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# BANKING & FINANCE

M A T T E R S

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## Does Demand Always Mean Demand?

by Robert D. Betteridge

### CATEGORIES OF CREDIT FACILITIES

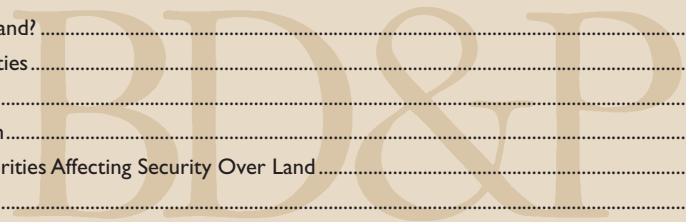
Classically, credit facilities are broadly catalogued into one of two categories: demand loans (that is, loans that may be demanded and are repayable at any time at the discretion of the lender); and term loans (loans that commit the lender and are only repayable at the end of their specified term or upon the occurrence of a specified breach or default). We have noted the development over time of a hybrid category of loan documentation that includes elements typical to both demand loans and term loans. Unless carefully drafted and considered, employing one of these “hybrid” loan agreements may have unexpected consequences.

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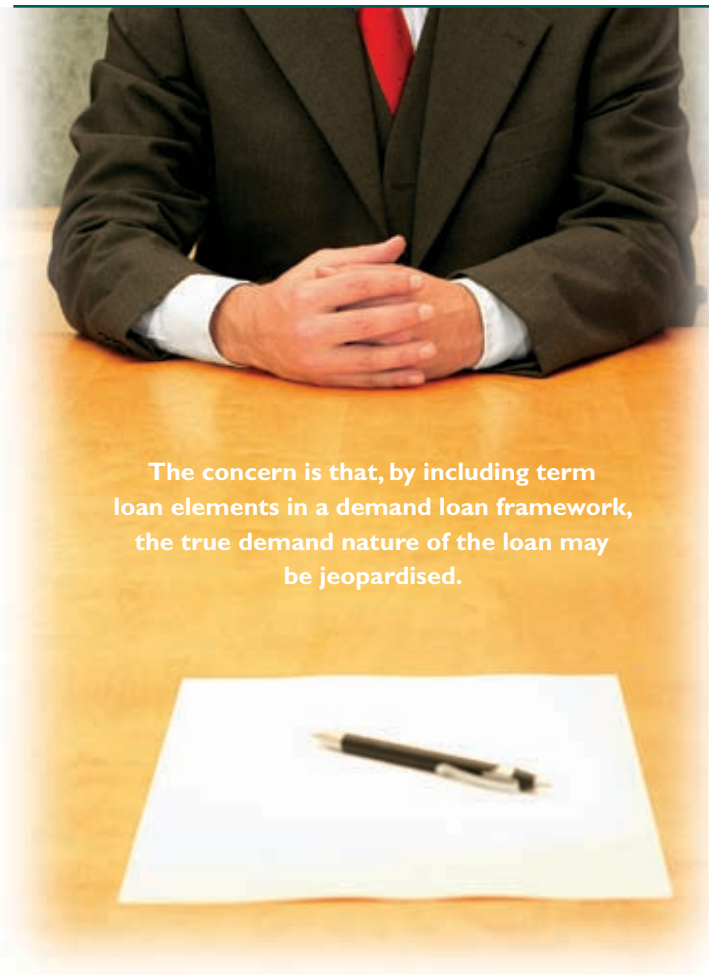


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The concern is that, by including term loan elements in a demand loan framework, the true demand nature of the loan may be jeopardised.

## DEMAND LOAN

Considering that a demand for repayment on a demand loan may be made at any time, very little is needed in order to document the terms of such a facility. At its most basic, all necessary terms can be encompassed within a few paragraphs; the debt is acknowledged, an interest rate and payment mechanism is specified and a clear statement that the loan is payable on demand is included. Money is advanced to the borrower and, upon the lender's demand (which can be made for any reason whatsoever); the money is repayable within a reasonable time thereafter.

## TERM LOAN

Conversely, term loan documentation is necessarily more complex since the lender will need ability to cause repayment under specific circumstances. For example, and in addition to obvious defaults like a non-payment event, a lender would typically want to terminate its commitment and be repaid where the credit worthiness of the borrower has deteriorated or where the borrower has taken on other obligations that could affect the lender's position or its security (if applicable). In the context of a term loan agreement, the lender accomplishes the goal of ensuring an ability to cause early repayment through the document mechanics of "an events of default" concept and the interaction of loan covenants.

