Commitment Letters in Turbulent Times: Market MAC Clauses and the Solutia Litigation

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As equity sponsors and robust economic conditions drove merger and acquisition activities to new heights through the first half of 2007, the competition to finance those acquisitions and other corporate transactions intensified. Banks and other financial institutions competed fiercely to act as lead arranger for these transactions and, in addition to committing to structure and arrange credit facilities, committed to provide the financing regardless of whether the loans could be syndicated. As the competition increased, the conditional nature of commitment letters decreased. Banks and other financial institutions issued long term commitments with committed pricing to finance acquisitions and other corporate transactions that would occur months or even a year in the future. Notwithstanding the commitment to provide the entire financing, the banks and other financial institutions issuing commitment letters frequently intended to sell all or a substantial portion of the loan contemporaneously with closing the transaction. The problem with this model is that, unlike a bond offering which is typically priced within days of closing, lenders were forced to price a loan months or even a year in advance. In spite of the fact that no bank or financial institution could predict with certainty the market clearing price of a loan so far in advance, the model worked well in relatively

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stable credit markets and loans were routinely syndicated at or shortly after closing. However, when credit markets deteriorated and volatility increased, banks and other financial institutions that had committed to provide financing found themselves funding loans on below market terms and either holding the loans on their books or selling the loans at substantial losses. In order to protect against this scenario, lenders began seeking to allocate market risk to borrowers. The result was the re-introduction of so-called "Market MAC" clauses into commitment letters. A Market MAC clause essentially excuses lenders that have issued a commitment from funding the loans in the event of an adverse change in the capital markets that impairs the ability to syndicate the loan.

Given the unprecedented turmoil in the capital markets over the past year, Market MACs are once again prominent features in commitment letters. This article explores Market MACs generally, and discusses what practitioners should expect when negotiating and dealing with disputes over Market MACs, particularly in light of the recent Solutia litigation.[2]

1. The Role of Market MACs in Financing Transactions

Unlike a Company MAC, which is tied to material adverse changes in a company's business, a Market MAC is linked to changes in the loan syndication, financial and capital markets generally. While the parties to a commitment letter often intensely negotiate the particular language of a Market MAC, a typical Market MAC provides, as a condition precedent to closing, that no change in the relevant financial markets has occurred between the signing of the commitment and the closing of the

[2] *Solutia Inc. v. Citigroup Global Markets Inc., et al.*, Case No. 08-01057 (Bankr. S.D.N.Y.).

transaction that adversely affects syndication of the loan. For instance, one common version of a Market MAC conditions the lenders' funding commitment on "there not having occurred a material disruption of or material adverse change in conditions in the financial, banking or capital markets that, in our judgment, could reasonably be expected to materially impair the syndication of the Facility."

Historically, the use of Market MACs has depended on credit market conditions. When credit markets are strong, borrowers typically parlay their negotiating leverage to resist Market MACs. Conversely, in a tight credit market, lenders have more leverage to insist on Market MACs. During the Russian ruble crisis of the late 1990s, for instance, many lenders insisted on Market MACs. In the strong credit markets of the five years prior to mid 2007, Market MACs had fallen out of favor and were rarely included in commitment letters in the acquisition context or in other contexts where a borrower had significant negotiating leverage. Market MACs reemerged in the aftermath of the subprime credit crisis.[3]

The primary battleground during negotiations over the Market MAC is the scope of the Market MAC. Lenders want broad language that provides them with maximum discretion to determine whether an adverse change is sufficient to trigger the Market MAC. Conversely, borrowers seek to circumscribe the lenders' discretion by negotiating as narrow provisions as possible to define the requisite adverse change that will trigger the Market MAC. These competing agendas often result in Market MACs that contain subjective standards such as "material" and "reasonable judgment." While this is fairly

[3] Heidi Moore, *Deal Journal Blog: How Bad Is It: The $2.2 Trillion Debt Crunch*, Wall St. J., Apr. 3, 2008.

standard language in commercial contracts, there is precious little caselaw interpreting what this language means in the Market MAC context. Indeed, the *Wall Street Journal* described MACs as "maddeningly vague" last fall,[4] and Vice Chancellor Leo Strine, Jr. of the Delaware Court of Chancery wrote in 2001 that evaluating whether a Company MAC had occurred was "dauntingly complex."[5] Faced with this largely blank slate, one participant at the 2008 Tulane University Corporate Law Institute equated the Market MAC test to Justice Potter Stewart's obscenity test: "You know it when you see it."[6]

