Client Alert

September 2021

Australia: The Arrium Series (#5) – Interpretation and application of Material Adverse Change clauses

In brief

The Arrium Series

Welcome to issue #5 of our **Arrium Series**, where senior members of the Baker McKenzie team involved in the successful defence of proceedings against the former CFO, former Treasurer and other former employees of the Arrium Group, consider key issues arising in those and related insolvent trading proceedings and from the judgment handed down on 17 August 2021.[1]

A summary of the relevant background to the Arrium proceedings, some key terms and the key issues to be considered in this **Arrium Series** can be found in issue #1 here, issue #2 (which considers solvency in the context of large debts due in the relatively distant future) can be found here, issue #3 (which considers when and how duties of care may be owed to lenders) can be found here and issue #4 (when may company officers and employees be personally responsible for representations) can be found here.

In this issue

Today's issue - interpretation and application of Material Adverse Change clauses

Key issues in the Lender Proceedings included whether the (so-called) "MAE Representation" made to lenders was true.

As explained in issue #1, this turned upon the interpretation of relevant syndicated and bilateral facility agreements (**Facility Agreements**) and, particularly, whether changes in the Arrium Group's financial position since 31 December 2012 (in one instance) and, otherwise, since the date of Arrium's last Accounts (31 December 2015), had had a "material adverse effect" on the ability of an Arrium Group member to perform its obligations under the Facility Agreement or other "transaction document" (the **Arrium MAE Clause**).

The Arrium MAE Clause was a (complex) version of a "material adverse change" (or MAC) clause, which are commonly found in loan and security documentation, acquisition agreements and other contracts.

The proper interpretation and application of MAC clauses is critical for debtors, creditors, company directors, finance teams, lawyers and insolvency practitioners alike.

[1] *Anchorage Capital Master Offshore Ltd v Sparkes (No 3); Bank of Communications Co Ltd v Sparkes (No 2)* [2021] NSWSC 1025

Key elements of a MAC clause

A MAC clause is designed to "allocate risk presented by adverse business or economic developments"[2] by giving a party the right to terminate an agreement or take other action (such as appointing a receiver), if there has been a material adverse change in a counter-party's position.

At its broadest, a MAC clause identifies the material adverse development(s) which trigger the right to take action which are often (but not always) expressed in **qualitative** terms, such as an adverse change in the "economic viability" of a business or the nature of a security or, as in Arrium, a change in financial position which materially adversely affects the capacity to perform contractual obligations (i.e. a MAE clause).

While not essential, it is also quite common to provide the party with the right to take action in the event of a material adverse change to determine whether that change has occurred (e.g. by giving a lender or security agent the right to subjectively form an opinion as to whether a MAC has occurred) while given the serious consequences of breach it is also not uncommon, again as occurred in Arrium, for the party subject to the clause to have a cure right upon notice before an event of default actually arises.

Issues with MAC clauses

Because MAC clauses are usually expressed in quite general, qualitative terms (so as to almost inevitably require careful interpretation), and their application may also depend upon the reasonableness of a conclusion of breach and/or whether any breach has been remedied, their application is often open to considerable debate and risk, as was the case in the Lender Proceedings and also, of recent times, in the context of the COVID-19 pandemic, which has raised issues as to whether, and how, MAC clauses and **force majeure** can be reconciled, for example.

As a consequence:

- a MAC clause will usually be only one of many possible default triggers.
- it is rare to find a party alleging breach to only be relying on a MAC clause (as the Anchorage Plaintiffs were).
- as a consequence, it is also rare (particularly in Australia) to see judicial consideration of a MAC clause.

General approach to interpretation of MAC clauses

MAC clauses are to be interpreted like any other contractual provision, which is by discerning the objective intention of the parties by reference to the words actually used (usually by giving them their ordinary English meaning unless a different, technical meaning is established), the context in which they appear and, in a commercial contract, what a reasonable business person would understand those words to mean.

Issues with Arrium MAE Clause

As noted above, the application of the Arrium MAE Clause turned on two key issues:[3]

- first, whether there had been a relevant change in Arrium's **financial position** between the date of drawdown notices or drawdowns issued in January and February 2016 on the one hand and, on the other hand 31

[2] "Material adverse change clauses" - Investing in Infrastructure | International Best Legal Practice in Project and Construction Agreements | January 2016" Damian McNair, PWC (https://www.pwc.com.au/legal/assets/investing-in-infrastructure/iif-38-material-adverse-change-clauses-feb16-3.pdf)

[3] there was also an issue as to whether MAE gave rise to an **Event of Default** under a Facility Agreement where the Court held no because lenders had not given Arrium a remedy notice

December 2012 (in the case of a 2013 Facility Agreement) and, otherwise, 30 June 2015 (being the date of Arrium's last Accounts provided to lenders)?

- secondly, whether any change in financial position had a "**material adverse effect**" on the ability of an Arrium Group member to perform its obligations under a Facility Agreement or other transaction document?

