can cause that a party can get out of a contract if the fulfilment of the given promise of performance is hindered in such a way that the general purpose of the contract is frustrated. But a MAC clause operates somewhat differently from the doctrine of frustration on three accounts:

(i) It does not 'kill the contract', even though it might relieve one party from its obligation to perform but not necessarily the other party of its obligation under the agreement;

(ii) The party who is relying on the MAC clause (the lender) usually has the option to do so and to use it as an event of default; and

(iii) The express wording of the MAC needs to be so clear that in case of a MAC, as defined in the clause, the party relying on it can do so.[100] Supported by several courts results[101] it is a common belief that most MAC events would not be covered by the doctrine of frustration, either in the UK or the USA.[102]

6.2. How to measure "materiality"?

What is the actual meaning of "material" as used in the MAC clause? How big must an adverse change be, and how long must it last, in order to trigger the MAC clause and permit the lender (or in case of M&A the acquirer) to walk away from the loan (deal)? When a dispute over a MAC clause is taken to court, the court would generally be asked to determine if:

(i) the event in dispute constituted an "adverse event" in relation to the definition of the MAC; and

(ii) the event was "material."

[99] Sikkeland, "(No) Material Adverse Change Clauses – Norwegian Law with...", p. 8 – Birkett, Kirsten, "Untying the knot – Material adverse change clauses", PLC March 2002 p. 17-28, at 25.

[100] Hooley, *Commercial Law & Commercial Practice,* p. 308.

[101] Among those court cases in UK are: Davis Contractors Ltd. V Faraham UDC (1956) AC 696 at 729 and Pioneer Shipping Ltd v BTP Tioxide Ltd (The Nema) (No. 2) (1982) A.C. 724 s. 752 where the House of Lords expressed that the doctrine of frustration *„(is) not lightly to be invoked to relieve contracting parties of the normal consequences of imprudent commercial bargains"* (Sikkeland, p. 9).

[102] Sikkeland, "(No) Material Adverse Change Clauses – Norwegian Law with...", p. 9.

The former factor is relatively straightforward, or change for the worse, while the latter one is not, and in most MAC clause's related court cases, the language in the MAC clause is not specific enough in defining the meaning of what "material" stands for.[103] The term "material," is clearly the key component of the definition of "Material Adverse Change," but it is rarely defined. Some M&A agreements do though define the term with reference to some specific dollar amount, but the vast majority of those agreements do not.[104]

Generally, the MAC clause seems to be an exception to the basic purpose of a written contract, which is to clearly define the parties' agreement or understanding with respect to a transaction. And this has meant that through the years the courts have been struggling to define the term "material." The first place to look for the defined meaning of "material" is to search dictionaries. One definition from a dictionary is: "*being of real importance or consequence,"*[105] but it can in short also mean "*significant*"[106] or "*of much consequence; important."*[107] Those or other definitions are not helping at all, as it is still not clear how one determines the size or limits of those terms. Another place to look to determine the meaning of *material* is case law. In one UK case[108] the judge declared that the meaning of "material consideration" meant a relevant consideration. In another case[109] the Court of Appeal held that a "material" breach was one of "serious or substantial import" or "important." But this is not helping either. A little more help can be found in two court cases. The former is National Westminster Bank plc v Halesowen Pressworks Assembles Ltd[110] where it was concluded that the defendant bank had the right to combine the clients accounts based upon the nature of former arrangements and the resolution (Bankruptcy Act) constituted a material change of circumstances and therefore the bank was in the right to combine the accounts.[111] In the latter case, Levison v Farin,[112] where there was a dispute of an adverse change in net assets of the sellers company (Levison) of £8.600 (out of £64.000) between the date of

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103 Alexander, Joseph B., "The Material Adverse Change Clause (With Simple Language), p. 13.
104 West, and Parel, "Revisiting Material Adverse Change Clauses", p. 2.
105 Find Law for legal professionals: http://dictionary.lp.findlaw.com
106 Black´s Law Dictionary 991 (8th ed. 2004).
107 Dictionary.com: http://dictionary.reference.com/browse/material
108 Tesco Stores Ltd. V Secretary of State for the Environment (1995) 2 All ER 636
109 DB Rare Books Ltd v Antiqbooks (a limited partnership) (1995) 2 BCLC 306
110 National Westminster Bank plc v Halesowen Pressworks Assembles Ltd. (1972) AC 785 HL
111 Hooley, *Commercial Law & Commercial Practice, p.* 316.
112 Levison v Farin (1978) 2 All ER 1149, Queen´s Bench Division

balance sheet and completion date, so the buyer (Farin) refused to pay full purchase price (M&A). The result was that the decline was not a normal trade fluctuation but a MAC, and the 20 percent drop in assets in this period (four months) was *material*.[113] This case suggests that a MAC clause can apply to an event that possibly could have been foreseen or even guarded against (by the buyer in M&A).[114]

The same situation is when searching for results in USA case laws. Courts there do not seem to have looked to any of these above sources when defining the meaning of "material" as used in MAC clauses. [115] Instead, the case law has viewed the MAC clause as "*sui generis*"[116] and has tried to interpret the meaning of "materiality" without reference to any pre-existing body of law. So, as the term "material" is close to be an undefined term within a defined term, it seems to be surrounded with deal custom and tradition rather than clear legal standards. Nevertheless, few 'deal professionals' appear to use as a traditional rule of thumb, that a negative financial change between 10 to 20 percent is a must before an event or change is likely to be judged to be sufficiently "material" in order to constitute a material adverse change. But a rule of thumb is just a rule of thumb, and this has not been supported by any further court rulings as an appropriate general threshold of materiality.[117] In order to ensure that a MAC clause of any facility or agreement should be interpreted in accordance with a defined standard, one must build it in the definition of the MAC clause. If one wants it to be defined from the perspective of the buyer (M&A) or the lender, the MAC clause must simply say: *"... from the buyer's perspective (or lender's),"* and by this one is using more applicable language than used by the IBP court and surely a much better alternative than leaving the matter completely to the courts' discretion.[118]

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[113] Hooley, *Commercial Law & Commercial Practice*, p. 318.

[114] This is not that simple as there are cases from the USA suggesting the reverse, such as: Re JCs East, 1995 US Dist LEXIS 13607 (SDNY 1995) and Sinclair Broadcast Group v Bank of Montreal, 94 Civ 4677 (SDNY 1995).

[115] Schwartz, "A ´Standard Clause Analysis of the Frustration Doctrine and the Material Adverse Change Clause", p. 45.

[116] Hexion Specialty Chems., Inc. v. Huntsman Corp., 965 A.2d 715, 737 (Del. Ch. 2008), Schwartz p. 45.

[117] West, and Parel, "Revisiting Material Adverse Change Clauses", p. 2.

[118] Adams, Kenneth A., "A legal-Usage Analyses of 'Material Adverse Change' Provisions", *10 Fordham Journal of Corporate & Financial Law,* 2004, p. 26..

6.3. What does the term 'change' in MAC refer to?

It all depends upon the exact wording of the MAC clause in question. A traditional MAC clause may refer to adverse changes in three different factors: (i) the market of the borrower (seller in M&A), (ii) the financial operation of the borrower (seller in M&A), (iii) the general financial, economical, or political environment (local and international).[119] As mentioned before, MAC clauses are very common in *Representation* and the *MAC Event of default* provisions in typical loan facilities. In the former the borrower represents and warrants that since a defined date no MAC has occurred in its business operation, its assets, or prospects or conditions, and this can relatively easily be tested by the lender. If changes have occurred, the lender (often a syndicate of banks) can suspend its obligation to advance the loan. In the latter case, a MAC event of default refers generally to events, or circumstances that reasonably might affect the borrower's ability to fulfil its obligations of the facility. When faced with an event of default the lender always has the option of accelerating the loan, and unlike MAC representation, the MAC event of defaults does not focus entirely on factors related to the borrower. But a MAC event of defaults generally requires that the related events will affect the borrower's ability to perform its obligations under the facility. What will trigger the MAC clauses differs from clause to clause and is usually a matter of negotiation.[120]

6.4. Is there a quantitative approach to MAC?

In order to relieve the courts from the responsibility of determining if a certain adverse change is material or not, parties to a facility or agreement sometimes use quantitative guidelines to provide what will constitute a MAC, and such guideline has served as an exclusive base in a USA court case when determining whether an adverse change is a MAC.[121] Quantitative guidelines can also serve as a supplement to traditional definition of a MAC clause, but there are four serious problems with such an approach: (i) it is almost impossible to set thresholds for all possible situations and impractical, and to limit it to a few ones would be questionable, (ii)

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[119] Hooley, *Commercial Law & Commercial Practice,* p. 320.

[120] Ibid., p. 322.