While Market MACs enable lenders to avoid funding if properly invoked, their primary utility is to provide lenders with leverage to reopen negotiations with a borrower to restructure a financing that then can be successfully syndicated in the then current market. Sometimes, however, efforts to renegotiate will fail. In that situation, someone—typically the borrower—might consider filing a lawsuit to challenge the other side's position. Even here, though, the litigation usually is only a means to an end. To reframe Clausewitz's famous dictum, the litigation is merely a continuation of negotiations by other means. Litigation intensifies the pressure for both sides to reach a settlement. A borrower will not want to risk losing the financing in its entirety, while the lenders will be concerned about creating bad precedent, damage to their reputation, and the balance sheet consequences of funding a transaction on below market terms.

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[4] Dana Cimilluca, *Deal Journal Blog*: *The Deal Flip-Floppers, MAC the Knife Loses its Edge*, Wall St. J., Sept. 20, 2007.

[5] *In re IBP, Inc. S'Holders Litig.*, 789 A.2d 14, 66 (Del. Ch. 2001).

[6] Heidi Moore, *Deal Journal Blog*: *Return of the MAC: Time to Get Specific*, Wall St. J., Apr. 3, 2008.

Thus, the inherent uncertainties of litigation, particularly given the dearth of case law interpreting Market MACs, provides a powerful incentive for all parties to settle their dispute by renegotiating the terms of the loan. This is particularly true because any victory in court may prove pyrrhic. Market MAC litigation can be extremely expensive and distracting. It diverts valuable organizational and management resources and creates reputational risks—particularly for lenders. Likewise, a borrower who wins faces the risk of a reversal on appeal, and may have to account for that contingency on its balance sheets and with its other constituents.

2. The Lessons of Solutia

The recent litigation between Solutia and its lenders highlights the dynamics of Market MAC provisions in today's environment. After spending several years in Chapter 11 bankruptcy, Solutia began soliciting exit financing proposals in June 2007. Solutia received twelve proposals that month, none of which included Market MACs. Before Solutia could enter into a commitment letter, however, the subprime mortgage crisis erupted. Solutia then suspended its solicitation efforts, renewing them in September 2007 when the credit markets appeared to be rebounding. And, indeed, there was a mini-recovery in September and October 2007, as significant amounts of leveraged loans were syndicated, and market commentators noted that "most participants expect[ed] the [Leveraged Loan] index to rally further as the broad cross section of the mid-tier and small-cap loans catch up with the larger, more liquid names".[7]

[7] Standard & Poor's Leveraged Loan Commentary & Data, February 11, 2008, page 1.

Solutia secured a commitment for its exit financing during this mini-recovery. On October 25, 2007, Solutia signed a commitment letter with Citigroup Global Markets Inc., Goldman Sachs Credit Partners L.P., Deutsche Bank Trust Company Americas, and Deutsche Bank Securities Inc. (collectively, the lenders) in which the lenders agreed to provide Solutia with $2 billion of exit financing subject to specified terms and conditions. In light of the volatility in the leveraged financial markets and the fact that there was likely to be a three month time frame between the execution of the commitment letter and the funding of the transaction, all three lenders insisted on a Market MAC in order to shift the risk of another market downturn to Solutia. After extensive negotiations, the parties agreed to include a Market MAC clause providing that the lenders' obligation to fund was subject to the absence of any adverse change in the financial markets since the date of the agreement that, in the reasonable judgment of the lenders, materially impaired the ability to syndicate the Solutia exit financing. The commitment letter was scheduled to expire on February 29, 2008.

Shortly after the commitment letter was executed, the credit markets began to deteriorate once again, and took a precipitous nosedive in January. In January 2008, Solutia demanded that the lenders fund the $2 billion commitment on January 25. With the leveraged financial markets in the midst of one of the worst deteriorations in history, and after the lenders had attempted unsuccessfully to syndicate the loan facility, each of the lenders independently concluded that the Market MAC condition precedent had not been met and so advised Solutia.