Meaning of "financial position"

The considerable debate, particularly in the Anchorage Proceedings, as to what the expression "financial position" actually meant and how it could be discerned in practice graphically illustrates the drafting and interpretation issues, challenges and risks often associated with MAC clauses.

For their part, the plaintiffs contended for a broad interpretation of "financial position" which would "encompass any change relating to Arrium's business that has an impact on its ability to comply with its financial obligations". The Anchorage Plaintiffs in particular alleged a "shopping list" of changes in financial position[4] including changes in external environment and market conditions (particularly decrease in commodity prices and demand), changes in Arrium's "key financial metrics", changes in cash flow, debt levels and liquidity, shortfalls against budgets and forecasts, a lender's demand that Arrium provide cash collateral, Arrium's "need for" a standby facility agreement and a going concern disclosure in Arrium's 30 December 2015 Accounts.

For their part, the defendants (and cross-defendants) contended that "financial position" required a narrow interpretation to be confined to Arrium's assets and liabilities as shown in its balance sheet because (it was argued):

- first, Arrium's "Accounts" provided the relevant "comparator" where changes in financial position were to be determined by reference to two points in time.
- second, it was a requirement of the Facility Agreements that those Accounts be prepared in accordance with Australian Accounting Standards and those standards used the term "financial position" in a technical sense as a reference to assets and liabilities (see, for example, AASB 101).
- finally, it was "not practical" for a determination of whether there had been a change in "financial position" to be made by reference to the lengthy and complex criteria contended for by the Anchorage Plaintiffs each time a drawdown notice was to be issued.

The Court also considered, and ultimately preferred, a third, "intermediate" position (in the face of "far from perfect" drafting), which was that "financial position" referred to "the information disclosed in Arrium's "Accounts"" because:

- the fact that the Accounts needed to be prepared in accordance with Australian Accounting Standards did not mean that the parties objectively intended to adopt the technical meaning given to "financial position" in those standards.
- where a word or phrase has both an ordinary meaning and a recognised technical meaning, "the meaning the parties intended the word or phrase to have is to be resolved in accordance with ordinary principles of contractual interpretation".
- there was "no rule of law which required the Court to choose a technical meaning over the broader, ordinary one".
- not all changes in financial position find their way into a balance sheet (citing, by way of example, "an increased risk of insolvency").
- while it was "no doubt" more difficult ("requir[ing] the exercise of some judgment") to determine whether there had been a change in financial position once more than a balance sheet comparison was required, that "does not mean that the comparison cannot be made" or should not be made.

[4] by contrast, the BoC Plaintiffs' "only" relied on changes in gearing and interest cover ratios and what was alleged to be changes in the likely sale price of Arrium's Mining Consumables business

- there was also "no commercial reason" to distinguish between information in the balance sheet and other information in the Accounts, where the purpose of the MAE Representation "was to give the Lenders a level of comfort that was similar to the one they could get by reviewing the Accounts themselves in respect of the period for which they did not yet have Arrium's Accounts".
- at the same time, it was "not clear" why the parties would have intended the [MAE Representation] to go beyond the type of information available from the Accounts" given the representation and warranty in relation to changes in financial position was only given in respect of changes since the relevant Accounts were provided.

Meaning of "material"

The Court regarded "material" as an ordinary English word to be construed in the context in which it appears, so that the question was whether "any of the changes in financial position identified by the plaintiffs materially affected Arrium's ability to repay the facilities and, most immediately, those due in July 2017."

Was there a change in financial position?

While each case will be fact specific, it is informative to consider the Court's conclusions with respect to the following categories of alleged change in financial position:

Alleged change in financial position	Court's determination
Changes in external environment and market conditions?	Not a change in Arrium's financial position but may have had an "effect on Arrium's financial position".
Changes in Arrium's key financial metrics?	Changes in net assets and net profit which "had consequences" for gearing and interest cover ratios **were** relevant but changes in the financial performance of individual business units were generally **not** relevant except to the extent that those changes were reflected in Arrium's financial position as a whole.
Change in cash flow, debt levels and liquidity?	Yes. Losses in HY16 and early 2016 resulted in an **increase** in debt and decrease in net assets.
Shortfalls against Arrium's budgets and forecasts?	No. Shortfalls against budgets or forecasts (including liquidity forecasts) do **not** constitute a change in financial position because "to take an obvious example, the budget or forecast could have predicted that Arrium would do substantially better than the previous financial year whereas in fact it may have … [merely] … done no better."
A lender's demand that Arrium provide cash collateral?	No. Demand for, and provision of, collateral had no consequences for Arrium's net financial position.
A going concern disclosure?	The inclusion of a note and an auditor's "emphasis of matter" paragraph in Arrium's 31 December 2015 Accounts published on 17 February 2016, which addressed material uncertainties with respect to various matters relevant to Arrium's ability to continue as a going concern (such as changes in the external environment, including commodity prices), represented a change in financial position "since as at the date the accounts were signed management had formed the view…that there was a material uncertainty concerning whether Arrium could continue as a going concern whereas that uncertainty did not exist as at 30 June 2015 or 31 December 2012", with the