## HYBRID LOAN

In the case of 'hybrid loans', we've noticed a blending of the documentary elements. The concern is that, by including term loan elements in a demand loan framework, the true demand nature of the loan may be jeopardised. That is, the ability to demand repayment at any time may become merely a right to demand repayment upon the occurrence of a specified event of default. Although case law on this concept is sparse, a 1994 Ontario case illustrates the potential dilemma.

## JUDICIAL CONSIDERATION

In *National Trust Co. v. Saks* ("National Trust")<sup>1</sup>, National Trust Co. agreed to lend \$16,500,000 to Orle Developments Inc. in respect of a construction project.

National Trust Co. argued at trial that the loan was, on its terms, able to be demanded at any time. National Trust Co. relied on the definition of "Repayment Date" which specified that the loan was repayable "at the earlier of the date of demand for repayment by National Trust of the Indebtedness or thirty-six (36) months after the 31st day of January, 1990" [emphasis added].

Notwithstanding the inclusion of this demand language, the Court held that a proper interpretation of the agreement led to the conclusion that the loan could not have been intended to be a demand loan. In part this analysis turned on the inclusion in the agreement of a well-developed events of default concept spelled out in Article 7 of the agreement. Mr. Justice Borins said at para. 73:

The provisions of Article 7 are inconsistent and incompatible with what is customarily considered to be a demand loan. In my view, there would be no reason to comprehensively stipulate events of default, notice periods and opportunities to cure defaults if the loan was truly payable on demand.

This particular point was accepted and upheld on appeal<sup>2</sup> where the Court of Appeal stated at para. 6:

National also submitted that the trial judge erred in concluding that the loan agreement did not permit National to demand repayment of the loan at any time. We reject this submission and agree with the trial judge's interpretation that the word "demand" contained in the agreement means a demand following an event of default as specified in the agreement. It is not an unfettered right standing in isolation.

A similar approach and conclusion was reached in an older English case, that of *Titford Property Co. Ltd. v. Cannon Street Acceptances Ltd* ("Titford")<sup>3</sup>. In this case, a merchant bank provided a number of fixed term overdrafts to a property development business. Each facility letter included the following clause:

9. All monies due by you, whether by way of capital or interest, shall be payable on demand, and you shall have the right to re-pay all monies due without notice.

The lenders relied on this clause to demand repayment prior to the otherwise stated term date and appointed a receiver when the

developer refused to pay. In reviewing the facility letters and, in particular Clause 9, Justice Goff concluded that Clause 9, being “completely repugnant to the whole facility”, had to be either modified or ignored altogether in order to properly construe the proper reading of the facility letter.

More recent authority from the English Court of Appeal in *Lloyds Bank plc v. Lampert*<sup>4</sup>, however, indicates that simply having a specified date of repayment ought not to preclude the inclusion of a demand concept and suggests that the *Titford* case may have only limited application.

### SUGGESTIONS FOR DRAFTING

The outcome in any particular situation may depend on how a court interprets a particular loan document. In light of *National Trust*, it is important to ensure that the loan document, taken as a whole, is consistent with the true concept of demand. We have three suggestions on how this may be accomplished:

1. Ensure that there is always a clear and unambiguous statement that the loan is repayable on demand in the sole and unfettered discretion of the lender. Even where there may be other minor inconsistencies, a court will be hard pressed to push aside a clear statement that demand means demand.

2. Eliminate events of default. If the loan is actually a demand loan, events of default are at best superfluous. At worst they may be considered, as in *National Trust*, as an indication that the loan is not actually repayable on demand, or that the lender’s otherwise unfettered right to demand may be somehow modified or precluded unless one of the enumerated defaults occurs.
3. Consider covenants closely. While it is likely that most covenants would not be inconsistent with a demand concept on their own, there may nonetheless, be some concern where a lender attempts to demand at a point in time where the borrower is otherwise in compliance with all of its existing covenants. Perhaps a better solution, in order to ensure the integrity of the demand right, would be to draft covenants as ‘expectations’ of the lender versus ‘promises’ of the borrower. This would provide some guidance to the borrower in of the lenders expectations during the course of the relationship but would not be as tied up in the conventional event of default mechanics.

