Material Adverse Change ("MAC") clauses, sometimes referred to as Material Adverse Effect ("MAE") clauses, are found in many financing commitments and can often be heavily negotiated. In spite of this, MAC clauses are often the most ambiguously drafted clauses in a financing agreement and are thus often subject to multiple interpretations. However, this ambiguity is essential to the purpose of the MAC clause — which is, in the broadest sense, to protect the lender against gaps in due diligence, unforeseen changes to the borrower’s financial situation, unexpected and drastic market fluctuations, and anything else that could be considered a “material” change to the borrower’s ability to repay the loan. While borrowers may view MAC clauses as a sign of the lender’s unwillingness to fully commit to the loan, the lender should view MAC clauses as a necessary added protection against unforeseen and indeed, unforeseeable, material changes.

MAC clauses generally focus on the financial condition and assets of the borrower (and any additional credit parties), and the general ability of the borrower to meet its obligations to the lender. If the loan is secured, the MAC clause may also extend to the enforceability of the security granted to the lender. In all cases, however, the MAC clause is intended to protect the lender by monitoring the overall financial health of the borrower and ensuring that the lender has a “way out”, so to speak, if a material change occurs with respect to the borrower’s ability to repay the loan. To that end, MAC clauses are generally included in credit agreements in two ways: (i) as a condition of funding in which the borrower represents to the lender that no MAC has occurred since the time of the delivery of its latest financial statements; and (ii) as an event of default allowing the lender to terminate its commitment and accelerate the loan on the
occurrence of a MAC. As a representation, the borrower makes the determination that no MAC has occurred and represents that fact to the lender. As an event of default, the lender must decide if the relevant change is “material” enough to call the loan and terminate its agreement with the borrower.

As mentioned, in order to provide the lender with maximum protection, MAC clauses are necessarily ambiguous. For instance, MAC clauses often define a material adverse change as an adverse change that is, not surprisingly, material. With this in mind, how is a lender to know when a change is sufficiently “material” to engage the MAC clause in the financing agreement? Surprisingly, there have been very few Canadian cases to consider this issue in a lending context, but two cases from Canadian and international courts provide some insight as to how important proper drafting is to a court’s interpretation of the scope and enforceability of a MAC clause.

In Doman Forest Products, the British Columbia Supreme Court considered the definition of “materiality” in the context of a credit agreement which included an event of default upon the occurrence of a change that constituted a material adverse effect. The agreement defined “material adverse effect” very broadly to include a material adverse effect on (among other things) the condition (financial or otherwise), operations, assets, property, business or prospects of the borrower and any benefits or rights of the lender under the agreement, to be determined at the lender’s sole discretion. Although the borrower’s financial position was poor (as it was producing a low EBITDA), it argued that this was not relevant because the lender’s advances were fully secured by accounts receivable. The Court disagreed and found that the MAE clause was not limited to the value of the collateral, but actually extended to the overall financial condition of the borrower as per the wording of the clause itself. The Court therefore held that materiality is to be determined according to the language of the clause and the definition of materiality in the agreement, and found that the lender in this case could rely on the MAE clause in accelerating the loan. The Court also went on to support the lender’s right to exercise the MAE clause in its sole discretion, so long as the lender exercised its discretion reasonably based upon bona fide considerations and gave proper consideration to the facts supporting its decision to rely on the MAE clause. This decision is very favourable to lenders that use broadly worded MAC clauses in their financing agreements.

It is also worth noting the decision in Grupo Hotelero, wherein the U.K. High Court of Justice took an approach that is less favourable - but not necessarily prejudicial - to lenders by adopting a more objective standard when determining when a change is sufficiently material. The credit agreement in this case required the borrower, as a condition to funding, to represent that “there has been no material adverse change in its financial condition” since the date of the loan agreement. The lender refused to advance the funds, claiming that a material adverse change
had occurred with respect to the borrower’s financial condition. A full analysis of the court’s lengthy reasoning is beyond the scope of this article, but the Court made several comments of note. The Court acknowledged that the approach of English courts has long been to give effect to what the parties have stipulated in the contract,\(^7\) indicating that a lender is entitled to enforce the literal word of the agreement. However, the Court also put forth a number of considerations when interpreting MAC clauses. Among these, the Court stated that a lender should always review the financial information available to it regarding the borrower before relying on a MAC clause.\(^8\) Further, the material change must affect the borrower’s ability to repay the loan,\(^9\) must not be temporary in nature,\(^10\) and would not include circumstances or events which were known to the lender at the time the agreement was made.\(^11\)

Although the decision in Grupo Hotelero purports to narrow the circumstances in which a MAC clause can be invoked, it is important to note that the MAC clause in that case was already quite narrow, as it was limited to changes to the borrower’s financial condition. The differing interpretations by the courts in Grupo Hotelero and Doman Forest Products can largely be explained by the difference in scope of the relevant MAC clauses.

As the above decisions indicate, the enforceability and usefulness of MAC clauses is largely dependent on the specific facts of each case, as well as the scope and quality of drafting of each MAC clause. If a MAC clause is broad enough to cover the types or categories of change that are of central importance to a lender, and the lender exercises its discretion reasonably and with due consideration of all relevant information in declaring a default based upon a MAC clause, a MAC clause can, in the right circumstances, act as an effective ‘fail safe’ against unforeseen material adverse changes to a borrower’s ability to repay a loan. Nevertheless, due to the uncertainty associated with the interpretation of materiality in MAC clauses, many lenders are reluctant to act solely on a default based upon a MAC clause and prefer to have a second unrelated default under the applicable credit document before making demand and accelerating a loan.

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1. Doman Forest Products Ltd. v. GMAC Commercial Credit Corp. – Canada, 2005 BCSC 774 [Doman Forest Products].
3. Doman at para 127.
4. Doman at para 159.
5. Grupo Hotelero Urvasco SA v Carey Value Added SL, [2013] EWHC 1039 (Comm) [Grupo
Hotelero].

6 Grupo Hotelero at para 326.

7 Grupo Hotelero at para 340.

8 Grupo Hotelero at paras 351-352.

9 Grupo Hotelero at para 357.

10 Grupo Hotelero at para 363.

11 Grupo Hotelero at paras 360-362.

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**Travis Evens**  
Associate - Hamilton

- Email  
  travis.evens@gowlingwlg.com

- Phone  
  +1 905-540-3245

- vCard  
  Travis Evens
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