Alleged change in financial position	Court's determination
	Court holding that this change occurred on 11 February 2016, when the issue was first considered by the Arrium Board.
A material change in the gearing and interest rate cover ratios?	Yes, as a reflection of changes in Arrium's net assets and net profit.
A material change in likely sale price of Mining Consumables business?	No. The deterioration in the "prospects" of obtaining an "acceptable" price for Mining Consumables was not itself a change in financial position, while the BoC Plaintiffs had also failed to explain why a certain sale price was critical to the question of whether there had been a MAE.

Were established changes in financial position material?

It is also informative to consider the Court's conclusions on materiality:

Change in financial position	Court's determination
Changes in net assets and profit?	No. Plaintiffs had not explained how changes in net assets and profits **increased** the likelihood that Arrium would not be able to pay its facilities when they fell due. Also, while it may be possible to infer that a material change in risk occurred between 31 December 2012 and 31 December 2015, it was "not supported by evidence or submissions", it "appeared" lenders themselves did not reach that conclusion, no lender had suggested, following release of the FY15 accounts, that there had been a MAE and lenders continued to advance money.
Changes in the gearing and interest cover ratios?	No. The decline in ratios did not breach ratio covenants in the Facility Agreements and, if the covenants were not breached, it "is reasonable to infer that a change in the ratios alone would not materially affect Arrium's ability to comply with its other obligations under the agreements" and, in any event, the plaintiffs had failed to explain how the ratio changes had a MAE on Arrium's ability to comply with its obligations under the Facility Agreements.
The going concern disclosure?	Yes. The decision of the Arrium Board to include the going concern disclosure on 11 February 2016 was a MAE because "it indicated that there was an uncertainty (which may be material) … as to whether the Group will continue as a going concern and therefore whether it will realise its assets and extinguish its liabilities in the normal course of business" and "if Arrium's financial position had reached the point that warranted the inclusion of that note, it seems reasonable to infer that there was a material increase in the risk that the Lenders would not be repaid in full compared to the position as at 30 June 2015 (and 31 December 2012)."

The result was that the Court held that there **was** a change in Arrium's financial position which had a MAE on, and from, 11 February 2016 (being the adoption of the going concern note) but there had been **no** prior MAE.

10 key takeaways

In summation, the 10 key takeaways from the judgment in relation to MAC clauses are as follows:

1. MAC clauses are to be **interpreted**, in the same way as other contractual terms, by reference to the words actually used, the context in which they appear and, in a commercial contract, what a reasonable business person would understand those words to mean.
2. Quantitative measures of readily established facts (such as percentage declines in revenue, net tangible assets, net profits and the like) are to be **strongly preferred** over qualitative measures requiring complex analysis and the exercise of judgment over which views can legitimately differ.
3. Unarticulated ("amorphous") qualitative criteria are **particularly problematic**, both to apply in practice (such as with regular drawdown notices) and to prove, resulting in **dangerous** and potentially very costly, **uncertainty**.
4. Whether there has been a MAC or MAE will an **objective** question unless the contract provides that the issue is to be determined by reference to the **subjective** opinion of a party.
5. Even where a party's subjective opinion is relevant, there is **significant** potential for a costly and uncertain contest as to whether that subjective opinion needs to be held in good faith (invariably yes) or needs to be reasonably based (depends, so should be made clear in the drafting) and, if so, whether those requirements have been satisfied.
6. Shortfalls against budgets or forecasts are **not** changes in financial position and, if that is the desired result, the drafting again needs to make that clear.
7. Declines in gearing, interest rate cover and other ratios are unlikely to be "material" where they do **not** result in a breach of any express ratios covenants, which are a much clearer measure of an adverse development in any event.
8. The **onus** is on the party alleging a MAC to prove what changes occurred, and that they had the alleged material adverse change or effect, and how that party acted after they became aware of the relevant facts may be also be relevant to an assessment of at least materiality but also other things such as **waiver** or **estoppel**.
9. The traditional reluctance to rely upon MAC clauses to call breaches or defaults is **well** justified.
10. Never rely on only a (qualitative) MAC clause as the sole basis for default (unless you are really desperate).

Arrium series authors

Mark Chapple
Partner
Sydney
mark.chapple
@bakermckenzie.com

Jayme-Lyn Hendriks
Senior Associate
Sydney
jayme-lyn.hendriks
@bakermckenzie.com

Kathleen Jeremy
Senior Associate
Sydney
kathleen.jeremy
@bakermckenzie.com

Charlotte Hendriks
Senior Associate
Sydney
charlotte.hendriks
@bakermckenzie.com