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CLIENT ALERT

Does the COVID-19 Pandemic Constitute a Material Adverse Effect Under New York Law-Governed Credit Agreements?

APRIL 2, 2020

Material Adverse Effect ("MAE") provisions are common in credit agreements and other debt instruments. Frequently, a lender's obligation to fund under a credit agreement is conditioned on an absence of a material adverse change in the borrower's business, condition (financial or otherwise), assets, operations, or prospects. [1] Additionally, in most credit agreements, the borrower makes a representation at each borrowing that no MAE has occurred since a specified date. Some credit agreements and other debt instruments might also include a borrower MAE as an Event of Default.

Many clients in Latin America and elsewhere are now asking whether the effects of COVID-19 are significant enough to constitute an MAE under their existing credit agreements and other debt instruments that are governed by New York law.

Discussion

While much of the case law analyzing whether circumstances constitute an MAE is found in the context of mergers and acquisitions, where the issues usually occur, existing case law is helpful in determining whether or not a court might determine that the COVID-19 pandemic constitutes an MAE under a credit agreement or other debt instrument. Courts have traditionally imposed a heavy burden on a party seeking to invoke an MAE clause to avoid performance. Determining whether an MAE has occurred is highly fact-specific and largely depends on the wording of the relevant MAE provision, but courts have historically been consistent in analyzing whether a particular MAE has occurred. Courts applying New York law have explained that an event constitutes an MAE only if it (1) was unforeseen, i.e., outside the contemplation of the parties at the time of the transaction, (2) substantially threatens the overall earning potential of the assets/company, and (3) did so in a durationally significant manner. For example, a short-term hiccup in earnings should not suffice; rather, the MAE should be material when viewed from the longer-term perspective of a reasonable acquirer.

Whether or not the circumstances underlying the MAE are company-specific might also impact whether or not the COVID-19 pandemic constitutes an MAE. MAE clauses in credit agreements typically do not include specific carve-outs for macro-level risks or "Acts of God" and do not specifically differentiate between company-specific and industry-specific risks. In contrast, MAE clauses in merger agreements often allocate macro or systematic risk to the

buyer (unless the underlying circumstances have a disproportionate and unforeseen impact on the seller's particular business—an inherently difficult fact-specific inquiry) and company-specific risk to the seller. Given policy considerations and case law interpreting MAE clauses in merger agreements, courts may require company-specific problems rather than industry-wide conditions for there to be an MAE under a credit agreement or other debt instrument.

Conclusion

Any party invoking an MAE clause must meet a heavy burden to show the crisis has caused a material adverse change that is material to the agreement as a whole and is durationally significant. It should be noted, however, that courts may take a more lenient approach to the durational significance requirement in the context of a borrower's ability to meet interest and principal payments in a credit agreement as compared to the acquisition context, in which courts have required buyers to establish a longer-term impact on the target company's business in analyzing whether an MAE has occurred. In addition, the more the impact of the COVID-19 pandemic can be demonstrated to be company-specific or having a disproportionate and unforeseen impact on the borrower's particular business, the more likely it is that a court would determine that such impact constitutes an MAE

Of course, any analysis of the impact of COVID-19 in relation to any particular MAE clause should be considered only in light of the actual language of the applicable MAE clause, including any specific carve-outs to the MAE definition and the specific impact on the company (in particular, the impact on the borrower's ability to meet its financial obligations under the credit agreement). This memorandum does not, and of course cannot, take into account any legislative or other governmental actions that might affect the conduct of business in the United States or elsewhere in light of current circumstances.

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View all of our COVID-19 perspectives here. Contact a member of our COVID-19 Legal Task Force here.

[1] As noted below, the impact of COVID-19 in relation to any particular MAE clause should be considered only in light of the actual language of the applicable MAE clause. For example, whether or not the definition includes a material adverse effect on a borrower's prospects could determine whether or not the COVID-19 pandemic constitutes an MAE.

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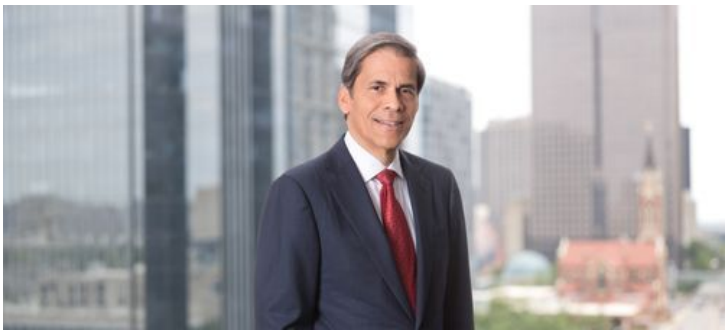

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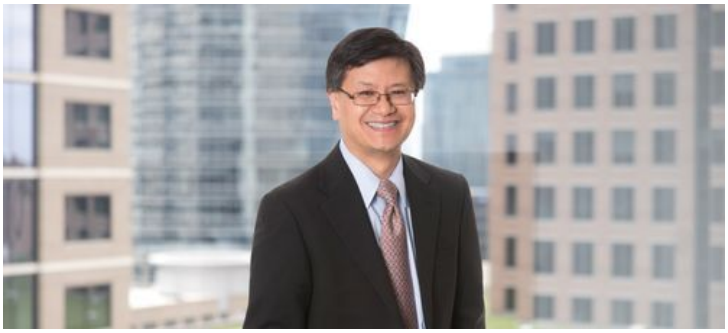

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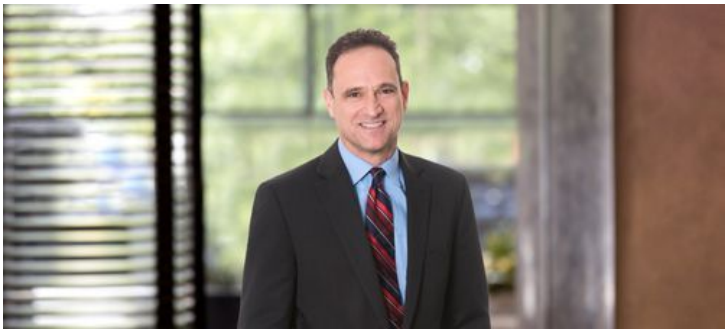

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