Lender Liability and COVID-19
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Summary:

- Lenders should consider the potential for lender liability claims when addressing disruptions to their borrowers' business due to COVID-19.
- Refusing to fund a borrowing request or calling a default based exclusively on a “material adverse change” clause should be done thoughtfully and with caution, only after careful consideration of the language in the loan agreement and, more importantly, the specific factual circumstances affecting the borrower.
- Actions taken to mitigate risks to the lender are subject to such lender’s contractual and statutory obligations to conduct itself reasonably and in good faith.

Continuing uncertainty about the business impact of COVID-19 has many lenders assessing the potential for adverse effects within their loan portfolio and evaluating what can be done to minimize potential risks of loss. With the rapidity of cancellations, suspensions and other extraordinary efforts being made on a daily basis across all aspects of daily life, it would be understandable for a lender to instinctually desire to similarly make quick and extreme decisions in the management of its loan portfolio. Instead, in formulating an action plan a lender should, more than ever, exercise prudence, and be careful not to inadvertently expose itself to a lender liability claim resulting from its actions.

Impact of COVID-19

COVID-19 has the potential to cause a variety of adverse outcomes across a broad spectrum of industries. The virus could trigger material disruption of global supply chains, especially for companies dependent on goods made in China where COVID-19 has already curtailed manufacturing and shipping operations. Borrowers may also face softening demand for goods and services due to travel restrictions, event cancellations, quarantines, or their customers’ reticence to engage in normal commercial activities. Finally, borrowers may be confronted with non-performance from contractual counterparties unwilling or unable to fulfill their obligations due to disruptions to their own businesses.

Determining the scope of the potential adverse effect of COVID-19 on a borrower’s business will require careful analysis of current financial statements, material contracts, insurance policies and management predictions. With respect to borrowers experiencing material business disruptions, lenders will have to carefully strategize a game plan that reduces credit risk while also mitigating legal risk of liability.

Invoking MAC Clauses to Halt Funding or to Exercise Remedies

One avenue lenders may take in order to address disruptions caused by COVID-19 is invoking the material adverse change (“MAC”) clause in their loan agreements. The specific definition of a MAC will vary from deal to deal, but in many loan agreements the non-existence of a MAC is a condition...
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precedent for funding additional advances under a revolving loan and the occurrence of a MAC will constitute an event of default. As a result, a MAC clause purports to give a lender broad authority to decline to fund or to commence the exercise of remedies.

While a MAC clause appears on its face to provide a powerful tool for a lender to protect itself from unforeseen circumstances such as COVID-19, lenders should proceed with caution. Suspending funding will often put a borrower into financial distress or bankruptcy, and history is replete with examples of lenders facing liability in instances where a borrower has successfully asserted a breach of contract claim with respect to the lender’s refusal to honor its commitment to fund. In many jurisdictions the burden is on the lender to prove that a MAC has in fact occurred, and without a carefully drafted MAC definition and, more importantly, a firm command of the facts relied upon to support the existence of a MAC, a lender may struggle to demonstrate the justification for its refusal to fund (or similar action). Proving a MAC is a highly fact-specific inquiry dependent upon the specific circumstances impacting the borrower and its operations. At a minimum, a lender should expect to be required to show that COVID-19 has had a realized impact on the actual and material financial condition, operations or creditworthiness of the borrower, rather than a mere abstract or prospective effect.

Prior published court decisions provide little to no guidance on whether an outbreak of disease (such as the SARS epidemic in 2003, the swine flu pandemic in 2009, or multiple outbreaks of MERS starting in 2012) constitutes a MAC. However, the present COVID-19 pandemic may prove to be of more significant scope, duration and severity than prior outbreaks. Generally speaking, the greater the disruption to a borrower’s operations, financial condition and prospects, the stronger a lender’s justification will be to rely upon such disruption to exercise its discretion to utilize the MAC for a particular purpose. Similarly, the more significant the lender’s proposed action, the more critical it is that the disruption to a borrower’s operations or financial condition be factually supported, objectively measurable and correlative to a commercially reasonable need to protect identifiable credit risk to the lender.