[121] This was actual in the case of Great Lakes Chemical Corp. v Pharmacia, 7888 A.2d 544, 577 (Del. Ch. 2001) where the purchase agreement at issue defined MAE as „*a negative effect or a negative change on the operations, results of operations or condition (financial or otherwise) in amount equal to $6.500.000 or more.“* Adams, p. 28.

establishing one or more quantitative thresholds will probably complicate and lengthen the negotiation process severely, (iii) listing exclusive quantitative samples might mean that the court would not consider other situations not listed as a MAC, (iv) bearing in mind that the major purpose of the MAC clause it to catch the unknown, so if a party can list and quantify situations, it might be better to include them somewhere else in the facility. These are also the major reasons that quantitative guidelines are not used that much in MAC definitions.[122]

6.5. How does the Force Majeure clause relate to MAC?

The closest "relative" of the MAC clause can be said to be the '*force majeure clause'*, bearing in mind that as early as at the Mandate letter's stage the effects of a material adverse change should be anticipated.[123] The basic definition of the '*force majeure clause'* is: "a clause in an agreement that excuses performance in the event that a force majeure makes the performance impracticable or impossible",[124] so it entitles the beneficiary party of the contract to walk away from a contract, in whole or partly, or gives him the option to suspend performance of the contract or possibly claim an extension of a given time for performance, in case of some unexpected events or events completely out of his control. The '*force majeure clause'* has similar effects under the common law as the MAC clause, as contracting parties are negotiating for some new and unknown circumstances. It is not a part of English law, but better known in the continental legal system. One major difference between it and the MAC clause is that a MAC clause does not contain an obligation on the part of the beneficiary party of the clause to conserve a contractual relationship (except maybe a moral duty to do so). In the UK court case, Paragon v Staunton,[125] the judge upheld the lender's (beneficiary) right to increase an interest rate, given that he did so in an honest and fair way. One should expect that an exercise of a MAC clause would be treated by similar consideration.[126]

But is a MAC clause actually a '*force majeure clause'*? The term as such is not a part of English law, as mentioned before, but when considering its definition

[122] Adams, "A legal-Usage Analyses of 'Material Adverse Change' Provisions", p. 29.
[123] Julien, and Lamontagne-Defriez, "Material Adverse Change and Syndicated Bank Financing: Part II", p. 197.
[124] Find Law for Legal Professionals: http://dictionary.lp.findlaw.com
[125] Paragon Finance plc v Staunton (2001) EWCA Civ 1466 (2001) 2 All ER (Comm) 1025.
[126] Julien, and Lamontagne-Defriez, "Material Adverse Change and Syndicated Bank Financing: Part II", p. 197.

one can say that in substance, it is describing also what a MAC clause does. However, in financial facilities (and M&A agreements) the general MAC clause is in its basic form quite different from the traditional '*force majeure clauses'* which are common clauses in those agreements and a part of many standard financial agreements such as the LMA loan facility. In such agreements the MAC clauses can take on various forms, the most common are offer, warranty or representation, or event of default. In addition to that the party relying on the MAC clause could possibly hold certain rights which would not be possible to get in case of a traditional '*force majeure clause'*. This means e.g. in such a situation, when a MAC clause triggers an event of default in a loan facility, the lender has the option to be relieved of his obligation to advance further funds, but he can also accelerate the loan in whole. And if the loan is also secured the lender might be in the position to take some control over the borrower's business or appoint a receiver or administrator. Those are the major differences of forms between MAC clauses and force majeure clauses.[127]

6.6. Subjectivity of MAC or Good faith?

Sometimes the MAC clause is phrased in such a way that the lender can determine subjectively what the triggering events or change will be. Alternatively, the clause may employ an objective standard, meaning that in order to determine whether an adverse event is material, courts can use an objective standard of what a reasonable lender (buyer in case of M&A) would consider as being material.[128] Courts in the USA have been using this test like in the court case of Parnes v Gateway.[129] The objective standard would be preferred by the borrower while the lender would prefer the subjective test. It is known that a MAC clause can expressly state that an event of default occurs when in the lender's *reasonable* opinion there has been a MAC. In most cases the word will probably be read into the clause whether it is expressly written there or not.[130]

In regards to '*good faith',* there have been a few instances taken to court in the USA where defaulting borrowers have claimed damages for the lender's assumed failure to meets its unstated obligation of '*good faith*' in dealing with a

[127] Hooley, *Commercial Law & Commercial Practice,* p. 313.
[128] Alexander, "The Material Adverse Change Clause (With Simple Language), p.13.
[129] Parnes v Cateway 2000, Inc. 122 F3d 539 (8th Cir. 1997).
[130] Hooley, *Commercial Law & Commercial Practice,* p. 315.

customer when the lenders have terminated a line of credit, accelerated a payment, or foreclosed on a collateral.[131] Just as '*force majeure'* the general doctrine of '*good faith'* is not a part of the UK laws, but the UK laws have developed in part, solutions in response to obvious problems of unfairness as can be seen in a few UK case laws.[132]

6.7. The way out, Carve-outs

The history implies that case law has been more on the seller's side (in M&A), meaning it has limited the buyer's ability to successfully invoke the MAC. And the development has also been such that sellers have also been able to limit further the comfort that the standard MAC gives the buyers (borrowers) by being able to insert several exclusions or carve-outs into them. Following are a few examples of the more frequent events or changes, the occurrence of which are frequently excluded from the definition of MAC:

- changes in general political, economic or financial market conditions;
- changes in industry conditions that do not disproportionately affect the target company;
- changes resulting from the announcement of the transaction;
- changes resulting from the parties´ compliance with the terms of the agreement;
- changes in generally accepted accounting principles;
- changes in law;
- acts of terrorism or war. [133]

These carve-outs can cause many different difficulties when events are interpreted. Let's say that a major decline in revenue was faced by the target company involved in an M&A. The questions that need to be answered are: Was this due to problems related to the company's products or services that caused the decline, or was it a consequence of a decline in the economic environment or maybe just because the company was in the process of being sold? So, the message to the buyers (lenders) is to avoid the carve-outs due to limiting effects built in them.[134]

6.8. Relations to other provisions of the facility

Taken to court the MAC clause as such is not assessed alone and independent from other provisions of a given facility or contract. The relationship with the '*force*

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[131] A sample of such a court case is e.g. Reid v Key Bank, 821 F 2d 9 (1st Cir 1987) and KMC v Irving Trust, 757 F 2d 752 /6th Cir 1985). Hooley, p. 515.

[132] A sample of such a court case is: Interfoto Picture Library Ltd v Stiletto Visual Programmes Ltd. (1988) 1 All ER 348. Hooley, p. 315.

[133] West, and Parel, "Revisiting Material Adverse Change Clauses", p. 2.

[134] Ibid., p. 2.

majeure' provision has already been covered, but there are other provisions which the courts will consider and can be influenced by what is or is not included in them. This has been demonstrated in a few USA case laws related to M&A disputes. One example is a case law where the court uses a narrow scope of a representation (or condition) as basis when reaching the conclusion that MAC had not in fact occurred, and it can be concluded that this had not been the result if the representation provision had not been included the condition.[135] Another court case deals with a topic which is actually not addressed in a given contract and therefore was probably not a material subject to the included parties.[136] The court found that a certain downturn in daily production constituted some inaccuracy of given representations in the M&A agreement and also the absolute MAC representation, and this was based on the absence of a representation covering the production, stating that if the parties had considered the production material (important) they would have included it, which they did not.[137]

6.9. Burden of proof

Generally, there are two ways in which a party can invoke a MAC provision. One is to do it in connection with a claim for damages and base it for example on incorrect MAC representation, and the other one, an affirmative defence when one is trying to avoid performing under a contract. In general a court is likely to hold that the party invoking a MAC provision would have the burden of proof and that party would be required to provide evidence that a MAC occurred.[138] One, who wants to address a MAC related burden of proof issued in a facility, must include in it, who actually has the burden of proof, if a MAC provision or carve-out is invoked, and must also state what the burden of persuasion is in each and every case.[139]

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[135] In the court case, Gordon v Dolin, 434 N.E.2d 341, 348 (III. App. Ct. 1982), the buyer in an M&A dispute claimed that a absolute MAC representation was „*triggered by the decision of the seller´s principal customer to shift part of his business to a new supplier. The court ruled that the buyer could not rely on the absolute MAC representation, as the narrower condition modified and limited the absolute MAC presentation: ´Where a contract contains both general and specific provisions relating to the same subject, the specific provision is controlling´*." Adams, p. 49.

[136] Northern Heel Corp. v Compo Industries, Inc., 851 F. 2d 456, 465-66 (1st Cir. 1988).

[137] Adams, "A legal-Usage Analyses of 'Material Adverse Change' Provisions", p. 49.

[138] Ibid., p. 46.

[139] Ibid., p. 47.

7. MAC invoked - incorrectly

Up to this point it has been covered in what ways the MAC clause can be invoked and what the consequences might be. But what if it has been invoked incorrectly or wrongfully, accidently or on purpose, what will the consequences then be? In the following two chapters this subject will be covered to some extent. The event of invoking a MAC, by the lender, might cause severe consequences for the borrower (the seller in case of M&A) and also have marginal effects due to cross-default effects. Parties involved must be fully aware of their responsibilities when it comes to this stage. In general remedies are linked to the appropriate causes of any damages, but in practice a lender (a bank) would generally not be solely responsible for the total damages caused to the borrower's business as certain elements will be deducted based upon each case.[140] This is telling us that it might not be so smart of the lender to rely too heavily on a MAC clause if he is considering pulling the plug on his borrower, as the penalty for doing it incorrectly or wrongly could be severe and the following statement describes this very well:

> In this era of lender liability concerns, it is a brave banker who will rely exclusively on the MAC clause as the basis for accelerating a credit. Most commentators agree that in the absence of some other objective event of default, the change affecting the borrower would have to be 'cataclysmic' before a lender could be certain that the materiality was satisfied.[141]

The lender can of course invoke a MAC clause and by it activate whatever means he has contracted for if that happens. But if he gets it wrong and finds himself in breach of the facility, he will definitely become liable to the borrower for damages enough to get the borrower in a similar position as he would have been in if the loan or advance had not been cancelled due to invoking the MAC clause. So, the lender might be facing a huge risk that substantial damages might be awarded against him.[142]

If the lender is in the position of being in a breach of a contract after invoking a MAC and did not make advantage or had accelerated the loan prematurely, what are the remedies available to the borrower, if any? The general rule seems to be that specific performance will not be granted (in cases that damages are an adequate

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[140] Julien, and Lamontagne-Defriez, "Material Adverse Change and Syndicated Bank Financing: Part II", p. 197.

[141] LC Buchheit, 'How to negotiate the material adverse change clause' (1994) IFLR (March) 31 at 32, Hooley, *Commercial Law & Commercial Practice,* p. 327.