Rather than agree to renegotiate the terms of the loan to facilitate syndication, Solutia filed a lawsuit in the U.S. Bankruptcy Court for the Southern District of New York on February 8, 2008 seeking, among other things, an order of specific performance forcing the lenders to fund the $2 billion commitment by the February 29 termination date. Solutia contended that the lenders' failure to fund by February 29 would cause its confirmation plan to unravel. In view of the February 29 deadline, the bankruptcy court ordered expedited discovery and scheduled a trial to begin on February 21, only 13 days after the complaint was filed. During this 13-day period, approximately three million pages of documents were exchanged and more than 20 depositions were taken. Opening arguments began on Thursday, February 21, and the lenders rested their case-in-chief late Saturday night, after the court heard testimony from eight fact witnesses, two expert witnesses, and videotaped deposition testimony from additional witnesses. The court scheduled closing argument for Monday afternoon. On the eve of closing arguments, Solutia and the lenders settled the lawsuit by renegotiating the terms of the loan to bring the terms in line with current market conditions and facilitate syndication. The bankruptcy court approved the revised terms on February 26, and the exit financing closed as scheduled on February 28. Based on the renegotiated loan terms, the lenders were able to successfully syndicate the facility.

The Solutia litigation puts a spotlight on the types of arguments one can expect to face in a Market MAC dispute. As summarized below, even contract language that is viewed by institutional lenders as completely clear and unambiguous nevertheless can be challenged; and a judge is far more likely to want to hear extensive trial testimony rather than interpret a Market MAC provision as a matter of law based solely on the pleadings.

As a result, the potential enormous costs and diversions of management time engendered by such complex litigation, coupled with the inherent uncertainties of the litigation process, serve as powerful incentives for the parties to renegotiate the terms of the loans to achieve certainty of outcome.

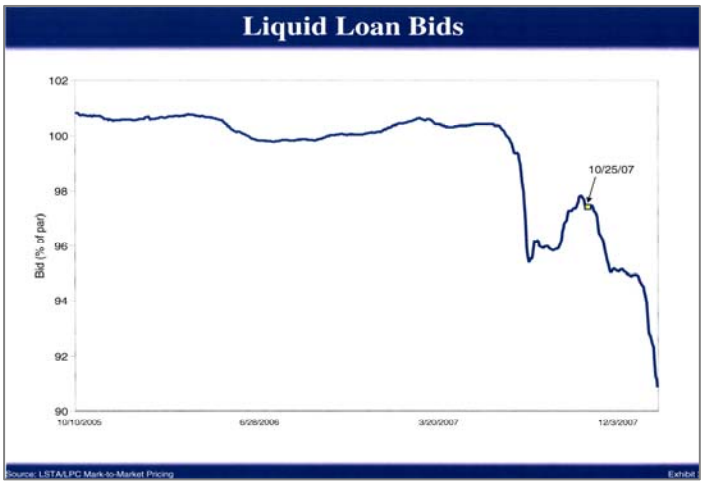
Avenues of Attack

Was the Market MAC Inconsistent with an Underwritten Commitment? Solutia first argued that the commitment letter was ambiguous because it contained a Market MAC that was tied to an impairment of syndication and a separate condition that stated syndication was not a condition to the commitment. It contended that there was a conflict between the Market MAC provision and the agreement's "firm commitment" language, which provided that the completion of syndication was not a condition to the lenders' funding obligation; and subject to the satisfaction of all other conditions, the lenders would fund prior to the completion of the syndication of the facility. Therefore, according to Solutia, the lenders' inability to syndicate the facility was not a basis for refusing to fund.

The lenders countered that the two provisions did not conflict. Their evidence demonstrated that it is not uncommon for commitment letters to contain both types of provisions and that, far from being inconsistent, they reflect a clear allocation of risk between borrowers and lenders. The lenders bore the risk of nonmarket, transaction specific factors that could impair syndication (for instance, mispricing the transaction, overleveraging the borrower, misallocating the debt among tranches), while Solutia bore the risk of financial market downturn that adversely impacted syndication.