### Footnotes

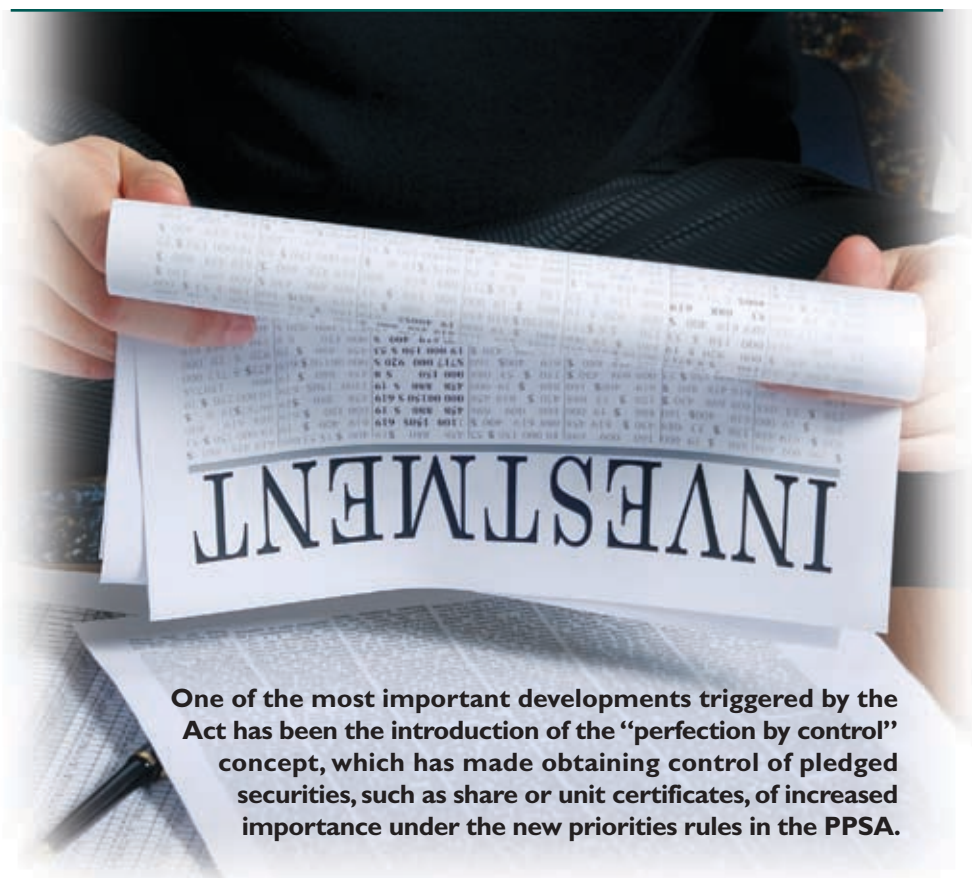
- 
- <sup>1</sup>[1994] O.J. No. 2488
  - <sup>2</sup>[1998] O.J. No. 2335 (C.A.).
  - <sup>3</sup>22 May 1975, unreported
  - <sup>4</sup>[1999] 1 All ER (Comm) 161

# The PPSA and Book-Based Securities

by David S. Kolesar

## INTRODUCTION

On January 1, 2007, the Securities Transfer Act (Alberta) (“the Act”) came into force, which promulgated significant changes to the way securities could be transferred and, in addition, introduced significant amendments to the Personal Property Security Act (Alberta) (“the PPSA”).



**One of the most important developments triggered by the Act has been the introduction of the “perfection by control” concept, which has made obtaining control of pledged securities, such as share or unit certificates, of increased importance under the new priorities rules in the PPSA.**

One of the most important developments triggered by the Act has been the introduction of the “perfection by control” concept, which has made obtaining control of pledged securities, such as share or unit certificates, of increased importance under the new priorities rules in the PPSA. In essence, the new priority rules make clear that a secured creditor who establishes control over these types of investment property will take priority over a secured party that has simply registered its interest. Further, a secured party that manages to establish and maintain control will rank prior to other secured creditors who establish control at a later date.

In the case of actual share certificates, “control” is achieved by simple possession whether in bearer form or by way of endorsement. On the other hand, book-based securities present a more difficult challenge. Control is more difficult to establish and may, in fact, be achieved by multiple secured parties, along with the securities intermediaries which may include clearing agencies, brokers and financial institutions that hold the book-

based securities on behalf of the issuer. While transferring these book-based securities to an account controlled, in both the practical and legal sense, by the secured party is an option; its lack of feasibility has led to the widespread use of “Control Agreements”.

### CONTROL AGREEMENTS

A Control Agreement is, in most cases, a contract among the secured party, the debtor and the intermediary whereby the intermediary grants control over the pledged securities to the secured party. While Control Agreements, in one form or another, existed prior to the Act, it is useful to look back after a year of dealing with the new rules to review use and application.

