INTRODUCTION

Given the frequency with which "material adverse change" ("MAC") or material adverse effect ("MAE") clauses occur in commercial documents, it is remarkable how few reported cases there have been on such clauses. Unusually, there were two such reported cases in 2013 Grupo Hotelero Urvasco SA v Carey Value Added SL and Another [2013] EWHC 1039 (Comm) and Cukurova Finance International Limited and another v Alfa Telecom Turkey Limited [2013] UKPC2

This note discusses such cases, and what we can learn from them.

THE FACTS OF THE CASES

The Urvasco case

The Urvasco group owned a site in London to develop as a hotel. Various group companies (as borrower or guarantor), entered into a loan agreement with Carey Value Added SL ("Carey") to *** the development of the site, Carey stopped lending in early June 2008, notifying the borrower that information had come to its attention which indicated a substantial deterioration in the borrower’s financial condition and prospects and doubted its ability to fund the completion of the development. Receivers were appointed receivers and the development was sold. Urvasco issued proceedings against Carey for damages for failing to advance funding. Carey defended such proceedings on the basis that it was not in breach because it was no longer bound to continue to lend, as MACs and other events of default had occurred.

The Carey and BBVA loan agreements contained:

- representations on the part of the borrowers and guarantors that "there has been no material adverse change in its financial condition (consolidated if applicable) since the appropriate dates".
- an event of default if "any representation by [the obligors] under or in pursuant to the Carey loan agreement is or proves to have been untrue when made... or any [default] occurs".
- a right for Carey to cease lending on the occurrence of a breach of representation or the occurrence of an event of default.

The court set out the general principles applicable to MAC/MAE clauses, based on the existing authorities, as follows:

- There is little case law on such clauses, perhaps reflecting the fact that (unlike an insolvency event
which is usually clear-cut) the interpretation of such provisions may be uncertain, proof of breach difficult, and the consequences of wrongful invocation by the lender severe, both in terms of reputation, and legal liability to the borrower. However, this should not be overstated. These clauses can be important and the circumstances may be such that it is obvious that the borrower's financial condition has deteriorated to such an extent that the repayment of advances is in serious doubt.

- The assessment of the financial condition of the company for a MAC should normally begin with its financial information at the relevant times and a lender seeking to demonstrate a MAC should show an adverse change over the period in question by reference to that information. The financial condition of a company during the course of an accounting year will usually be capable of being established from interim financial information and/or management accounts. If a MAC needs to be established by reference to eg a company's business or prospects, the clause must include these words. However, an enquiry as to financial condition is not necessarily limited to the company's financial information. There may be compelling evidence to show that an adverse change sufficient to satisfy a MAC clause has occurred, even if an analysis limited to the company's financial information might suggest otherwise.

- An adverse change must be material. Unless the adverse change in its financial condition significantly affects a borrower's ability to perform its obligations, in particular its ability to repay the loan, it is not a material change. Suitably modified, the same test applies where the obligation is one of guarantee.

- A lender cannot trigger the clause on the basis of circumstances of which it was aware at the date of the contract since it would be assumed that the parties intended to enter into the agreement in spite of those conditions, although it will be possible to invoke the clause where conditions worsen in a way that makes them materially different in nature. The court approved a US decision which described a MAC clause "as best read as a backstop protecting the acquirer from the occurrence of unknown events".

- In order to be material, any change must not merely be temporary.

It then applied these principles to the various Urvasco companies:

- it held that a MAC claim would have succeeded in respect of one obligor because:
  - it had stopped paying its bank debts from mid-June 2008;
  - the director's report in its 2008 accounts reported a "serious economic situation mid-year" and a "deterioration in the financial situation since the last quarter of 2007";
  - there were credible press articles dealing with a possible "collapse" of the Urvasco Group from May 2008. Although the court did not consider press articles generally to be reliable evidence, it described the content of these articles as "consistent with the overall picture".

Although the financial information as at the date of the representation that no MAC had occurred was not clear, the court "read back" from later events to conclude that the representation was false at the relevant time. (This claim however failed for other reasons.)

- Carey's case for a MAC in respect of another obligor depended on demonstrating losses in respect of derivatives and exchange exposures. The court held that even if such losses existed (and the evidence was uncertain in this respect), the losses alleged were unrealised and uncrystallised - in effect, they were only losses of the "mark to market" variety.

- Carey's MAC case in respect of the borrower was that it did not have the funds to complete the development of its hotel. The court held that a funding gap did exist. However, Urvasco had not committed to the liabilities it might need to incur to complete the hotel. To rely on such a funding gap for MAC purposes would involve taking into account the ability of the company to fund future prospective liabilities which it had not yet incurred. It was satisfied that this was "impermissible as a matter of principle". The court also doubted whether this would have amounted to a change given that such a funding gap had existed from the outset of the relationship with Carey.

