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COVID-19: Credit Facility “Material Adverse Effect” Considerations

Whether you are a borrower or a lender, the immediate impact of COVID-19 under credit facility documentation may be more subtle than the effect on financial performance. While financial performance metrics in the form of financial covenants will often take a big picture, trailing 12-months approach, the provisions relating to “material adverse change” or “material adverse effect” (“MAE”) may be implicated much more immediately when events such as the COVID-19 pandemic occur. However, although implicated, borrowers and lenders must be very careful when declaring an MAE, and seeking the counsel of finance and restructuring lawyers is paramount to a successful outcome when declaring, or not declaring, an MAE.

In its simplest form, most middle-market and up-market credit facilities contain at least a covenant to notify the lender (or agent) of the occurrence of any event that would reasonably be expected to result in an MAE. The failure by the borrower to deliver such a notice (if there is found to be, in fact, an MAE) almost invariably would trigger an automatic “event of default” (no grace/cure period) as a result of the operation of the provisions outlining which covenant defaults are automatic and which permit the borrower a grace or cure period.

The MAE provisions may also appear in the (1) conditions to borrowing, (2) representations and warranties, and (3) events of default section, i.e., a direct “event of default” occurs as soon as the MAE occurs.

The effect of any “event of default” under credit facilities is usually the same: first, the lender(s) has (or have) no further obligation to extend credit; second, the loans may be accelerated, yet for syndicated facilities, a vote of a majority of lenders (by loan/commitment holdings) is usually required to accelerate; and third, if accelerated, the agent/lenders may exercise rights and remedies and foreclose (for secured credits).

Notwithstanding the relatively straightforward cause and effect analysis above, the decision by agents/lenders/borrowers to make the declaration of an MAE must be carefully considered in light of the totality of the circumstances and the effect of the declaration. The analysis often, in its most basic form, takes the following question-and-answer format:

- How is the definition of MAE drafted? Does it relate only to the borrower's financial performance or does it relate to more intangible metrics such as "prospects?"
- Is the effect short-term or long-term? It may be too early in the development of events surrounding the COVID-19 pandemic to be certain.^[1]
- Under the credit facility, what will the effect of the declaration of an MAE be on the lender and the borrower?
- In the case of agents/lenders, will the declaration of an MAE create exposure to potential lender liability suits? Does the credit facility documentation provide and protections to agents/lenders in such circumstances?

The foregoing is a small piece of the overall analysis required to advise and counsel agents, lenders and borrowers through the COVID-19 pandemic and its effect on credit facilities. In addition to credit finance lawyers, agents, lenders and borrowers will often require advice from legal experts in the areas of bankruptcy/restructuring and litigation. However, it is most important to create a meaningful and informed dialogue between the two sides with the goal of allaying fears and creating protections for both parties, without declaring an MAE before it's appropriate.

In addition to lenders/borrowers, MAE provisions have bearing on M&A deals. For companies contemplating or currently engaged in a merger or acquisition transaction, our business combinations attorneys have written about MAE provisions as it relates to uncertainties surrounding COVID-19. See, ["Is the COVID-19 Pandemic a Material Adverse Change?"](#)

To provide guidance and support to clients as this global public-health crisis unfolds, Frost Brown Todd has created a [Coronavirus](#)

Response Team. Our attorneys are on hand to answer your questions and provide guidance on how to proactively prepare for and manage any coronavirus-related threats to your business operations and workforce.

[1] At least in the context of a merger, *Channel Medsystems, Inc. v. Boston Scientific Corporation* (Dec. 2019), the Delaware Court of Chancery opined that “there must be strong evidence that [the] effects [of the bad event giving rise to the MAE assertion] on the seller will be significant and long-lasting.”

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