While each Control Agreement will vary in content, there are some general provisions that should be common to all agreements:

- ▶ the agreement should make clear whose instructions the intermediary must follow in respect of the account and provide for how such notices must be given;

- ▶ from a risk perspective, given that a security interest of the intermediary could arise out of the advance of credit or margins to the pledgor, it would be useful to have each of the intermediary and the pledgor covenant that it will not permit such activities;

- ▶ the intermediary should subordinate its interest in the account, along with its interest in the pledged securities, to the secured party;

- ▶ the agreement should include any restrictions on the pledgor’s dealings with the account (e.g. withdrawal of securities or cash from the account);

- ▶ the agreement should include the conditions under which control passes to the secured party—such as a default or event of default, prior to realization. Until that point, rights of the pledgor to instruct the intermediary or receive dividends and interest should be clear;

- ▶ if the intermediary is to have termination rights adequate notice periods prior to becoming effective should be included;

- ▶ the securities intermediary should represent to the secured party that the account of the pledgor has indeed been established and that the intermediary does not know of any other claim or agreement with respect to the account or the pledged securities held therein;

- ▶ the extent to which the intermediary will be indemnified by the pledgor and the secured party and any limitations on such indemnity.

### CLOSING THOUGHTS

Our recent experience suggests that intermediaries in Canada are becoming more accustomed to requests for Control Agreements and we anticipate the content of such agreements will become increasingly standardized across the country. While the process to homogenize these Control Agreements has already begun, we would urge secured parties and intermediaries to ensure that standard form documentation is flexible enough to address any unique fact circumstances, as well as, incorporate new and improved terms.

# Banking & Finance at BD&P

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- ◆ International trade financing
- ◆ Mezzanine and subordinated financings
- ◆ Income trust conversions
- ◆ Inter-creditor arrangements
- ◆ Syndicated loan transactions
- ◆ Loan documentation and related security for operating credits
- ◆ Equipment leasing and financing
- ◆ Aircraft leasing and financing
- ◆ Renegotiation and restructuring of debt
- ◆ Letters of credit and other aspects of import/export financing
- ◆ Cross-border lending transactions
- ◆ Secured financing
- ◆ Asset securitization

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- ◆ Project funding agreements
- ◆ Security documentation
- ◆ Inter-creditor and subordination arrangements
- ◆ Off balance sheet arrangements involving special purpose vehicles
- ◆ Bankruptcy remoting
- ◆ Securitizing contracts such as leases
- ◆ Construction and operational loans for facilities
- ◆ Various guarantee arrangements for sponsor support
- ◆ Note purchase arrangements for institutional investors
- ◆ Pass through certificate arrangements



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# DEVELOPMENTS IN THE LAW OF PRIORITIES AFFECTING SECURITY OVER LAND

*Royal Bank of Canada v. Head West Energy Inc.*

*by Sunil A. Joneja*

## BACKGROUND

**H**istorically there was a distinction at law between a legal mortgage (a ‘mortgage’) and an equitable mortgage or fixed charge (a ‘fixed charge’) over land. A mortgage was a security arrangement that involved transfer of title to land by the owner (the ‘mortgagor’) to another person (the ‘mortgagee’) on the condition that title to the land would be returned on discharge of the obligations owed by the mortgagor to the mortgagee. A mortgage specifically applied to the interest in land over which it was created and could not extend to additional land acquired by the mortgagee after the creation of the mortgage.

By contrast, no transfer was necessary in order to create a fixed charge over land. Rather, the owner (the ‘chargor’) simply needed to agree to charge the land as security for its obligations to another person (the ‘chargee’). An advantage of a fixed charge (as opposed to a mortgage)

was that the chargor could also agree that land acquired by the chargor after the creation of the charge would form part of the charge granted in favour of the chargee. The ability of a chargor to create security over after acquired property led to the recognition of the floating charge<sup>1</sup> discussed in further detail below.

Under the Land Titles Act<sup>2</sup> (the “LTA”), the practical difference between taking a fixed charge over land and taking a mortgage is now gone. In effect, all mortgages over land are now the equivalent of what used to be known as fixed charges and priority is governed by the order in which the relevant instrument or caveat evidencing the mortgage appears on the register relating to the applicable land<sup>3</sup>.

## FLOATING CHARGE OVER LAND

A floating charge is a charge on a category of assets (both present and future) of a debtor, which in the ordinary course of that debtor’s business, is intended to fluctuate

from time to time through acquisitions and dispositions. Until some future step is taken by or on behalf of the secured party to crystallize the floating charge, the debtor may carry on its business in the ordinary course as it relates to the charged property<sup>4</sup>. The floating charge was generally considered to be vulnerable as it was liable to be displaced by a subsequent fixed charge or mortgage<sup>5</sup>.