[142] Ibid., p. 328

remedy), and this has been supported by one UK court case, the South African Territories Ltd. v Wallington, where the House of Lords refused to do so.[143] There have been exceptions from that general rule and then in case of an unsecured loan agreement.[144] So, in case of a claim for damages for breach of a contract, what is the scope of it? It is, as said before, in general designed to compensate for the damage, injury and/or loss the borrower has suffered as a consequence of the breach, and the aim is that he will be in the same financial situation as if the contract had actually been normally performed, and this has been supported by the Galoo case.[145] Three factors need to be kept in mind and considered:

(i) causation, or the breach was actually a cause of the loss;

(ii) remoteness, where the lender is liable for losses that occur 'naturally' after the breach and also for losses that did not occur 'naturally' but were in a reasonable knowledge of both parties at the time the contract was made;

(iii) the question of mitigation, where the borrower must take all reasonable steps to minimise his potential loss.[146]

There are at least five possibilities of potential outcome in case of a breach of facility and all of those outcomes are supported by different court cases which are listed along:[147]

(i) As the borrower will be able to secure a similar loan from another source he will only recover minimal damages (assumed no extra loss is involved)[148], but if there is a negotiation or special cost involved related to getting the new loan it may be also be recovered.[149]

(ii) Same is if the total cost of the new loan is higher than the cost of the initial loan, the borrower should be able to recover the difference.[150]

(iii) The action of accelerating the loan or cancel the lending commitment could lead to a cross default mechanism and possibly lead to the bankruptcy of the

[143] South African Territories Ltd v Wallington (1898) AC 309 House of Lords. Hooley, *Commercial Law & Commercial Practice,* p. 328.
[144] Loan Investment Corporation of Australia v Bonner (1970) NZLR 724. Hooley, *Commercial Law & Commercial Practice,* p.328.
[145] Galoo Ltd v Bright Grahme Murray (1994) 1 WLR 1360. Hooley, p. 328
[146] Hooley, *Commercial Law & Commercial Practice,* p. 329.
[147] Those propositions are suggested by Hooley, *Commercial Law & Commercial Practice* p. 329-331.
[148] Manchester and Oldham Bank Ltd v WA Cook (1883) 49 LT 674 at 678, Day J.
[149] Prehn v Royal Bank of Liverpool (1870) LR 5 Exch 92
[150] South African Territories Ltd v Wallington (1898) AC 309 House of Lords

borrower or his business. The liability claim for such a loss could be enormous and could also include a loss of the going concern value of the borrower.[151]

(iv) Temporarily withholding payments of a loan could lead to some losses in the business operation of the borrower if the funds were fundamental in maintaining the operation. And while the borrower does his best to minimise his loss, damages might be awarded for lost business opportunities.

(v) Temporarily withholding payment and/or accelerating the loan facility could mean that the borrower is missing on a profit on particular business opportunities which then are lost to him. In order to be able to recover such a loss the lender must have been aware of and accepted this opportunity at the time when the facility was made.[152]

As shown here and mentioned before, there is a realistic possibility that the lender (buyer in case of M&A) will, in some circumstances, be facing substantial liabilities as a result of incorrectly invocating a MAC clause and by it suspending or accelerating a loan facility. Lenders as well as borrowers should be fully aware of this.

8. Before and after writing the MAC clause

It can seriously matter what was said and what the parties intended in the negotiation process between the parties involved prior to reaching the final facility agreement, if a dispute over a MAC clause goes to court. The same is in regards to the parties' conduct after the facility agreement has been finalised. The following two chapters will cover these subjects to some extent.

8.1. Pre-contractual statements and negotiations

One should be aware that statements during the negotiations process prior to finalising the loan facility could end up as very damaging in litigation at a later stage. Good examples of such harmful statements were given in two different USA court cases and related to MAC clauses.[153] Both cases relate to similar statements given

[151] Crimpfil Ltd v Barclays Bank plc (1995) CLC 385, Court of Appeal
[152] Manchester and Oldham Bank Ltd v WA Cook (1883) 49 LT 674 at 678, Day J.
[153] Solutia Inc. V Citigroup Global Markets Inc. (Case no. 03-17949(PCB)) (Feb 2008) and Sinclair Broadcast Group v Bank of Monteral, 94 CIV 4677 (SDNY 1995).

by the lender (the bank) in the negotiation process and are described in the following example (the given statement by the banker is underlined):

> During negotiations, the borrower questions the market MAC clause as conflicting with the borrower's need for fully committed facilities. In response, the banker says, '<u>It's just boiler plate from dark ages; the banks have never called it.</u>' The banker goes on to say, '<u>We hold the debt if it doesn't syndicate.</u>[154]

Such statements could be held against the lender if he tries to invoke the MAC clause, so, if the lender wants to be on the safe side, he should include in the facility a confirmation from the borrower that he will not hold the lender to any statements given in the negotiation process. On the other hand, such a confirmation might be unacceptable to sign by the borrower. And it is worth noting, that courts will likely draw a distinction between excluding liability for pre-contractual statements (like giving the above confirmation) and referring to statements given in pre-contractual negotiations in order to explain the meaning intended by parties involved. So, if the court considers the factual background of the dispute in the MAC case in his process to interpret the contract, pre-contractual statements might be relevant for that and might therefore be considered by the court.[155]

8.2. Post-contractual conduct

It is a general rule of the interpretation of an English contract law, that the court will not consider the conduct of parties involved after the agreement has been finalised. But anyway, some post-contractual conducts have turned out to be very important to the final outcome of a dispute on a MAC clause. And an English court may find that certain conducts of the lender to be unconscionable or it may give rise to an estoppel arising from invoking the MAC clause on the basis of conditions preceding the amendment, agreement to pay a fee or other conducts by the borrower to its damage.[156] It has not actually been answered; if a lender is aware that a MAC has actually occurred in the period between signing the facility and a date that a certain amendment is made, will he give up his right later to invoke the MAC clause if he does not notify the borrower of his right to call the MAC at a later date.[157] Both lenders and borrowers need to be aware of this.

[154] Mehta, "Material Adverse Change Clauses in Adverse Markets", p. 5.
[155] Ibid., p. 6.
[156] Ibid., p. 6.
[157] Ibid., p. 7.

9. Two recent important court cases on MAC[158]

The world financial crisis produced some court litigations where the MAC clause was involved and claims that lenders sought improperly to avoid performance of their commitment (Mandate) letters, using MAC clauses as closing conditions (M&A cases). The following two USA court cases from 2008, the Solutia case[159] and the Hexion case[160], have both been referred to in the previous text, but both are considered very important for future MAC disputes. They are therefore covered especially here and a more detailed description of them is attached in Appendixes III and IV. The former relates to the Market MAC clause while the latter to the Business MAC clause.

Market MAC clauses have not been very common in the USA since the 1990s, but following the drastic change in financial environment in recent years lenders may be more willing to use it in commitment letters and include a MAC clause there. The first borrowing company in the USA to have its loan accelerated by invoking a MAC clause after the financial crisis was Solutia Inc. and this was in January 2008. Solutia Inc. took the dispute to court and in the court case against Citigroup Global Markets Inc., (the lenders), Citigroup claimed they had the right to terminate their debt commitment in case of occurrence any adverse change since the date of the commitment letter. During the trial, the lenders presented evidence that huge changes had occurred in the market following the commitment date (25. Oct. 2007), which justified the invoking of the MAC clause. Solutia on the other hand claimed that: (i) adverse change had not occurred in the markets as all the underlying factors had been known to both parties at the commitment time; (ii) the commitment letter stated that a completion of syndication was not a condition to funding and the MAC clause conflicted with that; and (iii) when the lenders had invoked the MAC they had not used "reasonable judgement."[161]

The case was settled between the two parties before the court had ruled on it. But the case is helpful in relation to MAC clause disputes in two ways: (i) it covered and emphasized the major issues that lenders will be facing in typical Market MAC disputes, and (ii) showed how difficult it is for the lenders to establish the occurrence

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[158] Linklaters, "Commitment letters: Lessons from recent US litigation." This chapter is based on this newsletter.

[159] Solutia Inc. V Citigroup Global Markets Inc. (Case no. 03-17949(PCB)) (Feb 2008).

[160] Hexion Specialty Chem. Inc. v Huntsman Corp., C.A. No. 3841-VCL (Del. Ch. Sept. 29, 2008).

[161] See more briefing of the case in Appendix II.

of a typical Market MAC, even in the current financial crisis. So, the Solutia litigation to some extent reinforces the central meaning of the Market MAC provisions, or that they provide important leverage to lenders to convince borrowers to re-negotiate loan terms in order to move them closer to current market conditions.[162]

As was covered in chapter 2.2., the Business MAC clause has been rather common in the USA commitment letters. In the court case, *Hexion Specialty Chemicals Inc. v. Huntsman Corp*.[163] the court stated that invoking a Business MAC is not appropriate unless "there has been an adverse change in the target's business (e.g. its EBITDA had decreased by 41 percent from its pre-signed forecast for 2008 and its debt increased largely) and that it is consequential to the company's long-term earnings power over a commercially reasonable period of time, which one would expect to be measured in years rather than months". The court looked to what the proper benchmark was for deciding whether the changes in the business operation post-signing constituted a Business MAC, and decided that EBITDA changes were actually the correct measure for examining Business MACs based on operational results of a business. Looking at the fall in projections, the court found that the projection decline, although large, could not be a basis for a Business MAC because representations with respect to Huntsman's projections and forecasts were specifically disclosed and because the parties failed to include prospects in the Business MAC Clause. As a result, there was no representation or warranty with respect to Huntsman's forecasts. Instead, the court compared the financial results with the same period the previous year; its result was that the changes of three to seven percent decrease did not qualify as a Business MACs. The court also concluded that many of the problems in Huntsman operation were considered to be short term due to the cyclical nature of the industry, and consequently, in this context, did not have a Business MAC.[164] It was also mentioned in the court results, that the Delaware courts have never before found a Business MAC to have occurred in the context of an M&A as only "durationally significant" events could constitute a Business MAC and in the case of not a clear contractual language to the opposite, the party invoking a Business MAC therefore has the burden of proving that a

[162] Zimmerman, George A. and Jacobson, Seth E., "Commitment Letters in Turbulent Times: Market MAC Clauses and the Solutia Litigation", *American Bar Association, Newsletter*, July, 2008, p. 14.

[163] See more briefing of the case in Appendix IV.

[164] Bricker, Ross B., Courtney M. Beemer and Jodi K. Newma, "Living In a Material World: The Evolution, Purpose, and Future of Material Adverse Change Clauses", *Jenners & Block publication*, New York, 3. 12. 2008.

Business MAC has occurred. The final result was that the court ordered Hexion to fulfil all of its covenants and obligations according to the M&A agreement, except for its obligation to close.

