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Trends in Private Company M&A Provisions: The "Materiality Scrape"

January 24, 2018
Bloomberg Law
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In terms of apportioning responsibility for a target company's liabilities as between buyer and seller in an M&A transaction, a "materiality scrape" can be one of the most important provisions within the transaction documents. And yet this provision?and its significance to the overall risk profile of an M&A transaction?is often not fully understood or appreciated. This article is intended to summarize the effect and implications of a materiality scrape, as well as to identify usage trends.

What is a "Materiality Scrape"?

A "materiality scrape" is a provision sometimes contained in a purchase agreement (such as a stock purchase agreement, merger agreement, or asset purchase agreement) that effectively eliminates, for indemnification purposes, any materiality qualifiers in a representation and warranty (or covenant) when determining whether a breach of the representation and warranty (or covenant) has occurred. Put another way, the typical materiality scrape provision eliminates materiality qualifiers from one or more sections of the purchase agreement, for purposes of determining whether or not a breach of those sections has occurred.

For example, if a purchase agreement contains a materiality scrape, a representation and warranty that states "the target company is not party to any material litigation" would be read, in determining whether a breach of that representation and warranty has occurred for indemnification purposes, as "the target company is not party to any litigation." In other words, the statement is read as if the word material was never included in the first place – the materiality qualifier otherwise applicable to the representation is "scraped" away.

A materiality scrape provision is sometimes referred to as a "double" or "blanket" materiality scrape if it applies to determining both: (a) whether or not a breach has occurred and (b) the amount of indemnified losses resulting from that breach. Although including a double materiality scrape is common in purchase agreements, as noted below, applying a materiality scrape to the determination of losses resulting from a breach, but not as to whether or not the breach occurred (a "single" materiality scrape), is not uncommon.

The types of breaches most commonly subject to a materiality scrape are breaches of representations and warranties. Occasionally, though much less typically, covenants (obligations to do, or refrain from doing, something) or agreements are subject to a materiality scrape.

The qualifiers most commonly subject to a scrape are materiality and material adverse effect ("MAE"). Occasionally though rarely seen is a "knowledge scrape," which eliminates knowledge qualifiers from representations and warranties (or covenants).

Why Include Materiality and MAE Qualifiers within a Purchase Agreement to Then Have Them Negated by a Materiality Scrape?

Materiality and MAE qualifiers serve different purposes within a purchase agreement, and the materiality scrape usually eliminates these qualifiers for some but not all of those purposes. Materiality and MAE qualifiers generally serve four different purposes:

1. Determining whether closing conditions have been satisfied (e.g., closing conditions may require that the seller's representations and warranties be true and correct "in all material respects" at the closing or that there be no MAE in effect as of the closing);
2. Determining the scope of the seller's disclosure (e.g., a representation may affirmatively require disclosure of all "material" contracts);
3. Determining whether a breach of a representation has occurred (e.g., whether specific facts are contrary to the seller's representation that it has complied with applicable laws "in all material respects"); and
4. Determining the losses resulting from such a breach (in other words, where a representation is qualified by materiality, are the resulting losses that are subject to indemnity only those above a "material amount"?).

How are Materiality Scrapes Implemented?

Materiality scrapes are generally either embedded within the indemnification provisions of the purchase agreement or set forth as a standalone provision. The following is an example of an embedded materiality scrape provision:

The Seller shall indemnify, defend and hold harmless the Purchaser and its Affiliates and their respective employees, officers, directors, stockholders, partners and representatives from and against any losses, assessments, liabilities, claims, damages, costs and expenses (including reasonable attorneys' fees and disbursements) incurred by such indemnified party as the result of any misrepresentation in, breach of or failure to comply with, any of the representations, warranties, covenants or agreements of the Seller contained in this Agreement, in each case, with respect to any such representation or warranty, as if such representation or warranty would read if all qualifications as to materiality, including each reference to the defined term "Material Adverse Effect," were deleted therefrom.

Comparatively, a "standalone" materiality scrape provision (covering only representations and warranties) may read:

For purposes of determining whether there has been a breach and the amount of any losses that are the subject matter of a claim for indemnification, each representation and warranty in this Agreement will be read without regard and without giving effect to the term "material" or "material

adverse effect" (fully as if any such word or phrase were deleted from such representation and warranty).

