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Seller Beware: Potential Pitfalls and Unintended Consequences of the 'Materiality Scrape'

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In the private M&A context, buyers appear to be increasingly successful in obtaining a so-called "materiality scrape" clause providing that "materiality" or "Material Adverse Effect (MAE)" qualifiers in the seller's representations and warranties will be disregarded or ignored for purposes of the post-closing indemnification provisions. In a recent study sponsored by the American Bar Association,[1] approximately 22% of the relevant surveyed agreements contained this clause. While that statistic is not enough for buyers to be able to make the magic "standard market term" claim, it did represent more than a 50% increase from the previous study[2] two years earlier, which indicated that approximately 14% of the relevant agreements contained the clause.

This article initially discusses the application and interpretation of the typical materiality scrape provision and the buyer's basic arguments in favor of the provision. The article then proceeds to highlight several potential issues that sellers and their counsel should consider when reviewing and negotiating the provision. Next, the article offers some potential "middle-ground" compromises that deal parties may wish to consider when negotiating the provision.

The article concludes that sellers should either attempt to reject the clause altogether or propose language that will mitigate the potentially harsh effects of the provision.

Application

A typical example of the materiality scrape clause is as follows:

> **In determining whether any breach of any representation or warranty made by Seller in this Agreement has occurred, the terms "material," "Material Adverse Effect" and other similar qualifications based upon materiality shall be disregarded and given no effect.**

The interpretation and application of a materiality scrape is generally straightforward. Take a typical, simplified "compliance with law" representation:

Seller is in compliance, in all material respects, with all applicable laws.

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If the acquisition agreement contains an express materiality scrape for indemnification purposes, then the representation would be deemed to be read as follows:

Seller is in compliance, in all respects, with all applicable laws.

For indemnification purposes, the seller would be liable (subject to any other limitations set forth in the acquisition agreement) for any losses incurred by the buyer as a result of the seller's failure to be in compliance with all applicable laws.

Buyer Perspective

The buyer's principal argument for this clause has the benefit of being simple and straightforward: The acquisition agreement already contains a "basket" (i.e., a minimum aggregate loss that must be suffered by the buyer before the buyer can seek recovery under the indemnification provisions) and that basket is, by definition, the negotiated standard for materiality in the seller's representations and warranties. Without an express materiality scrape clause, the seller is essentially getting "double materiality" protection (the buyer argues). Moreover, buyers also note that, without a materiality scrape provision, post-closing disputes over what is material are inevitable (and undesirable).

Buyer's counsel often also explains that the clause serves both parties' interests by allowing the seller to have comfort in the accuracy of its representations and warranties (and to ease the preparation of its disclosure schedules) while not unduly shifting the risk and responsibility of losses to the buyer. In addition, buyer's counsel may note that the seller will get the benefit of the materiality/MAE qualifiers in the representations and warranties when it comes to the "bringdown" of those representations and warranties in the closing conditions (though sometimes the "bringdown" is qualified by MAE in its entirety).

Seller Considerations

Buyers' positions in favor of the materiality scrape for indemnification purposes are easy to articulate and, perhaps in the "pick your battles" spirit of acquisition agreement negotiation, sellers appear to be increasingly acceding to those positions.[3] However, there are several countervailing considerations that sellers and their counsel should take into account when reviewing this issue.

Sellers should consider whether the agreed-upon basket amount (particularly if it has been derived with the ABA Deal Points Studies or other similar studies in mind) already assumes an appropriate sprinkling of materiality/MAE qualifiers throughout the seller's representations and warranties. Interestingly, despite the approximate 50% increase in the use of the materiality scrape, basket amounts (expressed as a percentage of transaction value) actually seemed to have trended downward during the same time period.[4] At a minimum, the presence of an express materiality scrape for indemnification purposes should factor into the negotiation of the basket amount (i.e., allow sellers to argue for a higher basket amount). Moreover, it should also provide the seller with an additional argument in favor of a "true deductible" versus a "soft" or "tipping" basket. On the other hand, if the seller has negotiated for a *de minimus* threshold (sometimes also referred to as an "eligible claim" threshold) in addition to the basket, the buyer would seem to have a much stronger case in favor of the materiality scrape (lest the buyer be faced with "triple materiality") and a lower basket amount.

Sellers should also consider that the additional losses for which they may be responsible as a result of the materiality scrape clause relate, by definition, to items that the buyer did not care to know about when agreeing to purchase the business. For a buyer to then, post-closing, insist on the right to reappear and seek indemnification for these matters may seem to some sellers as defeating the purpose of the materiality/MAE qualifiers. Relatedly, sellers may point out that the presence of the clause simply provides an incentive for the seller to list any and all issues (no matter how immaterial) on the disclosure schedules. Such an approach could potentially "move the fight" to the disclosure schedules and delay the transaction by giving rise to additional arguments over the inclusion of generic catch-all language in the disclosure schedules.

There are several other situations within the confines of a typical acquisition agreement where the application and interpretation of this clause produce an unusual, confusing and/or perhaps unintended result:

- *10b-5 representations*. A typical 10b-5 representation reads as follows: "No representation or warranty made by the Seller in this Agreement contains an untrue statement of a material fact or omits to state a material fact required to be stated herein or necessary to make the statements contained herein not misleading." Given that the representation is derived from Rule 10b-5 under the Securities Exchange of 1934, as amended, "material" would seem to be at the essence of the representation (as opposed to simply a "qualifier"). However, if the acquisition agreement contained a materiality scrape, would it be the parties' intention that this representation be read without the word "material"?