The floating charge was effectively made redundant with respect to personal property (i.e. property other than land) as a result of the enactment of the Personal Property Security Act<sup>6</sup> (“the PPSA”) in Alberta. The PPSA prescribed the concept of a ‘security interest’ as a fixed and specific charge over personal property (both present and future) to which it applies even though the debtor may have a broad discretion to dispose of such personal property in the ordinary course of its business<sup>7</sup>.

The floating charge, however, has been retained in Alberta with respect to charges over land granted by a corporation. The LTA does not recognize a charge against land generally held now or in the future by a particular debtor and floating charges are therefore not typically registered under the LTA as a result of the administrative burden and expense of making individual registrations against each parcel of land. Nevertheless, the recent Alberta Court of Queen's Bench decision in *Royal Bank of Canada v. Head West Energy Inc.*<sup>8</sup> (“*Head West*”) has demonstrated the fundamental importance of registration of charges in the land titles system and specifically addresses the question of priorities between a floating charge registered under the LTA and a subsequent mortgage.

## FACTS OF HEAD WEST

876652 Alberta Ltd. (“876”) executed a security agreement in favour of the Royal Bank of Canada (“RBC”) which included a floating charge over all real property of 876 including certain land in Alberta (“the Land”). The security agreement was registered at the Alberta Personal Property Security Registry and later a caveat to register the floating charge against the Land was filed at the Land Titles Office.

Subsequent to the RBC security agreement, 876 executed a mortgage over the Land in favour of Provost and Provost advanced \$340,000 to 876. Provost's mortgage on the Land was registered at the Land Titles Office five days after the caveat in favour of RBC. 876 then became insolvent and a receiver was appointed under the terms of the RBC security agreement, which was when the floating charge in favour of RBC crystallized. The receiver then sold the Land and both RBC and Provost claimed priority to the proceeds of sale.

## DECISION

The Court held that although the floating charge crystallized after the date on which the mortgage in favour of Provost was registered at the Land Titles Office, priority was determined by the date on which each was registered at the Land Titles Office. As such, the floating charge in favour of RBC ranked ahead of Provost's mortgage. The Court followed the Alberta Court of Appeal's judgment in *CIBC v. W.G. Fahlman Enterprises*<sup>9</sup> (“*Fahlman*”) in which it was held that a

floating charge over land ranked ahead of the interest of a subsequent mortgagee with prior notice of the floating charge.

## ANALYSIS

The general practice in Alberta is to register a floating charge over land in the Personal Property Registry as is permitted by section 64 of the Law of Property Act<sup>10</sup> (the LPA”). Under this system, a competition between two competing charges over land would be governed by the order of registration. However, section 64(8) of the LPA expressly provides, among other things, that section 64 is subject in all respects to the LTA and that priority of any interest registered or filed under the LTA will be determined under that statute. It is permissible under the LTA to register an uncrystallized floating charge against a specific parcel of land which, in accordance with the decision in *Head West*, will rank in priority to any security interest including a mortgage which is subsequently registered against such land in the land titles system and in priority to any previous or subsequent charge over land which is registered in the Personal Property Registry. Put simply, the charge holder need only ensure that it is the first to register in the land titles system in order to gain priority.

### **Under the Land Titles Act (the “LTA”), the practical difference between taking a fixed charge over land and taking a mortgage is now gone.**

The difficulty with granting an uncrystallized floating charge over land registered by way of caveat priority to a registered mortgage over the same land arises from the nature of a floating charge. Mr. Justice Buckley in *Evans v. Rival Granite Quarries*<sup>11</sup> described a floating charge as follows:

A floating security is not a future security; it is a present security, which presently affects all the assets of the company expressed to be included in it. On the other hand, it is not a specific security; the holder cannot affirm that the assets are specifically mortgaged to him. The assets are mortgaged in such

a way that the mortgagor can deal with them without the concurrence of the mortgagee. A floating security is not a specific mortgage of the assets, plus a licence to the mortgagor to dispose of them in the course of his business, but is a floating mortgage applying to every item comprised in the security, but not specifically affecting any item until some event occurs or some act on the part of the mortgagee is done which causes it to crystallize into a fixed security.