Not all writers on the MAC clause agree to the long-term consequences that a MAC must have according to the above court result, and even consider this Delaware court result an error, as the court should have recognized that a short-term loss can have long-term consequences for the value of a given business, and as the MAC clause generally says nothing about duration, only that the change must be adverse and material. The result should therefore be that even a short-term problem should, if relatively severe, qualify as a MAC.[165]

10. MAC in loan agreements of Icelandic companies

One fundamental task of this thesis was to find out if MAC clauses are included in major international loan agreements that the largest banks and companies in Iceland have used, how they look, how they were negotiated, and if the clause had changed through the recent financial crisis. The three major banks were contacted, and two visited (Arion bank never responded). A meeting was also held with the lawyer of the former Icebank, who is now working for the Icebank's Resolution Committee. Two private lawyers were also interviewed, who are experienced in contract law and have worked with numerous loan facilities and know the MAC clause very well. A list was made up of few large Icelandic companies who are likely to have taken large loans. Four responded so a meeting was scheduled with their representatives. All the meetings were with the banks' or companies' head lawyers who had been involved with the loan negotiations and their closings, so they generally knew the loan facilities well. A list of questions was drafted to use at the meetings.[166] The loan facilities of the banks and companies are very confidential, so it was not permitted to read through them, but a copy was received in most cases of the MAC clause in at least one loan contract from each company. Following is a brief from each meeting and findings along with copies of the MAC clauses received. The final section will then summarise the general findings of those meetings.

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165 Schwartz, "A ´Standard Clause Analysis´ of the Frustration Doctrine and the Material Adverse Change Clause", p. 49.

166 See Appendix I. This is the basic list of questions brought to the meetings. It changed some depending on the company/person how relevant it was to ask many of them, and the meetings were relatively short.

10.1. Landsbanki Íslands[167]

Most of Landsbanki Íslands (LI) loan facilities are based on standard LMA facilities and a standard MAC clause is a part of all of them. The facilities more and less come from the same foreign parties, drafted by the syndicate and have not gone through many changes through the years. However, they thought they had seen the MAC clause developed slightly in the direction of getting a little narrower up to the newest facilities. They mentioned that the phrase 'material change' has been used in some other loan facilities and been defined there as 10 percent change in assets or debts and that has been their understanding of the size of 'material change' when MAC has been used in their standard facilities (but not defined as such). Large majority of facilities have been based on English law and UK jurisdiction. In cases where LI was the lender the governing laws and jurisdiction has usually been in the country where the borrower had most of his assets. They said that in no case were loans accelerated based on a MAC regardless of financial crises and the fact that LI closed down.

Both of them had attended a seminar in London on LMA financial facilities lead by Sue Wright,[168] and at the seminar they were told that it is much more convenient to wait until payment date and accelerate loans based on non-payment instead of base it on a MAC, as that is much more riskier and might lead to a large damage claim. No recent developing can be seen in LI loan facilities as there have been no new loans from abroad for about two years. Following is a copy of the MAC clause which is part of the Event of Default section of one of LI loan facility, where they are the lender and it is relatively new – late 2009:

> **Material adverse change**. If the Borrower is in default under any agreement to which it is a party or which it might be bound, or if litigation, arbitration or administrative proceedings are initiated at or before any court, arbitral tribunal or governmental body which would in the opinion of the Lenders have material adverse effect on the business or the assets of the Borrower.

A copy of a provision in a standard loan facility in Icelandic (loan to an Icelandic company) was also supplied, which is very much like a quantitative

[167] The meeting took place on 3 March and at the meeting were Gunnar Viðar, Head of the LI Legal Dept., and Einar Kristinn Jónsson Manager of LI Corporate division.

[168] Sue Wright is a specialist in standard loan documentations with concentration on LMA loan documents. She is the author of the book *International Loan Documentation* (used as the text book in the course *International and Domestic Loan Documentation* at University of Reykjavik 2009) and has taught at numeral LMA documentation seminars in London and at least one in Iceland, which many Iceland lawyers and bank specialists have attended.

MAC.[169] This clause (which is a part of the Financial Covenants) is generally stating that LI can accelerate the facility solely without any prior warnings or special notice if book value of the lender's equity goes below a certain stated value and if changes of given ratios changes by a given size. This is all based upon quarterly accounting settlements. Those quantitative measures have been tightening recently.

10.2. Islandsbanki[170]

Ingvar Örn Sighvatsson (IOS) said that most of Íslandsbanki (IB) loan facilities were on standard LMA facilities or similar ones. He had attended a seminar in London on LMA financial facilities led by Sue Wright (like the LI lawyers had done). Almost all loan facilities he remembered included a MAC clause. They usually reviewed the standard facility's draft from their lenders (arranger of a syndicate) and the MAC clauses were always included, and he could not remember that IB ever touched it, and since the credit crunch 2007 no loan facilities had been processed, so no development is obvious since then. Most of their facilities were based on English law and UK jurisdiction except for several large facilities from German lenders who were based on German law and German jurisdiction. Icelandic loan facilities (where IB is the lender) have not included clear MAC clauses, but he mentioned that they have a similar clause as the 'force majeure' clause, where it is stated that in case of 'substantial changes' or 'substantial variation from prediction' the loan can be accelerated. Those loan facilities are based on Icelandic laws and Icelandic jurisdiction.

Following the bank's disaster in the autumn of 2008 the MAC clauses were never mentioned by their lenders and no loan was accelerated on that basis. IOS is well aware of the seriousness if a loan facility would be accelerated based on a MAC and mentioned possible cross default mechanism which could lead to very costly consequences and potential damage claims. So, he thought that this way out for a lender is not feasible. But a MAC clause was not in all IB loan facilities, and the reason was that the lender had not included it in their draft. The credit market is frozen at the moment and likely that IB will not be negotiating any large loans from abroad until next year. IB lawyers and other professionals negotiate the loan facilities themselves and do the final revisions without assistance of any foreign law firms,

[169] The facility which is from July 2009 was not shown as such, only the provision.

[170] The meeting took place on 23 March and at the meeting was Ingvar Örn Sighvatsson, lawyer in the Treasury and Capital Market´s division.

except in case of large bond facilities. It was not possible to read through any loan facility, but copies of five different MAC clauses from four different facilities were received. The following is a MAC clause from an English loan facility since 2007:

> **16.9 Material adverse change.** There shall occur any material adverse change in the business, financial condition, prospects or circumstances of the Borrower that would, in the reasonable opinion of the Lender, affect the Borrower‘s ability to perform its obligation under this Agreement.

Following are three samples of a MAC clause from three different German loan facilities:

> **German facility I** (2006).
> (j) Any event or series of events occurs which, in Lender's reasonable opinion, is likely to have a material adverse effect on any of the following:
> (i) The Borrower's business or financial condition;
> (ii) The Borrower's ability to perform any of its obligations under this Agreement; or
> (iii) The validity or enforceability of this Agreement.
>
> **German facility II** (2007)**.**
> **8.7 Material Adverse Change:** The Borrower shall promptly inform the Lender of (i) any material adverse change in its business and financial conditions as the same is reflected in the latest financial statements from time to time made available by it to the Lender and (ii) the occurrence of any of the events stipulated in Clause 9 upon aware of the same.
> **9. Default.** 9.9. any event or series of events occurs (including any material adverse change in the business, assets, financial condition of the Borrower) which would in the reasonable opinion of the Lender be likely to have a material adverse effect on the Borrower's ability to meet its financial obligations under this Agreement (the term, „material adverse effect" to be construed so as to include any change which is so significant that had such change occurred prior to the date hereof a reasonable and diligent banker would not have entered into this Agreement upon terms and subject to the conditions hereof): then the Lender may forthwith or at any time hereafter, by notice to the Borrower, cancel the Facility and declare all outstanding Loans to be immediately due and payable whereupon they shall become so due and payable together with all interest accrued up to the date of such payment and all other amounts payable by the Borrower pursuant to this Agreement.
>
> **German facility III** (Nov. 2007).
> Event of Default. 19. (f) There is or in the reasonable opinion of the Lender there is a material adverse change to the Borrower's financial condition which materially affects the Borrower's ability to perform its obligations under this Agreement.

In an Icelandic loan facility (loan where IB is the lender) from 2007 there was a clause that operates in a very similar way as a MAC clause. In the section of 'None-performance‘ („*Vanefndartilvik – dráttarvextir – vanefndarúrræði*"), it is stated that in the case of a non-payment the facility can be accelerated without further notice, but such a clause is not a MAC clause.

10.3. Icebank[171]

Daði Bjarnason (DB) said that the standard LMA loan facility format or similar ones were mostly used in large loans. They generally included MAC clauses, which were included in the drafts they received. The facilities were in most cases viewed by a law firm they used in London. When the three largest Icelandic banks collapsed in the autumn of 2008 Icebank was in a very critical situation toward the Central Bank of Iceland, but neither then, nor at a later stage, when the bank went under, were MAC clauses ever mentioned in discussions/negotiations with the lenders. But instead the liquidation clause and other provisions were used to accelerate loan facilities. He could not remember that the MAC clauses had changed at all in the years he had been there. Most of the facilities were based on English law and UK jurisdiction, but for Icelandic loans, where the Icebank was the lender, Icelandic laws were used and Iceland jurisdiction. DB was aware that the lenders were not ready to use the MAC clause to accelerate loan facilities because of the risk involved of being sued for damages so they used other clauses better defined. As the supply of funds was in abundance the lenders pushed for lending so the conditions were not too strict (more borrower friendly).

In their own facilities (when they were lenders) they used similar clauses as the basic MAC clause and they were usually in a stronger position toward their borrowers than their lenders were against them. A copy of one MAC clause was received which DB said was more and less in all their facilities in the Events of Default section and was in their last facility from 2008:

> **Material adverse change**. Any event occurs which might, in the opinion of the Majority Lenders, have a Material Adverse Effect.
>
> The Material Adverse Change (MAE) was then defined, in the definition section, as:
>
> **Material Adverse Effect** means a material adverse effect on (a) the business, operations, affairs, financial condition, assets or properties of the Group or (b) the ability of the Borrower to perform its obligations under this Agreement or (c) the validity or enforceability of this Agreement.

