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

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In terms of apportioning responsibility for a target company's liabilities as between buyer and seller in a 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 a 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 trends in its usage.

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." That is, for purposes of determining the existence of a breach, the statement is read as if the word "material" was never included in the first place.

The typical materiality scrape provision is sometimes referred to as a "double" materiality scrape in that it applies to determining both: (a) whether or not a breach has occurred and (b) the amount of indemnified losses resulting from that breach. However, 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. Less often, covenants (an obligation 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)." Less often seen is a "knowledge scrape," which eliminates knowledge qualifiers.

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

The answer is this: Materiality and MAE qualifiers have different purposes and effects within the purchase agreement, and the materiality scrape may eliminate the qualifiers for *some but not all* of those purposes. These materiality and MAE qualifiers generally have relevance in four different contexts:

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[1] or that there be no MAE in effect as of the closing);
2. Determining the scope of extent 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"?).[2]

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 (and knowledge) scrape provision (covering representations, warranties, covenants and agreements):

> 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, as each such representation, warranty, covenant or agreement would read if all qualifications as to knowledge or materiality, including each reference to the defined term "Material Adverse Effect," were deleted therefrom.

Here is an example of a "standalone" materiality scrape provision (covering only representations and warranties):

> 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)

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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 and get indemnified. 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; see endnote 1).
4. *Streamline Negotiations.* By reducing the significance of materiality and MAE qualifiers 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 will have a different view of the world when it comes to materiality scrape provisions. The arguments advanced by sellers against including a materiality scrape usually include the following:

1. "*Close and Sue*." Where the 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 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, which creates significant inefficiencies.
4. *Awkward Application in Certain Situations.* Eliminating materiality and MAE qualifiers from certain representations and warranties creates

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potentially awkward results.[3] For example:

a. If the seller represents that there has been no MAE since a certain date (which is a very 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 basket, most typically those relate 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 of the possible compromises to deal with the different perspectives of the seller and buyer with respect to a materiality scrape 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."
5. Except from the materiality scrape 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 operates as a pro-buyer provision in a purchase agreement. Accordingly, when M&A markets are buyer-friendly, one would expect to see greater usage of materiality scrapes (and vice versa).

In 2009, the American Bar Association (ABA) released its Private Target Mergers and Acquisitions Deal Point Study.[4] The 2009 study looked at

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purchase agreements covering 106 private company transactions that occurred in 2008. These transactions ranged in size from $25 million to $500 million, across a broad range of industry sectors.

According to the 2009 study, 24% of the agreements included a materiality scrape. This 24% represented a relatively small increase in materiality scrape usage as compared to 2006, when the usage stood at 22%. The ABA's similar review of transactions completed in 2004 showed a 14% usage level, so the materiality scrape provision saw a 50% increase in usage between 2004 and 2006, and a 9% increase between 2006 and 2008. Note that about one-third of the transactions with materiality scrape provisions reported in the 2009 study limited the provision to calculation of losses (and excluded its application to the determination whether a breach occurred), suggesting that this limitation is a somewhat common compromise.

Assuming that the ABA studies reasonably reflect general practice in M&A transactions, it is true that materiality scrape provisions both: (1) are becoming more common, and (2) are still seen only in about a quarter of private company transactions. Anecdotally, materiality scrape provisions seem to be more the rule, rather than the exception, in middle market private equity M&A deals.

Conclusion

The materiality scrape is here to stay and likely to rise in usage, even if in modified or compromised form, to accommodate the respective positions of buyers and sellers. Of course, like any substantive provision in a M&A agreement, inclusion of a materiality scrape will depend on how the provision fits with the allocation of risk between buyer and seller as a whole, the attractiveness to the parties of economic or other substantive terms, and the relative negotiation 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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[1] 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.

[2] 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.

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[3] *See, e.g.,* Tyler B. Dempsey, *Seller Beware: Potential Pitfalls and Unintended Consequences of the 'Materiality Scrape*,' http://www.abanet.org/buslaw/newsletter/0074/materials/pp3.pdf (last visited January 7, 2011); Ken Adams, *The Structure of M&A Contracts – Materiality Scrape Provisions* (Nov. 11, 2008), http://www.adamsdrafting.com/2008/11/11/materiality-scrape/ (last visited January 7, 2011).

[4] A project of the Mergers & Acquisitions Market Trends Subcommittee of the Mergers & Acquisitions Committee (formerly called the Committee on Negotiated Acquisitions) of the ABA's Section of Business Law.

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