

## PRECISELY DEFINING MATERIAL ADVERSE CHANGE CLAUSES

The recession has shown that lenders should tighten the wording of their loan covenants, including more strictly defining what constitutes a material adverse change (MAC). MAC clauses often treat materiality broadly and subjectively, providing that the occurrence of a "material adverse change" in business, operations or financial conditions constitutes a default by the borrower under the loan. Narrowly defining a material adverse change limits the subjectivity. The broader the terms of a MAC clause, the less clarity the parties (and a court) have in evaluating whether the clause applies to a particular set of circumstances. Broadly defined, MAC clauses are not always to the lender's advantage, since lenders are usually reluctant to declare a default based solely on a violation of a MAC clause.

Specific MACs enable the lender to more closely monitor a borrower and identify events that could potentially lead to repayment problems. Adverse changes could include indicators of financial performance or events particular to the financed project itself (such as the number of unsold units in a commercial property or unusual cost overruns in a construction project). By identifying specific criteria that constitute a material adverse change, lenders proactively identify and address developing problems and create a dialogue with their borrowers before the problems jeopardize repayment of the loan. For in-house counsel to craft such specific covenants requires working closely with the loan officer and the borrower to fully understand the borrower's business and financial statements. But because default is in no one's best interest, the benefits from specifying and monitoring MAC terms justify the effort.

### Amy King Condaras

Member, Corporate and Business Law  
acondaras@spilmanlaw.com  
Peer Review Rated

### F.B. Webster Day

Member, Corporate and Business Law  
wday@spilmanlaw.com  
Peer Review Rated

### Spilman Thomas & Battle, PLLC

## DUE DILIGENCE CONCERNS IN LOAN TRANSACTIONS

The "problem loans" that have gone into default in the past 12 months show that lenders must better understand the impact of the following key factors on 1) borrowers, 2) borrowers' collateral and 3) the rights of third parties in loan transactions.

1. Lenders must understand the interrelationships among borrowers and their affiliated companies, particularly those relationships that may give rise to contingent liabilities that may affect loan repayment. Be cautious in cross-soliciting personal and business loans with the same borrower because of the ripple effect that any financial problems can have. Conducting due diligence, including Internet research, will help uncover a borrower's past litigation, financial problems or public controversies.
2. Be aware that certain types of collateral require lenders to take special steps for perfecting their lien. For example, liens on aircraft, boats and mining rights may require filings with various local, state and federal agencies. Real estate may have zoning and permitting limitations and restrictive covenants that make the property hard to sell if the lender forecloses. Again, proper advance due diligence can reveal many potential problems.
3. Third parties including development authorities, other lenders and homeowner associations, may have rights to repayment of their obligations if the lender forecloses on a property. Lenders should ensure that all such third-party rights are disclosed and understood before the loan is made.

Given the consequences of unforeseen risks and liabilities, bank in-house counsel should develop due diligence checklists that loan officers can use to assess loan transactions. Being methodical and vigilant about completing a thorough checklist will help locate issues requiring further investigation.

### John D. Emmanuel

Shareholder  
emmanuel@fowlerwhite.com  
Peer Review Rated

### Donald R. Kirk

Shareholder  
dkirk@fowlerwhite.com  
Peer Review Rated

### Fowler White Boggs P.A.

## CURRENT CREDIT CRISIS: LITIGATION RISKS

Banks face increased litigation risks over previously accepted business practices that plaintiffs now allege caused or worsened the credit crisis.

For example, consumers who default on mortgages frequently charge that lenders granted loans inappropriate for borrowers' credit history and income, and seek class-wide relief that would challenge bank lending standards. Consumer litigants also pursue class damages for such bank business decisions as the assessment of overdraft fees, the reduction of home equity credit lines, and the increase of credit card interest rates without regard to credit history. Banks can defend these cases by raising merit defenses, such as: the banks fully disclosed the challenged practices to the consumers and, in the case of class defenses, demonstrating that class status is inappropriate given the wide differences in individual financial circumstances. Also, banks can seek to compel arbitration of financial claims; however, legislation pending in Congress could sharply limit future arbitration use.


Allegedly inappropriate consumer loans have also spurred lawsuits against banks by insurers that have paid on loss claims and note holders that have lost money on financial products securitizing now-defaulted consumer loans. Insurers seek to recover their payments by suing banks for failure to follow prudent underwriting guidelines in originally granting the loans. Many of these lawsuits target banks' entire loan portfolios, but banks can argue that the business decisions should be scrutinized on an individual basis and not portfolio-wide.

Given the severity of the financial crisis, more lawsuits against banks are likely in state and federal courts. In-house counsel should closely follow emerging case law trends, and should actively advise on litigation risks from otherwise standard business decisions.

### Bryan A. Fratkin

Partner, Litigation  
bfratkin@mcguirewoods.com  
Peer Review Rated

### McGuireWoods LLP

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