The Buyer's Position

The buyer's arguments for requesting a materiality scrape provision generally take the form of one or more of the following:

1. *Fill the Indemnity Basket.* A typical purchase agreement contains a "basket," which is intended to provide the seller (as the indemnifying party) protection from general indemnity claims below a certain negotiated amount. Thus, the basket protects the seller against "immaterial" claims. However, materiality or MAE qualifiers throughout the representations and warranties arguably create a "double materiality" threshold for the buyer to "fill the basket" before indemnity is triggered. Consequently, absent a materiality scrape, the buyer could incur many losses as the result of unrelated breaches of the seller's representations and warranties that are not individually material but are material in the aggregate, and such losses would not count toward the basket. Where agreements also have, in addition to a basket, a "de minimis threshold" (often called a "mini-basket")?i.e., claims of less than $X are not covered by indemnification nor counted towards the basket?the buyer can argue that the absence of a materiality scrape creates a "triple materiality" threshold.
2. *Eliminate Post-Closing Materiality Disputes.* Eliminating materiality and MAE qualifiers can help reduce or eliminate post-closing disputes between the parties as to what is and what is not "material."
3. *Clarify Breach/Loss Issue.* The materiality scrape provision eliminates the potential seller argument that the materiality qualifier applies to the level of recoverable losses, not just to breach, and takes the uncertainty out of this issue (to the extent there is uncertainty).
4. *Streamline Negotiations.* By reducing the significance of materiality and MAE qualifiers generally and across the board for purposes of determining allocation of risk of breach (and loss), the negotiation of the purchase agreement becomes more efficient, as the parties need not negotiate every usage of those qualifiers with the same level of attention.

The Seller's Position

Not surprisingly, sellers have a different view of the world when it comes to materiality scrape provisions. Sellers' arguments against including a materiality scrape usually include the following:

1. *"Close and Sue."* If a materiality scrape eliminates materiality and MAE qualifiers from determining existence of a breach but not from determining whether closing conditions have been satisfied, the effect is that a seller can be forced to close "into a breach" and be held accountable immediately after closing for that breach.
2. *"Nickeling and Diming."*The buyer should absorb some level of risk of loss in connection with the acquisition of a business, and a materiality scrape allows or even encourages buyers to hunt for any claim, no matter how minor, to pursue against the seller.

3. *Increased Disclosure Burden.* If materiality and MAE qualifiers are to be read out of the representations and warranties requiring either affirmative disclosure (e.g., "Schedule 4.3 sets forth all material contracts") or negative disclosure (e.g., "except as set forth on Schedule 4.4, the seller is in compliance with all applicable laws in all material respects"), the seller will be forced to disclose everything and anything, even if immaterial and of no real interest to the buyer, creating significant inefficiencies.
4. *Awkward Application in Certain Situations.* Eliminating materiality and MAE qualifiers from certain representations and warranties creates potentially awkward results. For example:

a. If the seller represents that there has been no MAE since a certain date (a common representation), how can MAE be deleted from that statement?

b. The normal financial statement representation is usually tied to the GAAP standard that the financial statements "fairly present in all material respects" the financial condition of the target. Do the parties intend to deviate from the established GAAP standard via a materiality scrape provision?

c. The typical "full disclosure" representation is based on the language of Rule 10b-5 of the Securities Exchange Act of 1934 that the seller's statements (and/or other information provided in connection with the transaction) do not contain any untrue statement of material fact or omit to state a material fact necessary to make any of the statements, in light of the circumstances in which they were made, not misleading. Similar to the GAAP issue above, are the parties intending to alter the normal 10b-5 standard?

d. Some representations and warranties may not be subject to the indemnification basket, most typically those relating to title, taxes, ERISA, and brokers' fees. In the absence of a basket, should the materiality and MAE qualifiers remain in place in those representations?

Common Compromises

Some possible compromises to deal with the different perspectives of the seller and buyer include the following ways to lessen the impact of a materiality scrape:

1. Use a true "deductible" basket (where the basket amount is never recoverable but rather serves as a deductible against buyer claims) instead of a "tipping basket" (where the basket amount is recoverable from dollar one once the aggregate buyer claims exceed the basket amount). Using a deductible basket, which is pro-seller, arguably supports the rationale for a materiality scrape.
2. Increase the amount of the deductible basket or tipping basket.
3. Rely on specific dollar thresholds within the representations and warranties in lieu of materiality or MAE qualifiers.
4. Have the materiality scrape apply to the determination of losses resulting from a breach, but not as to whether or not the breach occurred, i.e., implement a single materiality scrape in lieu of a double materiality scrape.

