Materiality Scrape Provisions in Merger & Acquisition Agreements

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Introduction

In connection with the sale of a business, the seller will typically make a series of factual representations and warranties about its business to the buyer. The scope of these representations and warranties is often the subject of significant negotiation by legal counsel to both the buyer and seller and, invariably, one of the areas of "give and take" between the parties is determining which representations and warranties will be qualified as to the seller's knowledge and/or materiality. Similar qualifiers can also be added to the sections of the merger/acquisition agreement governing closing conditions and indemnification obligations of the parties. From a practical standpoint, these types of qualifiers serve the following purposes:

- They limit both the seller's representations and warranties to the buyer and the corresponding disclosures that the seller must make to the buyer as exceptions to the representations and warranties in the form of disclosure schedules to the definitive merger/acquisition agreement.
- They determine whether or not a breach of the seller's representations and warranties has occurred.
- They measure the amount of losses resulting from the seller's breaches of representations and warranties.
- They determine whether conditions to closing the sale of the business have been satisfied by the parties.

As a counterbalance to these qualifiers, buyers may attempt to introduce a provision into the merger/acquisition agreement that serves to exclude materiality, material adverse effect and similar materiality qualifiers contained in the seller's representations and warranties for the purposes of determining post-closing indemnification.[1] Commonly referred to as a "materiality scrape", an example of this type of provision is as follows:

> "For purposes of determining whether there has been any misrepresentation or breach of a representation or warranty, and for purposes of determining the amount of losses resulting therefrom, all qualifications or exceptions in any representation or warranty referring to the terms "material", "materiality", "in all material respects", or "Material Adverse Effect" shall be disregarded."

Buyer Arguments for Introducing Materiality Scrape Language

Buyers will argue that the inclusion of materiality scrape language is warranted for several reasons, including:

- It is typical for merger/acquisitions agreements to include contractual provisions that state that the buyer may not recover damages for seller's breaches of representations and warranties until buyer's total damages exceed a predetermined threshold. These indemnity "baskets" serve to protect the seller against immaterial claims for indemnification and, as such, disregarding materiality qualifiers in the representations and warranties is appropriate. Arguably, by not disregarding these qualifiers, a situation may arise where buyer has suffered damages from a series of immaterial breaches of seller's representations and warranties that, in the aggregate, exceed the indemnity basket but for which recovery is barred due to the materiality qualifiers.
- Often, deal lawyers do not go so far as to define what is meant by the term "material" when it is used in a merger/acquisition agreement. Although there is typically a level of shared understanding by the parties as to what the term means in the context of the sale of a business, opinions can differ (especially in the heat of a post-closing dispute) and, as such, eliminating materiality qualifiers can serve to reduce or eliminate disagreement between the parties as to what is and what is not "material".
- By disregarding materiality qualifiers for the purpose of allocating risk for breaches of representations and warranties (and resulting damages) amongst the parties, the drafting of the merger/acquisition agreement becomes more efficient and streamlined (since legal counsel need not negotiate every single use of a materiality qualifier in the definitive agreement with the same level of attention).

Seller Arguments for Avoiding Materiality Scrape Language

Conversely, sellers have equally compelling arguments for why materiality qualifiers should not be disregarded for the purposes of determining the seller's indemnification obligations. These include:

- The concept of materiality is central to several important representations and warranties, including "full disclosure" representations (that borrow from SEC Rule 10b-5 and usually state that the seller's statements in the merger/acquisition agreement do not contain any untrue statements 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) and those related to the seller's financial statements (which refer to the typical GAAP standard that the seller's financial statements "fairly present in all material respects" the financial condition of the seller). As such, disregarding materiality qualifiers can result in some awkward applications in the context of the merger/acquisition agreement.
- By introducing "materiality scrape" language that disregards materiality qualifiers for the purposes of determining the existence of a breach of seller's representations and warranties but not for the purposes of determining whether closing conditions have been satisfied, a seller may have no choice but to close "into a breach" and then be held immediately accountable for such breach post-closing by the buyer.
- Disregarding materiality qualifiers for the purposes of determining indemnification obligations can cause inefficiencies in drafting/negotiating the merger/acquisition agreement since the seller may feel compelled to "over disclose" exceptions to its representations and warranties in the disclosure schedules to the merger/acquisition agreement as a protective measure.

Compromise Positions

Invariably, there is middle ground to be found by parties to a merger/acquisition agreement. Reasonable buyers and sellers might agree on some or all of the following compromise positions in the context of documenting the sale of a business:

- Make the indemnity basket serve as a true deductible against claims for indemnification. In

other words, a party seeking indemnification for breaches of the other party's representations and warranties would not recover damages from "dollar one" but, rather, only for those damages that exceed the indemnity basket. Under this construct, the seller is partially insulated from the impact of the "materiality scrape" provision since indemnification for damages from a minimum level of immaterial breaches is still avoided.

- As a corollary to treating the indemnity basket as a true deductible, increase the size of the indemnity basket as a trade-off for introducing a "materiality scrape" provision.
- Specify that materiality qualifiers will not be disregarded in the instances of certain representations and warranties (i.e. financial statement and full-disclosure representations) so as to avoid awkward applications of the "materiality scrape" provision.
- Qualify representations and warranties through the use of specific numerical/dollar thresholds rather than by reference to materiality.
- Except affirmative disclosure requirements from the "materiality scrape" provision so that the seller need not disclose immaterial matters within its disclosure schedules.

For more information on materiality scrape provisions in mergers and acquisitions, please contact **Scott R. Bleier**.

Footnotes.

1. According to the 2013 Private Target Mergers & Acquisitions Deal Points Study published by the American Bar Association, 28% of reported transactions included "materiality scrape" language.