

## MAEbe So, MAEbe Not

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As COVID-19 continues to cause wholesale disturbance of numerous industries, lenders and borrowers will equally need to comprehend the potential consequences of their particular rights and obligations under their loan documents. While the crisis plays out, and as it becomes more apparent that the effects of COVID-19 will be enduring, lenders and borrowers may seek to implement material adverse effect (an “MAE”) clauses contained within documents. Ultimately, the issue they will face is whether COVID-19 is considered an MAE under their respective loan documents.

A “Material Adverse Effect” is a term of art used as a threshold to measure the effect of an event. MAE provisions protect both the lender and the borrower by codifying changed or unpredictable circumstances in the market, relating to the borrower or the real estate collateral. The language in MAE definitions may either be very broad or list specific items that would be considered an MAE. In general, a material adverse effect clause applies to circumstances that affect (i) the property, (ii) the use, operation or value of the property, (iii) the net operating income of the property, (iv) the business operations or financial conditions of the borrower, (v) the ability of the borrower to repay the principal and interest of the loan as it becomes due or to otherwise satisfy the borrower’s obligations under the loan documents, and/or (vi) the enforceability of the loan documents.

In financing transactions, a typical definition of a “Material Adverse Effect” includes any condition that has a material adverse effect on the capacity of the borrower to make payments under the loan documents, perform its construction and maintenance obligations, maintain insurance, and pay all taxes and other charges necessary to protect and operate the property. Additionally, typical language will cover circumstances that cause a material adverse effect on the ability to enforce the loan documents, the lien of a mortgage, or the remedies of an agent and lender under such documents. Standard MAE provisions may also cover situations which affect a guarantor’s ability to perform its obligations under a guaranty, the mortgaged property, or any collateral for the loan.

A sample definition of an MAE is as follows: “Material Adverse Effect” shall mean a material adverse effect on (a) the ability of Borrower to perform its payment obligations under the Loan Documents to which it is a party, maintenance of the Property or the maintenance of insurance or the payment of Property Taxes and Other Charges in respect of the Property, (b) the validity or enforceability of any of the Loan Documents, the Lien of the Mortgage or the rights and remedies of Agent and/or Lenders under any of the Loan Documents (except to the extent caused solely by an act or omission of Agent or the Lenders, respectively), (c) the ability of Guarantor to perform its obligations under the Guaranty or (d) the Property or any other collateral for the Loan.

MAE clauses are used in a number of ways depending on the type of document. Generally, there are four primary instances where MAEs are used. First, an MAE can modify a representation or warranty in a loan agreement. An MAE in this instance is used to qualify the extent to which the borrower’s representation is accurate or not. For example, a borrower will often make a representation in a loan document that there is no current litigation that does or would reasonably be likely to have a “material adverse effect.”

Second, an MAE can modify a borrower’s covenant in a loan agreement to act in the future. The MAE would qualify the degree to which the borrower is obligated to perform an obligation under a loan document. In theory, an MAE provision in this scenario allows the borrower to act or refrain from acting as long as there is no material adverse effect.

Third, while not universal, an MAE clause is sometimes used to constitute or codify an Event of Default if an MAE affecting the borrower occurs. While MAE provisions constituting an Event of Default were historically common, they are now less common.

Lastly, but nevertheless important to note, is a situation in which an MAE is used in a loan commitment. A commitment to lend is a contractual obligation where the lender is bound to lend money on specific terms. An MAE provision in a

commitment letter is often used as a condition precedent to funding. Since the lender is bound by the commitment, an MAE provision would give the lender some flexibility in its obligation to fund if there has been an MAE with respect to the operations of the borrower or the property, or generally with respect to market conditions. Essentially, an MAE provision in a commitment could enable the lender to terminate its obligations under such commitment. When a commitment is issued in conjunction with the borrower acquiring the property pursuant to a purchase and sale agreement or a merger or public company transaction, an MAE provision will most likely track the language contained in such acquisition document so there is consistency between the obligation to close the acquisition and the obligation to fund the financing. Over the years, there have been times when the market dictates that an MAE in these contexts would not relieve a lender of its obligation pursuant to a commitment but, instead, would trigger the ability of a lender to increase its interest rate to compensate for the change in circumstances. This language is referred to as a “flex” provision since the interest rate is “flexible.”

While it remains a significant concern for parties to a financing today whether the COVID-19 crisis constitutes an MAE, there is no clear answer to this question. Whether COVID-19 should be considered an MAE will be determined on a case-by-case basis by the courts. There is no recognized bright-line test to establish whether the effect of COVID-19 will constitute an MAE. However, a court may analyze whether there is an MAE based on the totality of the circumstances by considering the following:

- What is the specific language of the MAE provision?
- What is the temporal effect of the event? Are the consequences temporary or long-term?

Nevertheless, since there is very little precedent regarding interpretation of MAEs in real estate financing transactions and even less in evaluating a pandemic such as the current COVID-19 outbreak, it is very difficult to determine what constitutes a material adverse effect. The court’s analysis is likely to rely heavily on the specific facts of the transaction, the circumstances applicable to the properties and the specific contractual language.

Although it is not common to have a “pandemic” carveout in MAE provisions, the current crisis, at a minimum, will trigger negotiations and discussions regarding this occurrence.