5. Except from the materiality scrape any affirmative disclosure requirements, so that the seller need not disclose immaterial matters within its disclosure schedules.
6. Specify that the materiality scrape does not apply to certain specific representations and warranties?e.g., the financial statement and full disclosure representations, and/or representations that are not subject to a basket.

Trends in Usage of Materiality Scrape Provisions

A materiality scrape is a pro-buyer provision. Accordingly, when M&A markets are buyer-friendly, one would expect to see greater usage of materiality scrapes (and vice versa).

Every other year since 2005 the American Bar Association ("ABA") has released its Private Target Mergers and Acquisitions Deal Point Studies (the "ABA studies"). The ABA studies examine purchase agreements of publicly available transactions involving private companies that occurred in the year prior to each study (and in the case of the 2017 study, including the first half of 2017). These transactions range in size but are generally considered as within the "middle market" for M&A transactions; the average transaction value within the 2017 study was $176.3 million.

The ABA studies show a relatively steady increase in the presence of materiality scrape provisions from 2004 through 2016-2017. Most private company M&A deal points have relatively stable usage and trends in any direction usually are slow and incremental, particularly if relating to a deal point that has meaningful impact on risk allocation as between buyer and seller. The shift in practice norms for material scrapes over the 12+ years covered by the ABA studies is, in that context, therefore remarkable.

In the 2005 study, only 14% of the reported deals had materiality scrapes, but by 2017 that mix had flipped, so that only 15% of transactions did not have a materiality scrape.

As indicated above, a somewhat compromise position between buyer is to allow for a single materiality scrape. Using the example representation above, that "the target company is not party to any *material* litigation," this compromise position would mean that: (a) materiality would not be scraped in determining whether a breach had occurred so that non-material litigation would not trigger a breach; but (b) materiality would be scraped in determining the losses or damages resulting from that breach (i.e., damages would not be limited to whether or not they were material).

The common criticism of this compromise is that it offers very little to the buyer seeking the materiality scrape in the first instance. Most lawyers would assert that a materiality qualifier in a party's representation qualifies the representation only and, absent specific language to the contrary, has no direct bearing on calculating damages once the representation is breached. In other words, scraping materiality from damages calculation simply states the obvious, reflecting what would happen under normal contract principles, and therefore provides little or nothing to the party seeking a materiality scrape. The real focus of the materiality scrape, and where it has substantive impact, is on the determination of a breach of the representation qualified by materiality, not on resulting damages. More recently buyers and sellers appear to have adopted this view and have not limited materiality scrapes to damage calculations.

Conclusion

The materiality scrape is here to stay and, as the ABA Studies indicate, has recently experienced a large increase in usage, even if modified to accommodate the respective positions of buyers and sellers. Of course, like any substantive provision in an M&A agreement, inclusion of a materiality scrape depends on how the provision fits with the allocation of risk between buyer and seller, the attractiveness of economic or other substantive terms, and the relative negotiating strength of the buyer and seller.

A materiality scrape packs a lot of punch within a relatively small amount of wording, and practitioners should carefully consider the impact and operation of such a provision within their deal documents.

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[2]*Note that "double materiality" issues may also arise when this type of closing condition is tied to representations and warranties being true in correct "in all material respects," since some of the representations and warranties may already have materiality or MAE qualifiers. To address this, the closing condition can be bifurcated into two closing conditions: first, that the representations and warranties that are **not** qualified by materiality or MAE must true and correct in all material respects, and second, that the representations and warranties that **are** qualified by materiality or MAE must be true and correct in all respects.*

[3]*Though this issue is often cited as relevant in a materiality scrape context, it is not clear that absent a materiality scrape, a materiality qualifier would be applicable to both the breach and the resulting losses. See related discussion below.*

[4]*See, e.g., Tyler B. Dempsey, Seller Beware: Potential Pitfalls and Unintended Consequences of the 'Materiality Scrape'; Ken Adams, The Structure of M&A Contracts – Materiality Scrape Provisions (Nov. 11, 2008) http://www.adamsdrafting.com/materiality-scrape/.*

[5]*A project of the M&A Market Trends Subcommittee of the Mergers & Acquisitions Committee of the ABA's Business Law Section. References to years within the charts referenced in this article are to the respective years of the ABA studies.*