Accordingly, a floating charge attaches to the assets concerned from the date of its creation but does not specifically affect them until the floating charge crystallizes. Although the foregoing description of a floating charge is somewhat convoluted, the practical consequence for third parties is that until the floating charge crystallizes, the debtor has the general authority to deal with the relevant assets (including by way of sale or mortgage) in the ordinary course of its business<sup>12</sup>. A third party acquiring an interest in land subject to a floating charge (such as a purchaser or mortgagee) would therefore take its interest in such land free of the floating charge prior to its crystallization. Until the floating charge in favour of RBC crystallized, 876 should therefore have been able, unless otherwise prohibited by the terms of its agreement with RBC, to deal with its interest in the Land by granting a mortgage over it in favour of 876. The mortgage would, on enforcement, rank in priority to the security constituted by the floating charge in favour of RBC. In concept, this should not have been impacted by the registration of the caveat in respect of the RBC security agreement.

In reaching the contrary decision that the floating charge in favour of RBC took priority, the Court in *Head West* relied upon the decision in *Fahlman*. The Court in *Fahlman* had reasoned that as a floating charge creates an equitable interest in the collateral, which it affects from its creation (as opposed to crystallization), such interest prevails over subsequent equitable or legal interests (other than bona fide purchasers for value). The facts of *Fahlman* were distinguished from *Head West* on the grounds that the floating charge over the relevant land in *Fahlman* had been registered under the LTA and the mortgagee in that case had actual knowledge of such registration in

advance of the creation and registration of the mortgage in its favour. Nevertheless, the Court in *Head West* concluded that even though the floating charge in favour of RBC crystallized after the mortgage in favour of Provost had been created and registered, the priorities as between the floating charge holder and the subsequent mortgagee were determined by the relevant provisions of the LTA irrespective of when the floating charge crystallized or whether the mortgagee had prior notice of the floating charge.

In support of its conclusion, the Court in *Head West* determined that the following provisions of the LTA were relevant to his conclusion regarding priority of the competing charges (emphasis added):

14(3) For purposes of priority between mortgagees, transferees and others, *the serial number assigned to the instrument or caveat shall determine the priority of the instrument or caveat filed or registered.*

The following additional provisions of the LTA which clarify the priority arrangements set out in section 14 were also referred to:

56 Instruments registered in respect of or affecting the same land *have priority the one over the other according to section 14 and not according to the date of execution.*

135 So long as a caveat remains in force, an instrument registered subsequent to the caveat and purporting to affect the land, mortgage or encumbrance in respect of which the caveat is lodged *is subject to the claim of the caveator.*

147 Registration by way of caveat, whether by the Registrar or by any caveator, *has the same effect as to priority* as the registration of any instrument under this Act...

Both *Fahlman* and *Head West* fail to address how registration of the caveat and the foregoing sections of the LTA effectively changes the terms of an underlying security agreement creating the floating charge to remove the implied authority of the debtor to deal with its interest in land prior to crystallization or to eliminate the distinction between the common law characteristics of an uncrystallized floating charge and a fixed charge. In fact, the Court in *Head West*, relying on various Canadian authorities<sup>13</sup>, states that “[t]he registration of a

caveat protecting an interest or estate in land arising under an unregistered instrument grants full protection of the interests created by the unregistered instrument, here the security agreement, *but does not create additional rights over and above those found in the underlying document*” (emphasis added).

**By blurring the distinction between a fixed and floating charge over land, a lender lending against security over land will need to seek a release of security or subordination agreement from the relevant holder of a registered floating charge registered under the LTA...**

The Court argues that if it were to have found that priority of a floating charge is instead determined by the date of its crystallization, this would “blunt the usefulness of this flexible financing tool as lenders would be unwilling to advance funds upon a security which could be perfected only after default by the debtor”. Arguably the decision in *Head West* has the precise result of removing the usefulness of the floating charge as a flexible financing tool. By blurring the distinction between a fixed and floating charge over land, a lender lending against security over land will need to seek a release of security or subordination agreement from the relevant holder of a registered floating charge registered under the LTA in order to ensure that it will obtain priority over the floating charge. In any event, the Court’s concern that a contrary decision would somehow negatively affect secured lending practices appears somewhat exaggerated. If it were the case that particular parcels of land formed an important part of the security on which a lender intended to rely, current market practice is that the lender would require a mortgage as opposed to floating security over the relevant land as a condition to its advance of funds.

Although the Court did not specifically consider whether a third party purchaser of the relevant land would have taken its interest free of the floating charge registered


under the LTA, it would be irrational to conclude that while the relevant debtor could not deal with its interest in the land by mortgaging it, the debtor could nevertheless dispose of it free of the floating charge holder’s interest by way of a sale to a third party.

