Reinhart

Is a Borrower’s Ability to Draw on its Credit Facility Limited by the COVID-19 Pandemic?

POSTED:

Mar 31, 2020

RELATED PRACTICES:

[Banking and Finance](https://www.reinhartlaw.com/practices/banking-and-finance)
https://www.reinhartlaw.com/practices/banking-and-finance

RELATED PEOPLE:

[Robert J. Heinrich](https://www.reinhartlaw.com/people/robert-heinrich)
https://www.reinhartlaw.com/people/robert-heinrich

The COVID-19 outbreak, and the resulting economic devastation, is causing many lenders and borrowers to consider whether a Material Adverse Effect (MAE) has occurred under the definition in their loan documents. Depending on the language of the credit agreement, the pandemic's impact – supply chain issues, financial losses and an inability to conduct regular operations, to name just a few – could bar the borrower from drawing on a line of credit and even trigger a default.

To avoid potential liability, lenders should consult with counsel before taking any actions based on a determination that an MAE has occurred. Borrowers too should be reviewing their loan documents to ensure they are complying with MAE-related provisions.

Material Adverse Effect, Defined

MAE is a defined term in most credit agreements. The language will vary from agreement to agreement and lender to lender. However, there are normally at least three different concepts captured in the MAE definition.

1. A material adverse effect on the assets, business, financial condition or results of operations of the borrower and its subsidiaries, taken as a whole. Sometimes the definition can apply to the “prospects” of the borrower and its subsidiaries, but that is commonly negotiated out by the borrower. Having the “prospects” language in the definition gives the lender more latitude to assert that an MAE has occurred.
2. The definition usually includes a material adverse effect on the ability of the borrowers and guarantors, taken as a whole, to perform their obligations under the loan documents. Occasionally this is limited to their payment obligations.
3. The definition may include a material adverse effect on the validity or enforceability of the loan documents and the rights of the lenders to enforce the loan documents.

Occasionally you will see a carveout from the definition, excluding any effects that arise because of changes in political conditions or in economic or market conditions affecting business generally, except to the extent that any such

All materials copyright © 2023 Reinhart Boerner Van Deuren S.C. All rights reserved.

changes have a materially disproportionate adverse effect on the borrower and its subsidiaries (taken as a whole). This language could be helpful to borrowers under the current landscape. However, such a carveout is quite rare in the middle market.

We have yet to see any specific COVID-19 carveouts be accepted to the MAE definition in credit agreements, though borrowers will no doubt be proposing them.

Usage of "Material Adverse Effect" in Loan Documents

The term MAE is used in several spots in loan documents. Some of the most important provisions often include:

1. Conditions to an Advance; Representations: To draw on a committed revolving line of credit or a delayed-draw term loan, the borrower must re-make (or "bring down") its representations and warranties – including the standard representation that there has been no MAE since a specific date (typically, the date of the most recent financial statements).
2. Events of Default: The occurrence of an MAE, or an event or other condition that could reasonably be expected to result in an MAE, might constitute an Event of Default.
3. Notices: The borrower might be required to notify the lender of the occurrence of an MAE or the occurrence of an event that would reasonably be expected to result in an MAE.
4. Materiality Qualifiers: A borrower will negotiate to have MAE qualifiers sprinkled throughout the documents to ensure that any default triggered by a breach of representations or covenants only occurs where an MAE could reasonably be expected to occur as a result of such breach.

A Lender's Considerations When Invoking MAE

As noted above, the occurrence of an MAE may allow a lender to decline a borrowing request or to call an Event of Default. But, in doing so, the lender could be opening itself up to a breach of contract claim based on its failure to fund or a lender liability claim.

In most jurisdictions, a lender would have the burden of proving the occurrence of an MAE, and the bar is high. Courts interpret the wording narrowly based on the text of the written agreement and then apply the exact language to the facts at hand.[1] It is a fact-specific inquiry, addressing things like the severity of the

All materials copyright © 2023 Reinhart Boerner Van Deuren S.C. All rights reserved.

financial impact, how long it exists and whether the general economy is subject to the impact. For example, if the event itself (or the adverse impact of the event on the borrower) is short-term in nature, then a finding of an MAE appears less likely.

Another concern for lenders is reputational risk. A lender claiming an MAE due to the coronavirus outbreak should weigh possible post-pandemic repercussions to its reputation. Further, if a lender strays from how other similar lenders are interpreting MAE provisions, it could enhance a borrower's claim that the lender is not acting in a commercially reasonable fashion or in good faith.

Lenders generally are expected to act "reasonably" or to make "commercially reasonable" determinations, even where the loan documents do not explicitly require such a standard. In addition, there may be an implied duty of good faith and fair dealing under common law.

To be safe, lenders should treat similarly situated credits the same way, unless there is an objective reason to treat them differently. In a syndicated credit facility, the administrative agent should be sure that the other lenders are on the same page in any communications with the borrower.

Rather than use a purported MAE as the grounds for calling a default or denying a borrowing request, a lender is more likely to try to identify and use a clear-cut and objective contractual basis for doing so – for example, a financial covenant. Borrowers should therefore be vigilant in their compliance with the terms of the loan documents.

What if a Lender Funds Despite an MAE (or a Suspected MAE)?

A lender that makes a loan despite the existence of an MAE should send a reservation of rights letter to the borrower. Such a letter notifies the borrower that the lender is not waiving any defaults and reserves its rights to enforce the loan documents.

A step further is the situation where there is a suspected MAE or the expectation that an MAE will arise. There have been instances when a borrower drew on its revolving line, and the lender communicated to the borrower that – even though the lender was extending the advance – it was reserving its rights to deny subsequent draws depending on its analysis of the MAE issue.

A lender declining to fund – or calling a default – based on the MAE provisions in the loan documents could have massive ramifications for a borrower, and the lender would perhaps be opening itself up to liabilities, as discussed above.

All materials copyright © 2023 Reinhart Boerner Van Deuren S.C. All rights reserved.

Accordingly, both lenders and borrowers should review the MAE language in their agreements to confirm they are in complete compliance.

If you have any question about Material Adverse Effect, please contact your Reinhart attorney.

[1] Most of the case law analyzing MAE language has been in the mergers and acquisitions setting – acquisition agreements, not credit agreements – but a court would presumably borrow from such analyses.

These materials provide general information which does not constitute legal or tax advice and should not be relied upon as such. Particular facts or future developments in the law may affect the topic(s) addressed within these materials. Always consult with a lawyer about your particular circumstances before acting on any information presented in these materials because it may not be applicable to you or your situation. Providing these materials to you does not create an attorney/client relationship. You should not provide confidential information to us until Reinhart agrees to represent you.

All materials copyright © 2023 Reinhart Boerner Van Deuren S.C. All rights reserved.