Because of the high bar for proving a MAC and the potential for significant lender liability if a court or jury determines that no MAC in fact occurred, a lender should very carefully evaluate the language of the applicable loan documents and the specific factual circumstances underlying the change before invoking a MAC to exercise remedies, accelerate the loan or refuse to fund. Lenders should also consider the reputational risk of invoking MAC provisions to justify material decisions.

Lender’s Permitted Discretion and the Implied Duty of Good Faith

Many loan agreements provide additional avenues for mitigating the impact of unforeseen circumstances affecting the borrower. This is especially true in the asset-based lending (“ABL”) space, where lenders customarily have discretion to reduce borrowing availability or to restrict funding in a variety of ways, including by declaring certain accounts or inventory ineligible, reducing the value attributed to borrowing base assets, or imposing reserves against the borrowing base. ABL loan agreements frequently contain a “Permitted Discretion” definition governing the lender’s ability to make such determinations. More broadly, most loan agreements impose requirements on the lender to be “reasonable”, “commercially reasonable”, or another similar standard in exercising discretion. A lender’s first step in assessing whether or not a given discretionary response to COVID-19 is permitted by the loan documents (for example, declaring any inventory held at a location subject to quarantine to be ineligible for inclusion in the borrowing base) is to review the applicable language of the loan agreement to determine whether there exists any applicable contractual limitation on the lender’s ability to exercise its discretion.

It is important to note, however, that even if the loan agreement purports to grant the lender “sole and absolute” discretion in making a determination, a lender must remain mindful of its obligations outside the four corners of the document. No matter the terms of the loan agreement, a lender has a duty of good faith and fair dealing arising under the Uniform

1 See Capitol Justice LLC v. Wachovia Bank, 706 F. Supp. 2d 23, 28 (D.D.C. 2009) ("In deciding this question of first impression, this Court . . . concludes that the party invoking the MAC clause has the burden to prove that a MAC occurred.").
2 See id. at 30 (holding that a generic material adverse change clause was ambiguous and permitting the introduction of extrinsic evidence to determine the parties' intent as to what a material adverse change would be); Greenwood Place v. Huntington Nat’l Bank & Nat’l City Bank of Ind., 2001 U.S. Dist. LEXIS 78736, 3 (S.D. Ind. July 19, 2011).
Commercial Code ("UCC"), and in certain jurisdictions, also pursuant to common law. The precise contours of this duty of good faith will be shaped by the applicable state law governing the loan documents, but the UCC definition of “good faith” is instructive. UCC §1-201(20) defines good faith as “honesty in fact and the observance of reasonable commercial standards of fair dealing”. In this formulation, good faith is determined both subjectively (based on whether the lender actually believed itself to be acting honestly) and objectively (based on whether the actions taken were consistent with what a commercially reasonable lender would do).

To avoid liability for breaching its duty of good faith, a lender should consider whether its decisions related to COVID-19 will survive scrutiny under both the subjective and objective tests suggested by the UCC. A lender should communicate anticipated changes to the borrower directly and with sufficient advance notice when possible. Decisions should be based on objective data (such as current financial statements or a third-party collateral exam) or information provided directly by the borrower, and a lender should be wary of straying too far from the practices of other similarly situated lenders. Particularly with respect to the reaction to COVID-19, it is important for a lender to have a current and accurate insight into whether a proposed action it is considering will later be viewed as materially deviant from the “market” behavior of its peers during this uncertain period. It is also possible that courts and juries will be especially sympathetic to the impact of COVID-19 on borrowers, further reinforcing the importance of lenders to undertake a measured and strongly defensible decision making process when exercising discretion.

In conclusion, lenders should be carefully reviewing and monitoring the impact of COVID-19 on their loan portfolio and should take actions to protect themselves where appropriate, but we advise a careful consideration of the matters discussed in this alert as part of each decision making process.

3 Note that this revised definition replaces an earlier, exclusively subjective formulation and has not been adopted by all states.
not if, but how.

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