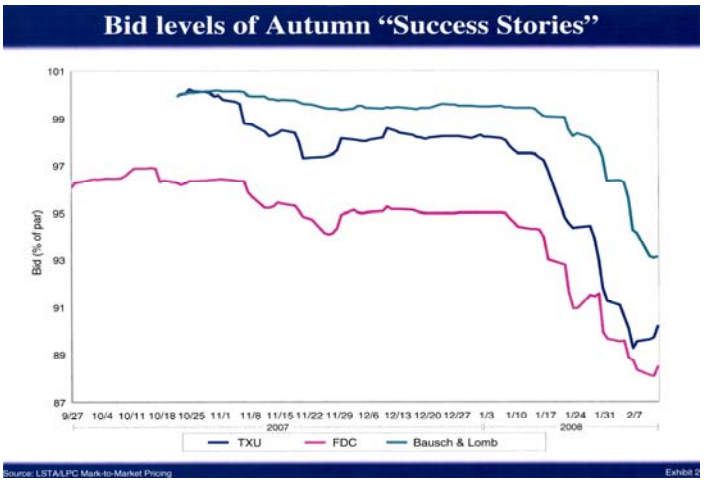
This debate proved critical. Prior to hearing testimony, the bankruptcy court initially expressed skepticism about the lenders' position, indicating its view that these two provisions were in conflict and therefore rendered the commitment agreement ambiguous. The court also suggested that the lenders were seeking to ignore the "firm commitment" language and trumpet the Market MAC as a superior provision. Once the lenders' case-in-chief was presented, however, the court appeared to have altered its view. Each of the lenders testified as to the meaning of the two provisions, and how they are completely harmonious with each other. The testimony also confirmed that institutional lenders in the leveraged finance markets uniformly viewed these two provisions the same way – i.e., as a specific allocation of syndication risk between an inability to complete syndication as a result of transaction-specific factors (a risk borne by the lenders) and an inability to complete syndication as a result of market factors (a risk borne by the borrower), and that participants in the leveraged finance market do not view these provisions as ambiguous or in conflict in any way. Importantly, Solutia offered no rebuttal testimony. Although the case settled before the court reached a definitive conclusion on this issue, the unrebutted evidence harmonizing these two provisions appeared to have impacted the Court's perception of the case.

Had there been adverse changes in the credit markets since October 2007? The evidence on this point was overwhelming. By any reasonable quantitative or qualitative measure, the credit markets had declined dramatically between October 2007 and January 2008. For instance, liquid loan bids had fallen sharply during that three month window:



Source: LSTA/LPC Mark-to-Market Pricing

Similarly, debt issued in September and October 2007 was trading at a substantial discount to par by late January 2008:



Source: LSTA/LPC Mark-to-Market Pricing

Other metrics, such as syndication volume and the LCDX index, had experienced similar declines during that period.

Solutia apparently recognized its problems on this front, and did not even attempt to dispute this issue. Instead, it argued that any decline in the credit markets after October 2007 was not due to a "change" in the markets, but rather to the preexisting sub-prime mortgage meltdown that began in July 2007. Under this view, the critical inquiry

was the cause of market problems, not their effect. According to Solutia, no matter how precipitous the decline in the capital markets, there could be no "adverse change" if the underlying causal factors existed at the time the commitment was signed. Thus, Solutia contended, the Market MAC was only designed to address unforeseeable changes in market conditions caused by new conditions that arose only after the commitment was executed.

The lenders countered that this theory stood the entire concept of risk allocation on its head. After all, a basic tenet of contract law is that the parties can contractually allocate the risk of foreseeable contingencies. Indeed, as the lenders pointed out, nothing in the Market MAC itself limited its scope to unforeseeable or new events. Given the high level of sophistication of the parties, they surely would have included this limitation had that been their intent.

While this was one of the major issues at trial, the court did not preview its views on the issue before the case settled. Nonetheless, it underscores the key fact that no matter how strong the facts appear to be, a highly motivated borrower facing the prospect of losing its financing can develop theories that, if accepted, render undisputed objective facts proving a collapsed market completely irrelevant.

The lenders failed to exercise reasonable judgment in concluding the Market MAC condition had not been met. Solutia argued that the lenders failed to conduct a principled evaluation of the market conditions, but instead engaged in a perfunctory result-oriented analysis in concluding that the syndication was materially impaired. In turn, each of the lenders presented evidence concerning the meetings they held to discuss

the syndication market, the metrics they used to evaluate the issues, and the analysis they each relied on to reach their independently derived conclusion that the Market MAC condition had not been met.