[171] The meeting took place on 5 March and at the meeting was Daði Bjarnason, Head of the Legal Dept. of Icebank.

10.4. BBA Legal[172]

Ásgeir Á Ragnarsson (AAR) LL.M, one of the partners at the BBA Legal law firm, has a long experience of drafting and negotiating large loan facilities for Icelandic banks and corporations and has first and foremost worked with the standard LMA facility. He said that following the credit crunch many involved believed that lenders would rely more on the MAC clauses to accelerate the loans, but that turned out not to be the reality, lenders waited for none-payment to happen. Lenders are always afraid that something will happen between the quarterly test days, but nothing happened and they waited for the next test date when the financial covenants were tested. His understanding is that the MAC is a clause which can be used to force re-negotiation of a loan, not to accelerate it, as that might be too risky. He has never seen or heard of acceleration based on MAC, and during his years working with loan facilities he has never negotiated a MAC clause either. He does not foresee any major changes on the MAC clause in the near future and has not seen any comments or suggestions from LMA on that issue.

But he assumed that during the credit crunch some lenders might have threatened to accelerate loans based on a MAC, but would have used it in order to get borrowers at the table to re-negotiate terms. As he has been involved in many negotiations of loan facilities, he cannot remember any discussion of a MAC clause wording and recalls only one occasion where a borrower wanted the MAC clause out, but that was not accepted. In most cases the facilities are based on English laws and jurisdiction, but Icelandic facilities on Icelandic law and jurisdiction.

A copy from one major loan facility which AAR had handled was received, and in the section of Event of Default was the following MAC clause:

> **24.17 Material adverse change.** Any event or circumstance occurs which the Majority Lenders reasonably believe has or is reasonably likely to have a Material Adverse Effect.

> The Material Adverse Change (MAE) was then defined, in the definition section, as:

> "**Material Adverse Effect**" means a material adverse effect on: (a) the business, operations, property, condition (financial or otherwise) or prospects of the Group taken as a whole; or (b)the ability of an Obligor to perform its obligations under the Finance Documents; or (c) the validity or enforceability of, or the effectiveness or ranking of any Security granted or purporting to be granted pursuant to any of, the Finance Documents or the rights or remedies of any Finance Party under any of the Finance Documents.

[172] Was referred to Ásgeir Á. Ragnarsson hrl at BBA Legal, but he is one of the more experienced specialists in the field of international loan documents in Iceland. The meeting took place on 10 March.

Notice that the MAC clause and the related definition of the MAE are almost identical to the ones in the loan facility of Icebank.

10.5. Orkuveita Reykjavíkur[173]

Ingi Erling Jóhannesson (IEJ) said that Orkuveita Reykjavíkur (OR) does not use standard loan facilities as such, as their loans are guaranteed by their owners, who are the city of Reykjavík, Akranes and Borgarbyggð. The laws governing the facilities depend on the lenders, and can be Icelandic, English, French or German. After going through some of the major loan facilities, he only found a MAC clause in one facility under the section of Event of Default. OR generally refuses to include such an open clause in their facilities and that has been respected by their lenders. In rare cases they have had a clause stating "...in the reasonable opinion of the bank." One of their lenders became worried during the credit crisis, and considered to accelerate his loan, but after reviewing his possibilities and realised the risk involved he decided not to. IEJ meant that a MAC clause or a similar clause was missing from Icelandic loan facilities.

The developments of loan facilities through the years has been that they have been getting longer and more detailed, even though they have tried to keep them as short as possible. He has no knowledge of request from lenders to re-negotiate a facility. OR has used seven to eight lenders and is currently with 20-25 active loan facilities and their major lender is the European Investment Bank (EIB) which specialises in loans to municipalities. The MAC clause which IEJ found is a part of the Event of Default section in a loan facility of EIB from 2009:

> If a Material Adverse Change occurs in relation to the Borrower or any of the Partners; where „Material Adverse Change" means, in relation to the Borrower or, respectively, a Partner, any event or change condition, as compared with its condition at the date of this Contract, affecting the Borrower or a Partner or any of the Borrower's subsidiaries, which, in the reasonable opinion of the Bank, materially impairs the ability of the Borrower to perform its financial and other obligations under this Contract, or in the case of a Partner, its ability to fulfil its guarantee obligations with respect to the Borrower's obligations under this Contract in accordance with the Act, or which materially affects any security provided by either of them.

[173] The meeting took place on 3. March and the company´s representative was Ingi Jóhannes Erlingsson, head of Finance- and Risk Division.

10.6. Össur hf.[174]

Tómas Eiríksson (E) said that Össur hf. had only one active large loan facility at the moment, which was through Kaupthing bank (Arion bank now) and it is a standard loan form but an American one, he believed. The facility is in English, since 2005. It includes a MAC clause and a definition of a MAE clause and both are parts of the standard loan format. He was not aware that this clause had ever been discussed or activated. As it is an Icelandic loan, it is governed by Icelandic law and Iceland jurisdiction. As Össur hf. are currently searching for re-financing possibilities he mentioned that this type of a clause will be looked at seriously. The MAE definition and the MAC clause are as follows:

> **„Material Adverse Effect“** means any effect which is, or reasonably likely to:
> (a) be materially adverse to the ability of the Group taken as a whole to comply with its payment obligations under any Finance Documents or its obligations under Clause 17 (Financial covenants);
> (b) be materially adverse to the business, financial condition or assets of the Group taken as a whole; or
> (c) result in any of the Finance Documents not being legal, valid and binding and enforceable substantially in accordance with their material terms against any Obligor.
>
> 19.17 **Material adverse change.**
> Any other event or series of events occurs after the date hereof which will in the reasonable opinion of the Facility Agent have material adverse effect on the ability of the Borrower to comply with its payment obligations under this Agreement and which, if capable of remedy, is not remedied within thirty (30) days of the date of any notice given by the Facility Agent to the Borrower requiring it to be remedied.

10.7. Landsvirkjun[175]

Geir Marelsson (GM) brought to the meeting two loan facilities that are currently active for Landsvirkjun (LV). Both are relatively new, not a LMA format, but similar standard format. One is a revolving syndicated loan arranged by Barclays Capital London and the other one is so called EMTN loan (Euro Medium Term Note) arranged by City Bank London. Neither of these loan facilities includes any MAC clause or any similar clause. GM was not sure why, but suggested the reason might be because LV is financially very strong with huge assets and the loan has a national state guarantee (LV is state owned) and both were taken before the financial collapse in Iceland. Both the loans are governed by English law and jurisdiction and

[174] The meeting took place on 10 March and the company´s representative was Tómas Eiríksson, the company´s lawyer.

[175] The meeting took place on 24 March and the company´s representative was Geir Marelsson, the company´s legal counsel.

LV uses an English law firm to assist them when negotiating large loans. GM has never noticed MAC clauses before or was familiar with the term as such and LV lenders have not mentioned it, in the past or during the recent crisis.

10.8. Marel hf.[176]

Árni Sigurjónsson (AS) said that Marel hf. used mostly European syndicated loan facilities and the LMA standard facility format. All their loan facilities include almost identical MAC clauses which are included in the form, and they never touch that clause in the negotiating process, even though no facility is identical. He is familiar with the MAC clause and attended a LMA seminar in 2004 with Sue Wright and knows it is risky to activate it and has never seen or heard that happen. He referred to a facility from 2009 and gave a copy of the definition of a MAE definition and a MAC clause which is a part of the Event of Default section:

> **The definition of MAE,** „Material Adverse Effect“ means a material adverse effect on:
> (a) the business or financial condition of the Group taken as a whole; or
> (b) the ability of the Company or any other Obligator to perform or comply with any of its payment obligations under any Finance Documents taken into account any resources actually available to the Company and the other Obligators from other members of the Group; or
> (c) the validity or enforceability of, or the effectiveness or ranking of any Security granted pursuant to any of the Finance Documents or the rights or remedies of any Finance Party under any of the Finance Documents.
>
> The MAC clause in the 'Event of Default' section. 28.17. Material adverse change. Any event or circumstances occur which have or is reasonably likely to have a Material Adverse Effect.

10.9. Advel[177]

The last interview was with Jón Ögmundsson (JO) partner at Advel law firm. JO has a practising experience both in USA and Iceland and like most other interviewees, has attended an LMA seminar in London and is therefore familiar with the MAC clause in loan facilities. The question to him was how a MAC clause case would be treated under Icelandic law. He had prior to the interview read the text of the thesis already finished. First he referred to the Norwegian chapter (3.4.) and said that regarding activating the MAC clause in Iceland he believed that we would very much follow the Norwegian practise as described, and look at all circumstances of the

[176] The meeting took place on 12 April and the company´s representative was Árni Sigurjónsson, the Corporate legal counsel.
[177] Jón Ögmundsson JD, hrl, is experienced in contract law and practised in the USA for years and for the last 10 years in Iceland. The purpose of a meeting with him was to get the borrower's side and learn how a MAC clause dispute would be handled by Icelandic courts. The meeting took place on 22 April.

case, not just within „the four corners of the contract " like the interpretation tradition is in both the UK and the USA. The doctrine of failed assumption will be taken into consideration and in defence of the borrower paragraph 36 of the Icelandic contract law would be used, but he does not know if paragraph 36 is very much the same under the Norwegian contract law. He assumed that based on paragraph 36 it would be considered unfair towards the borrower to activate a broad MAC clause. Lenders would hardly rely solely on the MAC clause but rather refer to other default provisions of the loan facility, which are more consistent with Icelandic contract laws and laws of obligations.

JO has been involved in several negotiations on loan facilities in the past years on behalf of his client companies with the Icelandic banks and he beliefs some major events must happen in order for the MAC clause to be activated and he knows of no such case. He believes that lawyers practicing contract law in Iceland agree that courts in Iceland would not be prepared to base their judgement solely on a typical MAC clause. The clause presents some novel concepts to Icelandic judges, which they are unlikely to accept without support of other provisions of the loan facility and Icelandic contract laws. All relevant circumstances would also play important roles in any interpretation of any triggering events of the clause. Judges would probably use paragraph 36 of the contract law to ensure it would not be enforceable against borrowers, if it would lead to unreasonable or unfair results and be contrary to established commercial practice.

