Real Property Law Section E-Bulletin

News from the Section:

Welcome to the September edition of the Real Property Law Section E-Bulletin.

Here are the features in this month's E-Bulletin:

A Featured Article: California Lenders Should Think Twice Before Exercising Remedies Under a Material Adverse Change Clause

The material adverse change ("MAC") clause has become a common provision in real estate loan documents. This clause typically provides, in broad terms, that a material adverse change in the financial condition of the borrower, the secured property, or any guarantor will constitute an event of default, upon which the lender may accelerate the borrower's obligations under the loan documents and exercise the lender's other remedies, including foreclosure. Given current economic conditions, lenders may be tempted to read the MAC clause literally, as a "catch-all" default provision for loans that are insufficiently collateralized, even though the borrower has not made any monetary defaults. This situation is most likely to arise in the context of construction loans, where the lender, not the borrower, is often required to fund monthly interest payments out of loan proceeds. While there is a dearth of authority on the enforcement of a MAC clause in California, several legal precedents should give lenders pause before taking action in reliance on a MAC clause.

MAC clauses have been most heavily litigated in the Delaware courts, typically in the context of corporate mergers and acquisitions. The most widely cited case discussing MAC clauses has been *In Re IBP, Inc. Shareholders Litigation, IBP, Inc. v. Tyson Foods, Inc.*, 789 A.2d 14 (Del. Ch. 2001), in which the Delaware Chancery Court rejected Tyson's assertion that a material adverse change had occurred and ordered Tyson, the buyer, to specifically perform the merger agreement. The court determined that "a buyer ought to have to make a strong showing to invoke a material adverse effect exception to its obligation to close." Furthermore, the court stated that the buyer must show that the material adverse change is "durationally significant," and that a "a short-term hiccup in earnings will not suffice". Subsequently, in *Hexion Specialty Chemicals, Inc. v. Huntsman Corp.*, 965 A.2d 715 (Del Ch. 2008), the Delaware Chancery Court rejected the buyer's MAC claim and stated that "[a] buyer faces a heavy burden when it attempts to invoke a material adverse effect clause. . ." The opinion noted that the Delaware Chancery Court has never found a material adverse change to have occurred and that "this is not a coincidence."

California law on MAC clauses is not as developed as Delaware law. However, in the case of *1601 McCarthy Blvd., LLC v. GMAC Commercial Mortgage Corporation*, (Case No. CGC-03-425848, California Superior Court), a San Francisco jury awarded an office building owner $33 million in punitive damages after its lender declared a default under a MAC clause. The borrower had deposited a $7.2 million lease termination payment into an impound account held by the lender. Pursuant to the terms of the loan documents, the impounded funds would be returned to the borrower when it found a replacement tenant. However, when the borrower leased the space, the lender attempted to renegotiate the loan documents to provide that the impounded funds would be used to pay down the loan balance. When this was unsuccessful, the lender asserted that there had been a material adverse change in the borrower's financial condition, constituting a default under the loan documents. In support of its argument, the lender showed that the mortgaged property had experienced a material decline in value, that rental rates had declined significantly, and that the property's income was insufficient to cover debt service. The jury was not persuaded, and it returned a special verdict finding that the lender breached its contractual obligations and acted with malice, oppression and fraud in committing a conversion of the impounded funds.

Several factors that may have influenced the McCarthy jury have also been addressed by the Delaware courts:

1. **Ex-post facto justifications are frowned upon**. In *IBP*, the Delaware court took issue with the fact that Tyson made no reference to material adverse change in its rescission letter, asserting the issue "post-hoc" instead. Likewise, in *McCarthy*, the lender approved two new leases, asserting its MAC argument for the first time after the borrower completed tenant improvements and the tenants had commenced occupancy.
2. **What you know and when you knew it may hurt you later in court.** For example, in *IBP*, the court noted that Tyson's statements and actions showed that it was previously aware of several issues that were the basis for its later assertion of a material adverse change. Similarly, in McCarthy, the borrower presented evidence that that the lender had approved two leases even though it had earlier prepared a confidential asset resolution plan, not disclosed to the borrower, which provided that the impounded funds would not be released unless the vacant space was rented at above-market rates sufficient to cover loan payments.
3. **Attempts to avoid contractual obligations due to changes in general economic conditions are viewed unfavorably**. In *McCarthy*, the borrower performed its obligations under the loan documents, but the lender attempted to avoid its corresponding obligations because of a decline in market rental rates that the borrower could not control. The jury viewed the lender's actions as evidence of bad faith. In the Hexion case, the economy deteriorated significantly between the time the parties entered into a merger agreement (i.e., July 2007) and the specified closing date. However, the Delaware court held that the buyer's MAC claimed failed. The

decision implied that it would be very difficult for a buyer to ever invoke a MAC clause to refuse to close a transaction.

While California law on the enforceability of MAC clauses remains unsettled, a few lessons can be gleaned from existing legal precedents: *First*, a lender should not invoke the MAC clause in a precipitous manner without giving adequate notice to the borrower and a reasonable opportunity to cure. *Second*, the lender should not deliberately conceal any information or hidden objectives from the borrower. *Third,* the lender should not assume that a general deterioration in market conditions gives it the unlimited right to declare an event of default even though the borrower is performing its obligations under the loan documents. *Fourth*, the lender should not use a MAC clause to exert pressure on the borrower to renegotiate essential loan terms. Any of the foregoing actions is likely to be used against the lender in court as evidence of the lender's breach of the implied covenant of good faith and fair dealing, and could be the basis for a damage award against the lender. Instead, lenders should make a concerted effort to act in a commercially reasonable manner at all times and, more specifically, to seek advice from experienced legal counsel before invoking a MAC clause.

We would like to thank Michael J. Zerman (mzerman@ztllp.com) of the Los Angeles office of Zuber & Taillieu LLP, and a co-chair of the Real Estate Finance Subsection, for preparing this article for the Real Property Law Section E-Bulletin.