## CONCLUDING THOUGHTS

It would seem that the anomalous result in *Fahlman* and *Head West* and the resulting uncertainty as to the rights conferred upon a holder of an uncrystallized floating charge over land could be largely avoided if, as is the case in British Columbia, only crystallized floating charges over land were accepted for registration in the land titles system. Although such a change in legislation would likely result in arguments about when crystallization occurred, it would resolve some of the present uncertainty regarding a floating charge holder’s rights in specific parcels of land subject to its charge. In practical terms, the consequence of the decision in *Head West* is that secured lenders and prospective purchasers of a parcel of land in Alberta will now need to determine whether a floating charge has in fact been registered against it under the LTA and deal with such a charge in the same manner as a registered mortgage.

## Footnotes

- <sup>1</sup> *Holyroyd v. Marshall* (1862) 10 H.L.C. 191, 11 E.R. 999; *Re Panama, New Zealand and Australian Royal Mail Co.* (1870), L.R. 5 Ch. App. 318.
- <sup>2</sup> R.S.A. 2000, c. L-4.
- <sup>3</sup> *Ibid.* Section 14(3).
- <sup>4</sup> *Re Yorkshire Woolcombers’ Association Ltd.* [1903] 2 Ch 284.
- <sup>5</sup> See generally Traub, W.M. ed. *Falconbridge on Mortgages*, Fifth Edition at para. 5-70.
- <sup>6</sup> R.S.A. 2000, c. P-7.
- <sup>7</sup> Ziegel, S. “Symposium: Recent and Prospective Developments in the Personal Property Security Law Area” (1985), 10 *Can. Bus. L.J.* 131, at p.152.
- <sup>8</sup> [2007] A.J. No. 268.
- <sup>9</sup> [1989] A.J. No. 238.
- <sup>10</sup> R.S.A. 2000, c.L-7
- <sup>11</sup> [1910] 2 KB 979, CA at p.999
- <sup>12</sup> Re priorities between floating and fixed charges see generally Wood, R.J. “The Floating Charge in Canada” (1989), 27 *Alta. Law Rev.* 191 at p. 210.
- <sup>13</sup> *Stephens v. Bannan* (1913) 5 *WW.R.* 201 (*Alta. C.A.*); *Royal Bank of Canada v. Donsdale Developments Ltd.* [1986] A.J. No. 1027 (Q.B.); *Alexander v. McKillop* (1912) 45 *S.C.R.* 551.



# Material Adverse Change CLAUSES

by Ruben Sekhon, Student-at-Law

## INTRODUCTION

**M**aterial Adverse Change or Material Adverse Effect clauses (“MAC”) allow parties to relieve themselves of their obligations under an agreement without liability. MAC clauses are a means of allocating the risks presented by adverse business or economic developments occurring between the signing of an agreement and the closing of a transaction. The MAC concept can also be included in positive and negative representations, or as an event of default after the closing of a transaction.

Recently, interest has been sparked in MAC clauses due to the continuing credit crunch in the USA. As the market weakened, the evolved lack of MAC clauses forced lenders to fund transactions even in cases where such lenders were unable to find buyers to syndicate the deals. MAC clauses have now resurfaced and lenders are relying on such clauses where they have an inability to secure funds in order to opt out of financing commitments. Whether or not general market conditions qualify as a MAC is an unsettled issue and depends largely on how a particular MAC clause is worded.

Case law demonstrates that a MAC clause in an agreement will be interpreted in accordance with general principals of contract law. The intention of the parties will be considered by looking at the agreement as a whole and a MAC clause will be enforceable if it is clear that it unequivocally expresses the intention of the parties. If the agreement is ambiguous, courts have looked to extrinsic evidence to determine the intent of an agreement, rather than simply applying a literal reading of the clause.

## JUDICIAL CONSIDERATION OF MAC CLAUSES

In *Re. IBP, Inc. v Tyson Foods, Inc. et al.*<sup>1</sup> (“*IBP, Inc.*”), Tyson Foods had entered into an agreement to acquire IBP and then attempted to back out of the merger based on IBP’s poor earnings performance over two quarters and a small asset write down of one of the subsidiaries. The Court found that IBP had not suffered a MAC within the meaning of the agreement as this downturn would not affect IBP in the future on a long-term basis. Furthermore, specific performance was the preferable remedy for Tyson Foods’ breach as it was the only method which would adequately redress the harm threatened to IBP and its stockholders. IBP, Inc. has been interpreted by some commentators as being a leading case supporting the view that MAC means any adverse change that would have had an effect on a given decision maker.