It would also be taken into consideration that the other party (the lender) is usually a much larger party in this field which are using highly skilled professionals in contract drafting. The position of the banks up to the crisis was not to allow any changes in the LMA facilities or only minor ones. The negotiation position of the borrowers was therefore very weak, and because of the dominant position of the banks, which they were aware of and used, they could take that stand and be stubborn. JO conclusion was that if a MAC clause dispute would be taken to an Icelandic court the judges would probably look for similar cases in Norway and Denmark to learn from and if no case law on the MAC clause have been established there it would not support such a case in Iceland and limit the effect of the clause here. The Icelandic courts would hesitate to interpret it directly and therefore base the judgement on the Icelandic contract law and law on obligations. Finally, JO mentioned that the LMA loan facilities had not yet been properly translated to

Icelandic which made interpretation even harder, as inevitably a presentation in a court case where an Icelandic translation is the document which would form the basis of the judge's decision.[178]

10.10. Summary of the meetings

The meetings were nine in total. All of them where rather short, lasted only for 30-40 minutes each. All the representatives (except LV) were familiar with the term 'material adverse change' (MAC) and MAC clauses were in most of their loan facilities (except LV). All of them (except two) had attended LMA seminars in London (at different time) with Sue Wright. They were in general aware of the risk involved for the lender if he decided to activate the MAC clause, but none of them had heard of such a situation and even recalled from the seminar (LI) that Sue Wright had mentioned that lenders should not try to activate the clause, rather use the clause to get the borrowers back to the table to re-negotiate the loans. In all the cases the MAC clause had been included in the facility draft coming from the lenders and no one remembered (except BBA Legal) that the MAC clause had been mentioned in the negotiation process or changed at all. No lender had activated the MAC clause during the financial crisis in the last couple of years in Iceland, not threatened to do so, not even when the banks collapsed, instead they waited until none payment to accelerate the facilities. One thinks, if the MAC clause was not activated under those circumstances, will it then ever be?

They generally had not seen any development at all in the wording of the MAC clause in the last years and probably as the MAC clause did not get any attention during the negotiation process they did not see any reason why the wording of the MAC clause would change in the future. Does that mean that the MAC clause is useless? All the MAC clauses received are very similar to the samples of the standard clauses listed earlier in the thesis and are generally all very similar. The last interview was not to discuss the MAC clause as such or to get a sample, but rather to get the borrower's side and how a MAC clause dispute would be treated under Icelandic law in Icelandic court. The result was that it would probably get a similar

[178] In his book, *Samningaréttur,* does Páll Sigurðsson mention that many standard contracts in Iceland are badly worded and carelessly worked out, and often include clauses that could not be relied on in court. Páll Sigurðsson, *Samningaréttur*, p. 152.

treatment as in Norway, meaning that an Icelandic court would probably not accept an acceleration of a loan based on a traditional vague standard MAC clause.

11. Future of MAC and some recommendations

It is obvious though that the MAC clause will continue to be a part of financial agreements (both loan facilities and M&A agreements) in the coming years as it has been for a long time. The world's financial crisis has now lasted for the last two-three years and it is not clear when things will return to normal again and actually what a "normal" situation will then mean. The current financial market conditions are therefore exceptional, requiring lenders and borrowers to consider new approaches to documenting facilities and to deal with issues arising under existing ones. But the legal scope and effect of the MAC clause is still largely uncertain and rather difficult to predict, both because there is unfortunately little case law on the subject all over and because the few case laws that do exist are not very helpful.[179] One of the reasons the case law on MAC clauses are so rare is because the most threatening MAC claims have been settled out of court, both in the UK and the USA.

Then it is obvious that a lawsuit over a MAC is extremely risky for both parties. It has the same effect if it is a lawsuit over a loan facility or an M&A agreement. In case of an M&A, a loss in a MAC litigation amounts to an official judicial statement that it has suffered a disastrous blow, which could ruin its market value or even lead to bankruptcy. And for the other party, the acquirer, a loss in MAC litigation would force it to merge with what has publicly been stated as a worthless entity. Lenders are likely to start to look more closely at borrower's performance and at events of default within the loan facilities, including the MAC event of default because of the current situation at the credit market. But under English law, historically it has been difficult to successfully call a MAC event of default. The courts have usually required the borrower to be insolvent or an event which has made insolvency look highly likely, before they will allow the lender to accelerate facilities based on a MAC.[180]

Given the method in which the courts have in recent years treated litigations with MAC clauses and the current credit environment, both lenders and borrowers should need to pay close attention to the language of the MAC clauses in their pre-

[179] Schwartz, "A ´Standard Clause Analysis´ of the Frustration Doctrine and the Material Adverse Change Clause", p. 42.
[180] Pinsent Masons, "Downturn Survival: Material Adverse Change Clauses – Fact or Fiction?".

closing negotiations. Because of that, some increased negotiation of these clauses will probably follow. Borrowers may therefore want to narrow what qualifies as a “material adverse change.” At the same time and in order to increase some of the certainty surrounding MAC clauses, lenders may add specific quantitative targets that expressly qualify as a “material adverse change” and are also likely to update their MAC clauses in order to be better able to capture the risks presented by the current credit environment. The net result will therefore be that the MAC clauses should and will be analysed much closer.

In the process of working this thesis two surveys were studied which are both performed by large law firms, one is Allen & Overy[181] and the other one is Nixon Peabody.[182] Both surveys cover trends of MAC clauses. The key findings of the Allen & Overy survey in regards to MAC clauses were that there is much more intense interest in financial covenants in loan facilities than before and thresholds are being re-adjusted. The strict legal consequence of an event of default is that the lenders can cancel further payments and accelerate existing loans, and in some cases there have been calls by lenders for a MAC clause, which gives more right to the creditors to decide whether there has been an adverse change in the borrower’s financial condition.

But few borrowers have looked for more protective clauses, and the question of whether there will be some new international market standard on that remains to be seen.[183] The results of the agreements surveyed, in regards to MAC clauses in the Nixon Peabody survey, show that the use of various MAC definitional elements remained generally steady since last year, but there was a slight decrease in the number of MAC exceptions in the agreements surveyed. The survey also confirmed that the majority of MAC clauses examined remained more „buyer-friendly“ (in M&A agreements) than before.[184]

[181] Allen & Overy, “Life after Lehman, analysis of changes in market parctice“. A&O is a large international law firm and the survey is based on answers from their leading partners in their offices around the world.
[182] Nixon Peabody Inc., “2009 Nixon Peabody MAC Survey, A Nixon Peabody study of current negotiation trends of Material Adverse Change clauses in M&A transactions“. Nixon Peabody Inc. is a large law firm in United States.
[183] Allen & Overy, “Life after Lehman, analysis of changes in market practice“, P 9.
[184] Nixon Peabody, “2009 Nixon Peabody MAC Survey“, p. 2.

11.1. General recommendations

In the light of the above there are various changes expected to develop in regards to the MAC clauses in the near and farther future, or different approaches to it on behalf of either the lender or the borrower. Following are some major items that are either recommended changes or expected changes. They are not listed in any importance or expectancy.

- The lender should identify any specific events or circumstances which are of particular concern to him and the occurrence of which would potentially add up to a MAC. This is based upon the experience that a vaguely-worded Business MAC clause will probably not justify a refusal to fund a loan.[185]
- Establish independent quantitative measures based on more objective criteria in order to activate MAC, such as lenders could use EBITA and /or maximum leverage tests.
- In Market MACs, not only use "adverse change" but expand it to use also the continuation of existing adverse conditions.
- The traditional effect of invoking the MAC clause is that it entitles lenders to accelerate the loan and walk away. But this has not been working out, so lenders might consider setting the benchmark a little lower by offering alternatives such as the right to invoke an expanded market flex provision in case of a MAC or "market-based" pricing.[186]
- It is likely under current financial crisis that lenders might require a Market MAC in the Mandate letter while borrowers will probably question the reliability of a commitment of such a Market MAC condition. The question to ask is whether it can be invoked. The key point there is to include the phrase: "continuation of any circumstance(s)" in the market MAC language. [187]
- LMA facilities, as most standard financing facilities, include representations stating that there has been 'no MAC' since a given date. Borrowers should be aware of those repeating representations as they can get them into the stage of default and should avoid such provisions in new facilities.[188]

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[185] Linklaters, "Commitment letters: Lessons from recent US litigation".
[186] Ibid.
[187] Clifford Chance, "Market MACs and Market Disruption", p. 2.
[188] Smith, "Looking beyond financial covenants", p. 2.

- It is important that borrowers understand fully their loan facility and review their compliance with the obligations on a regular basis. Facing an event of default, lenders might not wish to enforce or accelerate the facility, they may instead use it to force the borrower to re-negotiate new terms and increase fees.[189]
- Considering the risk involved, lenders will probably only use a MAC clause to cancel further drawings on the loan, instead of accelerating it. So, when negotiating a new facility, the borrower's aim should be to limit the subjective character of the clause by getting defined what 'material' stands for and make sure the subjectivity is not based upon the lenders' opinion or decision.[190]
- It has turned out that case law has focused heavily on facts and specific language of MAC clauses resulting in difficulties to predict the results, so it is obvious that a vague worded MAC clause is not giving the lender (or buyer in case of M&A) the protection he believes he has.[191]
- Because of generally vaguely worded MAC clauses they might be difficult to enforce, except drafted to cover objectively identifiable facts, such as a certain percentage fall in market share.[192]
- Based on what has been covered in this thesis, it is obvious that including a MAC clause in a facility can be valuable (from the lender's point of view). However, the drafter (the one who wants to include it) should be: (i) clear on why he wants it, (ii) know its limitations, and (iii) be aware of its potential costs and gain by inserting it. Otherwise there is no use of the MAC clause in the facility.[193]
- When drafting a new facility with a Market MAC clause and in order to minimise the risk of litigation, it is important to state clearly that the materiality determination is based upon the market which has already changed drastically, so the change needed to invoke the MAC should be defined (or from the lenders point of view minor).[194]
- In the light of MAC case law lenders should avoid relying on an excessively technical or literal approach when drafting the terms of the commitment letter.