Although Carey failed on its MAC contentions for the above reasons, it did, however, succeed in its claim that it was entitled to cease lending by reason of another event of default in the lending documents.

The Cukurova case

Cukurova Financial International Limited ("CFI") had entered into a facility agreement with Alfa Telecom Turkey Limited ("ATT") under which ATT lent US$1.35 billion to CFI secured by charges over a substantial indirect shareholding in the shares of Turkcell, one of the largest Turkish mobile telephone operators. Because of an existing shareholders...
agreement in relation to such shareholding, the shares to be charged were transferred into certain BVI companies. The other party to such shareholder agreement instituted arbitration proceedings alleging that such transfer was in breach of the shareholder agreement. It was successful in such arbitration and issued a press release that an arbitration award had been made for specific performance of the shareholder agreement. ATT then accelerated repayment of the loan, relying on the occurrence of a number of events of default principally that the arbitration award was "an event or circumstances which in the opinion of the lender (i.e. ATT) has had or is reasonably likely to have a material adverse effect on the financial condition, assets or business of the borrower" - non-compliance with the award would lead to a very substantial liability in damages. ATT appropriated the charged shares and CFI shortly afterwards tendered repayment of the loan which ATT refused, preferring to retain the shares, the acquisition of which had been its objective throughout.

The court decided that ATT was entitled to accelerate the loan. However, because the clause virtually entitled "ATT to be judge in its own cause on the issue of whether the MAC clause is satisfied and, if it is so satisfied, has a potentially drastic effect on the economic position of the other contractual parties", the court had to be convinced by admissible evidence that ATT did in fact form such opinion, as well as being convinced that the opinion was honest and rational. The court found that this was the case.

**COMMENT**

The decisions of the court in these two cases were, of course, based on the actual facts of such cases and, in particular, the specific wording of the MACs in question. However, one can perhaps draw some conclusions from them on MACs in general:

- It is important to understand the meaning of the various different types of "change". A MAC triggered only by changes in "financial condition", for example is limited in scope and excludes changes in "prospects" or external economic or market changes. However, the distinction may be blurred where, for example, market changes impacting on asset values are or should be reflected in a company's accounts. A "financial condition" test is backward-looking as it is primarily dependent on financial information. (In contrast a "prospects" test is forward-looking).

- But whatever the definition of change, the materiality test must be satisfied - will the borrower's ability to perform its obligations be significantly affected? In the Urvasco case, the court looked critically at the materiality of the alleged changes and found against Carey on most of them. It even went as far as to imply a materiality qualification into many of the development covenants. Despite the emphasis on the importance of financial information, when faced with large quantities of conflicting expert evidence on the companies' accounts, the court found it necessary to "stand back from the detail", and relied instead on the certainty of the company suspending payment of its bank debts and the admission of the directors in such accounts. This judicial preference for the relative certainty of unpaid debts over the relative uncertainty of accounts has echoes of the recent Eurosail case. This preference even extended to placing some credence on press reports as evidence of financial collapse.

- The Cukurova case shows what a strong position a lender is in by making the occurrence of a MAC/MAE dependant on "its opinion". In that case, the lender was described as "judge in its own cause", and its opinion was upheld notwithstanding that the court also held that the lender's commercial objective throughout was to take control of the shares owned by the borrower. A borrower should therefore always seek at least to include a reasonableness qualification. A lender should always document the making of its decision by eg a minute of the decision-making body.

- If a lender acts on the basis of a MAC which depends on its "opinion", then facts not known to it at the time of such decision will not be able to be advanced on its behalf at a later date if its opinion is challenged. In contrast, where a lender's case is dependent on a representation that a MAC has not occurred, as in the Urvasco case, it seems as if it may rely on information not known to it at the time of acting, in any subsequent litigation.

- A lender considering acting on a MAC may need to warn the borrower and to seek further information, before doing so if there is any doubt as to the strength of its MAC case. Carey was severely criticised by the court for not doing this.

The fact that these events went to litigation, and the complexity of these cases, does little to dissuade a prudent lender that MACs are devices of last resort. However, it is noteworthy that both lenders succeeded. Although Carey succeeded on other grounds, its MAC case for one company would have succeeded (but for other issues) on the basis of facts unknown to it at the time of ceasing lending, while ATT was held to be entitled to accelerate repayment of a loan on the basis of a contingent liability it believed would significantly affect a borrower's ability to repay yet such borrower tendered repayment of the loan and accrued interest a few weeks...
later. Perhaps a degree of optimism about using these clauses might be permitted after all.

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