In *McMillan v. Ludlow*<sup>2</sup>, Ludlow offered to sell his 50 percent interest in XY Ltd. to McMillan, the company’s co-owner pursuant to a shot-gun clause in a shareholder’s agreement. It was a term of Ludlow’s offer that there be no “material adverse change” to the financial position of the company before completion of the proposed sale. However, after the offer was made but before the completion date, McMillan withdrew the sum of \$223,600 from the company as a management fee to which he claimed to be entitled and also declared a sizeable dividend which the company was unable to pay. As a result of these actions by McMillan, Ludlow chose not to complete the sale. Given that these actions of McMillan put the company into a negative net worth position and deprived the shares of most of their underlying value, the Court held that the adverse changes destroyed the commercial purpose of the contract between the parties. In these circumstances, there was a breach on McMillan’s part of a fundamental term of the contract, thereby constituting a MAC and entitling Ludlow to relief from the obligation to complete the sale.

In *Mull v. Dynacare Inc.*<sup>3</sup>, the vendor brought an action for breach of contract against the purchasers regarding the purchase of shares in a holding company, a private medical laboratory which derived its revenues solely from a stream of income from the government. However, prior to closing, the government announced that the unit rate paid to private medical laboratories for services provided would be reduced. Ultimately, the Court ruled that the purchasers were entitled to refuse to close the transaction as the government announcement would have an adverse and material effect on the profitability of the private laboratory so as to come within the protective clauses of the agreement. The Court found that the MAC clause under the agreement included external events and were not limited to internal operation matters within the vendor’s control as the vendors had argued at trial.

## WHAT PRINCIPLES CAN BE DERIVED FROM THE CASES?

It is difficult to determine any hard and fast rules from the case law on MAC clauses considering that the cases are extremely fact and language specific. Although no set of guidelines will yield a flawless MAC, there are several considerations that may limit the potential for unexpected results. In the context of a banking transaction, it is apparent that a broadly worded MAC clause may not always provide the protection the lender is seeking. Unless drafted to cover objectively identifiable

facts, for example a 10% fall in market share, there can be difficulties in seeking to enforce a MAC clause. More likely, a general MAC clause can be relied upon to give leverage in renegotiating the contract rather than as a means to terminate the contract. For instance, if a lender has a strong claim for invoking a MAC clause before completion, the parties can renegotiate pricing or other loan elements; the borrower may prefer to close the transaction on these revised terms rather than trudge down the path to litigation. However, where a party wishes to protect itself from a specific event, an explicit and clearly worded MAC clause should be utilized rather than seeking to rely on a general MAC clause.

Although courts may determine that a broadly drafted MAC is ambiguous and open to interpretation (leading to the examination of extrinsic evidence and unanticipated outcomes), there are also dangers in drafting narrow clauses as they can be contrary to a party's basic interest in obtaining protection against unforeseen events. *IBP, Inc.* demonstrates that when a party is aware of certain potential events, such party should negotiate to have such known events specifically included within the MAC definition. As an alternative to drafting a specific MAC clause, parties can accommodate particular concerns by including them as specific closing conditions and include a broadly drafted MAC clause in agreements.

The following are some specific recommendations regarding the drafting of MAC clauses, which are derived from lessons learned from the consequences of American jurisprudence.

- ▶ Exclude specific adverse changes from the MAC definition by means of particular 'carve-outs'. Some examples include:
  - any change affecting economic or financial conditions generally;
  - any change affecting the party's industry as a whole;

- any change caused by announcement of the transaction or any related transaction;
- any failure to meet analyst or internal earnings estimates;
- any action contemplated by the agreement or taken at the other party's request; and
- any action required by law.

- ▶ Depending on the context, it may be beneficial to structure a given MAC provision so that adverse changes are aggregated.
- ▶ Defining MAC requires that one determine the 'field of change', namely what needs to suffer a MAC in order for a MAC to occur. A basic field of change could consist of the *business, results of operations, assets, liabilities, or financial condition* of the company in question; the particular formulation used would depend on the transactional context.
- ▶ State the field of change as generally as possible, as a court might fasten on any narrowing language as grounds for finding that a certain MAC does not fall within the field of change.
- ▶ Do not include in the MAC definition examples of changes that would fall within the definition; including examples merely increases the likelihood that a court would not consider circumstances different from the examples to be a MAC.

#### Footnotes

<sup>1</sup>C.A. No. 18373 (Del. Ch. June 18, 2001)

<sup>2</sup>[1995] B.C.J. No. 684 (B.C.S.C.)

<sup>3</sup>[1998] O.J. No. 4006 (Ont. Gen. Div.)

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