[189] Smith, "Looking beyond financial covenants", p. 3.
[190] Bryton, Simon, "The Effect of the Financial Market Conditions on Facility Documents", *Berwin Leighton Paisner, Newsletter*, London, December 2008.
[191] Mallesons Stephen Jaques, "Material Adverse Change Clauses", p. 3.
[192] Ibid., p. 3.
[193] Sikkeland, "(No) Material Adverse Change Clauses – Norwegian Law with...", p. 21.
[194] Mehta, "Material Adverse Change Clauses in Adverse Markets", p. 3.

- In the light of MAC case law it is important (for the lender) that Market MAC clauses are accompanied by a statement from the borrower that he is not relying on any pre-contractual statements which were given at that point in time.
- It should be verified by each party whether the loan documents include any specific exclusion to the MAC clause. This is important as in events where specific changes are expressly excluded from the MAC clause, and that change is decided a MAC by the lender and not an express exclusion, a court might view it to be subject to the MAC clause.[195]
- Given the undefined meaning of the term 'material' drafters of a facility should due to clarity reasons, only use it in MAC provisions and find other terms to express other levels of significance.
- Always use Material Adverse Change (MAC) not Material Adverse Effect (MAE) and not use both defined terms in the facility. In the interest of readability, spell the term out and not use the acronym MAC.[196]
- If the drafter of the facility wants to ensure that the lender will have the possibility of getting out of the facility due to a MAC caused by certain industry wide or other general developments, he should incorporate that concept in the facility and in representation, condition, or some termination provision, instead of including it in the definition of the MAC.[197]
- It is important not to include in the definition of the MAC examples of changes that might fall within the definition, as this might be used by a court and other changes might then be excluded if they do not resemble the examples. In order to avoid this include non-occurrence of those changes in representations or in a condition to closing provisions or as ground for termination of the facility.[198]

11.2. Recommendations related to MACs in M&A agreements

- Review carefully all carve-outs in M&A agreements, as changes in general economic conditions which possibly might limit the value of the MAC clause. Lenders might want to make it more lender-friendly and borrowers the reverse.

[195] Nixon, Christopher, "Evaluating Material Adverse Change (MAC) Clauses in the Loan Default Context", *Winstead PC*, Houston, May, 2009.
[196] Adams, "A legal-Usage Analyses of 'Material Adverse Change' Provisions", p. 51.
[197] Ibid., p. 52.
[198] Ibid., p. 52.

- In recent M&A agreements 'material change' has been defined more narrowly, such as if a target's revenues decreased by 10 percent.[199]
- In MAC clauses in M&A agreements the trend has been moving in the direction of favouring more the buyers as they are seeking more flexibility in order to terminate deals. If he is concerned about certain items he should specify, either directly in the MAC clause or in a separate provision.[200]
- Following cases as the Hexion case two developments in regards of the MAC clauses have been seen: (i) arrangers (e.g. lenders) might not be ready to conform the MAC condition in the commitment letter (as agreed between the seller and buyer in M&A), and (ii) the arrangers (lenders) might replace more importance in including a "bright-line" condition in the commitment letter bearing in mind the high standards courts have set on interpreting MAC clauses.[201]
- In relation to the Business MAC, buyers will be rethinking and restructuring the exclusion of decline in the general market conditions and therefore might also push to include a decline in projected results which constitute a MAC, or at least include a language that dependence on projections is not disclaimed for reasons of determining if a MAC occurred or not.[202]

12. Conclusion

In this thesis the author has gone through definitions of various MAC clauses, looked at different samples in both loan facilities and M&A agreements. Touched a little on how MAC is treated in several countries among them Norway, which he assumes is treating it the same way as it would be treated in Iceland. An effort was made in order to see if the recent financial crisis had and will affect the MAC clause and the general result is that it will probably narrow it and make it more defined. It was then covered how the MAC clause has been invoked and then interpreted in courts (in UK and USA), but the major problem was that there are close to none case laws directly on MAC clause disputes. The author's intention was then to see how the MAC clause was treated in loan facilities in Iceland, how it found its way into the facilities, how the negotiation process was on this particular clause and if and how it had been

199 Rothschild, et.al. "Drafting material adverse change clauses", p. 4.
200 Ibid., p. 4.
201 Ridealgh, "Recent Trends in Committed Financings", p. 5.
202 Dykema, "Market Adverse Change Clauses During Market Turmoil".

activated in the financial crisis in Iceland in the last two years. In order to find this out the author met with representatives of the banks and some major corporations in the country.

The finding was to some extent disappointing: all the representatives knew the MAC clause, but it was a part of the draft from the lender and it was hardly looked at during the negotiation stage and absolutely no negotiation was generally on the MAC clause at all. Not a single loan facility was accelerated on the ground of a MAC clause or even used to re-negotiate terms during the crisis in Iceland. All lenders instead waited for other default events to happen such as non payment. So, if a MAC clause is not activated during such enormous financial crisis as we have experienced in Iceland, will it then ever? In the Investigation Report of the Icelandic Parliament the MAC clause is mentioned in one chapter in regards to "open loan lines" of the Icelandic banks which they could withdraw on and it is especially mentioned that those lines were without MAC[203]. It is not clear why they mention that particularly, but the writers are probably trying to emphasize how dangerous this is as the lenders could accelerate the loans at any time due to default? But in the light of the above, was it so dangerous?

The general conclusion is that the traditional vague, wide, indirect MAC clause is not working in loan facilities in the way it was designed to and has therefore been included in most current financial (standard) facilities. The MAC clause is not providing the security that the lenders want it to give and in some cases is believed it gives. So in chapter 11 several ideas on how the MAC clause can be adjusted were listed in order for it to fulfil its initial purpose, to be the actual "catch all" default clause.

[203] *The investigation Report of the Icelandic Parliament* („Rannsóknarskýrsla Alþingis"),Chapter 7.8., April 2010.

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Appendix I

Questionnaire

Following is a list of questions that the author brought with him to the meetings with the representatives of the chosen companies. It was more as a guideline for the meetings and some of them were not asked. They were adjusted depending on with whom the meeting was (bank, company, legal firm).

1. Are your loan facilities standard LMA formats or individually written?

   (Eru lánasamningar ykkar standard LMA samningar eða sérgerðir?)

2. Is there a MAC clause in all your larger loan facilities?

   (Er MAC klásúla í öllum ykkar stærri lánasamningum?)

3. Why is it in there, part of the standard facility or inserted by the lender?

   (Hvernig er tilurð hennar tilkomin – standard eða sett sérstaklega inn af lánadrottni?)

4. Have you been able to negotiate the MAC clause or change it through the years?

   (Hafið þið náð fram breytingum á henni í áranna rás?)

5. Have you noticed any changes on the MAC clause in the facilities in the last three years?

   (Hafið þið orðið varir við breytingar á MAC klásúlunni síðustu þrjú árin?)

6. Has the MAC clause ever been activated, i.e. during the crises in the last two years?

   (Hefur einhvern tímann reynt eitthvað á þessa klásúlu – til dæmis í hruninu s.l. tvö ár?)

7. Are there any believes on changes of the future MAC clauses?

   (Einhver tilfinning fyrir áherslubreytingum hvað varðar þessa klásúlu í lánasamningum framtíðarinnar?)

8. What are generally the governing law of the facilities and the jurisdiction?

   (Hvaða lög gilda almennt um samningana og hvaða lögsögu tilheyra þeir?)

9. What will be your legal standing if your lender activates a MAC clause and accelerates a loan?

   (Einhver skoðun – mat á lagalegri stöðu ykkar ef lánadrottinn nýtir sér almenna MAC klásúlu til að gjaldfella lán?)

10. Do you include a MAC clause in your own lending facilities – and if so, is it different from the MAC clauses in loan facilities you receive as borrowers?

    (Eruð þið með MAC klásúlu í eigin útlánasamningum – er hún frábrugðin MAC klásúlum í lánasamningum sem þið fáið?)

Appendix II

Material adverse change – 15 questions to ask before you call a MAC event of default

Whether to invoke a MAC event of default is a notoriously difficult decision. Alexander Hewitt suggests how to make a preliminary assessment of your case for doing so.

1. Has your borrower become insolvent, or is it on the verge of insolvency? The only English cases in which a lender has successfully called a MAC event of default have involved a debtor insolvency, or something making insolvency highly likely. (Courts looking at corporate acquisition documents have sometimes been readier to find a MAC. But context is key to the modern approach to construing contracts. So these cases are probably a poor guide to construing a credit document.).
2. Has the adverse change come out of nowhere? If the borrower's plight was reasonably foreseeable given what you knew, or should have known, when you made your credit decision, US case law suggests you may not always be able to pass the change part of the test.
3. Can you rely on another actual or potential event of default? If you cannot, your MAC clause will have to be drafted in very pro-lender language if it is to protect you.
4. If you cannot answer yes to questions 1 - 3, do you have good evidence that events have significantly reduced the borrower's medium or long- term ability to pay? And can it still perform its other core duties under the finance document(s)? Not all MAC clauses expressly refer to an effect on performance. Showing one, however, is a major part of building a case that there has been a MAC.
5. Similarly, if your clause requires effects on things like the borrower's business or financial condition or the enforceability or value of security, how strong is your evidence on these matters?
6. If your evidence is weak, might your information covenants, or other sources, yield stronger evidence? Most litigation is won on the facts, not the law.
7. Or what about the financial covenants – can you wait until the next testing date? Most valid accelerations of international credit documents are based on breaches of financial ratios. Breach of a ratio is an objective fact. Five different people could have five different opinions about what is material.
8. When must the adverse change happen under your clause? Must the worst be over, or can you look to the future?
9. If the test in your clause looks ahead, how likely must any negative results be? Do you have to show disaster is likely, very likely, or something that might reasonably be expected?
10. Is your clause subjective or objective? If it's in your discretion to decide what is materially adverse, your duty is probably just to decide those questions honestly, in good faith, for the purpose for which the clause is there and not capriciously.