This is a particularly salient point for practitioners. The Market MAC provision in Solutia required the lenders to conclude in their reasonable judgment that the syndication was materially impaired. Under New York law, the lenders had to make this decision in good faith.[8] Accordingly, the lenders argued that as long as they acted in good faith, their decision could not be overturned even if the court might have reached a different conclusion. When negotiating the specific language of a Market MAC, practitioners should keep the implications of this discretionary standard in mind. In addition, if a lender has some measure of discretion to determine whether a Market MAC has occurred, it should make sure that it follows a careful, defensible process in reaching whatever decision it makes. It should prepare written materials, allow sufficient time for a full deliberation, and create a clear record that it exercised appropriate care and judgment.

3. Remedies

Market MAC clauses raise a number of remedies issues, and practitioners should carefully evaluate their potential claims (or liabilities) when dealing with Market MAC provisions. The classic measures of damages would give the borrower the benefit of the bargain as well as any consequential damages that flowed from a breach of a funding

[8] *See Misano di Navigazione, SpA v. United States*, 968 F.2d 273, 275 (2d Cir. 1992); *Components Direct, Inc. v. European Am. Bank & Trust Co.*, 572 N.Y.S.2d 359, 362 (N.Y. App. Div. 1991).

commitment.[9] Most commitment letters, however, require the borrower to waive consequential damages claims. Under New York law, these waivers are usually enforceable.[10] Compounding the problem for borrowers, New York law historically does not permit specific performance in failure to lend cases unless they involve the purchase of a specific parcel of real property.[11]

The combined effect of New York's law on consequential damages and specific performance can create enormous pressures for borrowers faced with a lender's potential breach of a commitment letter. However, in the recent Clear Channel litigation,[12] a New York state court denied the lenders' motion for summary judgment, and left for trial the issues of the availability of alternative financing, the uniqueness of the transaction at issue, and whether the borrower's damages can be proven with reasonable certainty in order to determine whether to award specific performance of the financing commitment. Thus, lenders and borrowers should not automatically assume that the general rules surrounding specific performance in the context of loan agreements necessarily will

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[9] *See, e.g., Sager v. Friedman*, 1 N.E.2d 971, 974 (N.Y. 1936) ("The measure of damages which flows from a breach of contract is the difference between the value of what has been received under the contract and the value of what would have been received if the contract had been performed according to its terms. Damages there are not limited to indemnity for loss suffered through the *making* of the contract. The injured party is entitled to the benefit of his bargain as written and is entitled to damages for the loss caused by failure to perform the stipulated bargain."); *accord Freund v. Washington Square Press, Inc.*, 314 N.E.2d 419, 420-21 (N.Y. 1974).

[10] *See, e.g., Metro. Life Ins. Co. v. Noble Lowndes Int'l, Inc.*, 84 N.Y.2d 430, 436 (1994) ("[A] limitation on liability provision in a contract represents the parties' agreement on the allocation of the risk of economic loss in the event that the contemplated transaction is not fully executed, which the courts should honor.").

[11] *See, e.g., Spoolan Realty Corp. v. Haebler*, 262 N.Y.S. 197, 198 (N.Y. Sup. Ct. 1931); *Leben v. Nassau Sav. & Loan Ass'n*, 40 A.D.2d 830, 830-31 (N.Y. App. Div. 1972).

[12] *BT Triple Crown Merger Co., et al. v. Citigroup Global Markets Inc., et al.* 600899/08 (Sup. Ct. N.Y. Co., May 7, 2008).

apply to large commercial transactions, particularly if the money is intended to be used to fund a unique or extraordinary event such as an exit from bankruptcy or an LBO, and alternative financing is not readily available.

Finally, lenders need to consider the possibility of third-party claims. In the wake of the aborted merger between The Finish Line and Genesco earlier this year, a Genesco shareholder sued The Finish Line's banks, alleging that they tortiously interfered with the Genesco shareholders' expectancy in the merger when they announced that they would not proceed to fund under the commitment letter until they finished examining Genesco's financial condition. While recognizing the claim was "somewhat novel," a federal court held that the shareholder had stated a claim for tortious interference, at least for pleading purposes.[13]

Conclusion

The Solutia litigation reinforces the central truth of Market MAC provisions: They provide significant leverage to lenders to convince borrowers to renegotiate loan terms to bring them more in line with current market conditions. Practitioners should keep this in mind when negotiating Market MACs and advising clients on how to respond to market downturns.

[13] *See Lasker v. UBS Securities LLC*, 2008 WL 1968737, at *9-10 (E.D.N.Y. Apr. 30, 2008).