11. Are you thinking of accelerating loans, or refusing further drawings on a committed facility? If a court later decides there was no MAC, there is House of Lords authority that (perhaps surprisingly) your borrower has a better chance of suing you for breach of your lending commitment than for wrongful acceleration. (Despite the Lords' ruling, however, a borrower may well try to sue for damages for any unjustified acceleration if it leads to cross default or other consequential losses.)
12. Does the borrower have other credit documents with tighter events of default? If so, your cross default clause may (sooner or later) kick in and give you the benefit of those tighter events of default – sooner or later depending on whether your document has cross default, or cross acceleration only.
13. Do you just want to get the borrower's attention? If so, you may want to take the line (without accelerating, or say, refusing to roll over a loan) that you have strong grounds for saying a MAC has happened. This may bring the borrower to the table.
14. Are you providing a liquidity facility? If the facility is there to provide funds even in bumpy periods, a court might construe any MAC clause it contains more restrictively than identical wording in a term loan – particularly if the borrower's problems seem short term.
15. Do you need advice on the laws of other jurisdictions? In some countries, you might not be able to rely on your MAC clause if a court finds this would give you too much power, or make your lending commitment too uncertain.

Source:

DentonWildeSapte…, *Bankes notes*, January 2008.

Available at:

http://www.dentonwildesapte.com/publications/bank_notes/bank_notes_24_january_2008.aspx

Appendix III

Case description: Solutia Inc. V Citigroup Global Markets Inc.

In 2003, Solutia, a Delaware company and its affiliated debtors ("Solutia") filed a voluntary petition for bankruptcy under chapter 11 of the U.S. Bankruptcy Code. On October 15, 2007, Solutia filed its Fifth Amended Joint Plan of Reorganisation (the "Plan") seeking to facilitate their emergence from chapter 11. Under the Plan, Solutia required an exit credit facility to fund distributions, replace Solutia's debtor possession credit facility, and provide working capital.

On October 25, 2007, the Commitment Parties signed a Commitment Letter to fund a $2 billion long-term exit financing package for Solutia. The Commitment Letter provided that the commitments were subject to "the absence of any adverse change since the date of the Commitment Letter in the loan syndication, financial or capital markets generally that, in the reasonable judgement of such Commitment Party, materially impairs syndication" of the financing (the "market MAC Provision").
On November 20, 2007, the court approved the exit financing package, and nine days later (in reliance on the Commitment Letter), the court found the Plan to be feasible and approved it.

On January 20, 2008, on a call to discuss closing, the Commitment Parties cited the market MAC Provision, stating that they would refuse to close and fund on January 25, 2008 if requested to do so. This was reiterated at a meeting on January 22, and in a letter of January 30 where the Commitment Parties refused to fulfil their obligations under the Commitment Letter at that time.

Solutia filed a suit for specific performance on February 6, 2008 in the Bankruptcy Court to order the Commitment Parties to provide the financing they had committed. In its complaint, Solutia claimed that Citi created the impression that the market MAC Provision was nothing more than recycled boiler plate. Solutia alleged that Citi had explained that the market MAC Provision was included in the Commitment Letter simply to comply with old-line bank policy, that Citi had never called a market MAC provision, and that it had minimized its significance. Solutia also argued that the Commitment Parties were aware of the adverse market conditions prior to execution of the Commitment Letter.

Solutia argued therefore that the Commitment Parties could not rely on the market MAC Provision in the midst of a tumultuous market that was not only foreseeable, but had long existed when they signed the firm commitment.
On February 25, 2008, Solutia reached an agreement with the Commitment Parties to fund Solutia's exit financing package. The Commitment Parties agreed to waive the market MAC Provision. Solutia agreed to dismiss the lawsuit once the exit financing was funded. Solutia emerged from bankruptcy on February 28, 2008.

Source: Mehta, Subrud, "Material Adverse Change Clauses in Adverse Markets", *Milbank*, UK 2008. Available at: http://www.milbank.com/NR/rdonlyres/F6BDC4A0-B496-43D6-A1D2-74896FFB2563/0/Material_Adverse_Change_Clauses_Mehta.pdf

Appendix IV

Case description: Hexion Specialty Chem. Inc. v Huntsman Corp

Background. In the summer of 2007, a bidding war ensued for Huntsman Corp. ("Huntsman") between Basell and Hexion Specialty Chemicals, Inc. In the end, Hexion agreed to pay $28 per share in cash for 100% of Huntsman's stock for a total value of $10.6 billion. The merger agreement did not include a "financing out" that would have excused Hexion from closing the deal if financing was not available. The merger agreement did include an obligation on the part of Hexion to use "reasonable best efforts" to obtain financing, uncapped damages in case of intentional breach by Hexion, liquidated damages of $325 million in case of certain other unintentional breaches, a relatively narrow definition of MAE, and a specific performance provision that allowed Huntsman to require Hexion to comply with all its obligations under the merger agreement short of closing the deal. Huntsman then reported disappointing financial results. Apollo and Hexion retained a valuation firm to provide an opinion that the combined entity would be insolvent, and Hexion then filed suit in the Delaware Chancery Court, asking the court to declare that it was not obligated to close the deal. Huntsman rejected Hexion's claims by arguing that the financing was not a condition to Hexion's obligation to close, that no MAE had occurred and that Hexion had intentionally breached various covenants under the merger agreement. Huntsman also requested the court to order Hexion to specifically perform its obligations under the merger agreement.

Material Adverse Effect. The court found that no MAE had occurred and noted that "a buyer faces a heavy burden when it attempts to invoke a material adverse effect clause in order to avoid its obligation to close," emphasizing that the fact that "Delaware courts have never found a material adverse effect to have occurred in the context of a merger agreement … is not a coincidence." The court stated that the important consideration to determine whether an MAE has occurred is "whether there has been an adverse change in the target's business that is consequential to [its] long-term earnings power over a commercially reasonable period, which one would expect to be measured in years rather than months." Furthermore, the court specified that a target's decline in earnings between signing and closing might constitute an MAE if such "poor results [are] expected to persist significantly into the future." As to the issue of what benchmark to use in examining changes in the results of business operations after signing the merger agreement, the court faced the alternative of using EBITDA or earnings per hare. The court determined that EBITDA "is a better measure of the operational results of the business." The court concluded that Huntsman had not suffered an MAE after comparing its past and projected EBITDA numbers.

The MAE provision in the agreement provided a carve-out for industry-wide effects unless they had a disproportionate effect on Huntsman. However, since the court found that Huntsman had not suffered an MAE, it did not reach the question of whether Huntsman's performance had been disproportionately worse than the chemical industry's as a whole. The court also rejected Hexion's request to compare Huntsman's results to its forecasts to determine whether Huntsman had suffered an MAE because Huntsman had expressly disclaimed any representation made with respect to them in the merger agreement. Finally, the court concluded "that absent clear language to the contrary, the burden of proof with respect to a material adverse effect rests on the party seeking to excuse its performance under the contract."

Knowing and Intentional Breach of the Merger Agreement. The court also had to determine the meaning of a "knowing and intentional breach" as used in the merger agreement. The court defined it as "a deliberate one–a breach that is a direct consequence of a deliberate act undertaken by the breaching party … even if breaching was not the conscious object of the act." The court then noted that the merger agreement contained Hexion's agreement to use its reasonable best efforts to consummate the financing and to inform Huntsman promptly if it no longer believed in good faith that it would be able to obtain the financing. Instead of approaching Huntsman, Hexion engaged a valuation firm to provide guidance as to whether the combined entity would be in danger of being insolvent. Hexion later received the insolvency opinion and failed to notify Huntsman of its contents as required under the agreement. The court found that this "alone would be sufficient to find that Hexion had knowingly and intentionally breached its covenants under the merger agreement," and "constitute[d] a failure to use reasonable best efforts to consummate the merger and show[ed] a lack of good faith."

Besides the affirmative requirement that Hexion provide prompt notice to Huntsman if the financing was imperiled, the merger agreement included a negative covenant that obliged Hexion to refrain from doing anything that could reasonably affect the likelihood or timing of the financing. The same day that the valuation firm delivered the formal insolvency opinion, Hexion's board approved the filing of the lawsuit in this case. The following day, Hexion sent the insolvency opinion to the lending banks, placing the financing in serious peril, which the court found was a deliberate breach of this covenant.

In view of these findings, the court noted that "to the extent that it is at some later time necessary for this court to determine damages in this action, any damages which were proximately caused by [Hexion's] knowing and intentional breach will be uncapped and determined on the basis of standard contract damages" as provided in the merger agreement (i.e., lost value of the merger to shareholders). The court said it would also place on Hexion the burden of demonstrating which particular damages were not proximately caused by its intentional breach, in which case those damages would be limited to the liquidated damages amount of $325 million under the agreement.

Specific Performance. The court noted that the merger agreement included, "somewhat unusually," a provision by which Huntsman was not allowed to request the specific enforcement of Hexion's duty to consummate the merger. Nonetheless, the court indicated that if all other conditions precedent to closing are met, Hexion would still be free to choose to refuse to close, subject to a possible finding of liability for what would appear to be uncapped damages.

Solvency. The court determined that the issue of solvency of the combined entity was not ripe for judicial determination. In doing that, the court explained that it would not reach the issue of solvency of the combined entity because it is not a condition precedent to Hexion's obligations under the merger agreement and would, therefore, not arise unless and until a solvency opinion is delivered to the lending banks and those banks either fund or refuse to fund the transaction.

Conclusion. Vice Chancellor Lamb's opinion in this case provides insight into the burden of proof required by the Delaware Chancery Court in order to show that an MAE has occurred. In addition, the opinion provides a rare example of the standard of conduct that will give rise to a finding that a party has breached a "reasonable best efforts" covenant.

Source: Friedenberg, Ellen S., Kenneth A. Lefkowitz, and Charles Samuelson, *Huges Hubbard & Reed LLP*, Oct. 2008. Available at: http://www.hugheshubbard.com/files/Publication/e1ee2551-28f9-4acc-8c95-b63a5676ec46/Presentation/PublicationAttachment/43fb524a-0284-4a4d-b5dd-c10c9097673c/samuelson_hexion%20v%20huntsman%20summary_oct2008.pdf