- *Lists*. Often, an acquisition agreement will contain the seller's representation and warranty with respect to the accuracy and completeness of certain lists (e.g., material contracts, licenses, intellectual property). As an example: "Schedule X sets forth a true and correct list of all material Intellectual Property used in the Business." Is it the intention of the parties that the word "material" be ignored when reviewing this representation in the indemnification context? Would the seller be potentially liable for not listing an item on the disclosure schedules that, by the express terms of the representations and warranties, was not required to be listed?

- *No MAE Representation*. Most acquisition agreements contain a representation and warranty similar to: "Since the date of the latest balance sheet, there has been no Material Adverse Effect." Reading this representation together with an express materiality scrape could lead to confusion and ambiguity. Similarly, what if the representation read "Since the date of the latest balance sheet, there has been no event which has had a materially adverse effect on the Business."? Is a judicial or other arbiter supposed to read that provision for indemnification purposes without the word "materially"?

- *Carved-out Representations*. Some representations and warranties (e.g., tax matters) are frequently "carved-out" from the indemnification limitations and, as a result, the basket does not apply to losses under these representations and warranties. The parties should consider whether materiality/MAE qualifiers in these representations and warranties are intended to be disregarded.

Other Considerations

One potential solution to this issue is to limit materiality/MAE qualifiers in the seller's representations and warranties and, instead, use dollar-specific thresholds to carve out immaterial matters within the applicable representations and warranties.[5] Under this approach, there is arguably less need for an express materiality scrape for indemnification purposes since the buyer has more certainty under the representation (as opposed to having to argue about what "material" means). This approach is obviously not perfect, however. Among other issues, it may force the parties to pick potentially arbitrary amounts in cases where the business risks are difficult (if not impossible) to quantify.

Other possible "middle-ground" approaches include: (1) disregarding materiality/MAE qualifiers for purposes of calculating damages or losses but only if the representation (read with the materiality/MAE qualifiers) has already been breached,[6] (2) disregarding only MAE qualifiers and substituting "in all material respects" in lieu thereof for indemnification purposes,[7] and (3) negotiating, on a "rep-by-rep" basis, which specific materiality/MAE qualifiers will be disregarded.[8] Anecdotally, it seems that the first approach (i.e., disregarding materiality/MAE qualifiers for damages purposes only) is a fairly common compromise. This approach has some similarities to a "tipping basket": in other words, if the buyer can prove that the seller breached the representation above a certain threshold (i.e., the materiality/MAE qualifier), then the buyer can reach back and recover any damages arising out of the breach (without having to prove the materiality of each breach).

Conclusion

While the current trend appears to be increased acceptance of the materiality scrape for indemnification purposes in the private M&A context, sellers should, at a minimum, consider the consequences of a blanket materiality scrape provision (including how the clause will be applied to their specific representations and warranties and whether this could result in liability for unintended breaches) before immediately conceding the point. In particular, sellers and their counsel should consider the issue in light of the basket amount and other indemnification provisions set forth in the acquisition agreement and either consider resisting the clause altogether or proposing some mitigating language.

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[1] The 2007 Private M&A Deal Points Study (the "2007 ABA Study") was a project of the M&A Market Trends Subcommittee of the Committee of Negotiated Acquisitions of the American Bar Association's Section of Business Law. The 2007 study analyzed 143 publicly available

acquisition agreements for transactions completed in 2006 that involved private targets being acquired by public companies.

[2] The prior version of the study (the "First Annual ABA Study") (also performed by the M&A Market Trends Subcommittee of the Committee of Negotiated Acquisitions of the American Bar Association's Section of Business Law) analyzed 128 publicly available acquisition agreements for transactions completed in 2004 that involved private targets being acquired by public companies. The 2007 ABA Study and the First Annual ABA Study are collectively referred to in this article as the "ABA Deal Points Studies."

[3] With certain important indemnification terms (e.g., decreasing caps and increased use of an escrow as the exclusive source of recovery) trending in favor of sellers recently, the increased prevalence of the materiality scrape could be a case of "buyer's revenge."

[4] The mean and median basket (whether deductible or first dollar) percentages (expressed as a percentage of transaction value) in the 2007 ABA Study were 0.52% and 0.40%, respectively, as compared to 0.69% and 0.60%, respectively, in the First Annual ABA Study. A different study, the Purchase Agreement Study by Houlihan Lokey, produced different numbers but would be appear to corroborate these findings with respect to basket trends: for transactions closed in 2006, the mean and median basket percentages were each 0.60%, as compared to 0.80% each for transactions closed in 2004. The Houlihan Lokey study did not analyze the prevalence of express materiality scrape provisions.

[5] An example of this approach, using the same "compliance with laws" representation, would be: "Seller is in compliance with all applicable laws, except where failure to comply would not, individually or in the aggregate, reasonably be expected to result in Losses to the Business in excess of $_____."

[6] An example of this approach can found in the merger agreement relating to the acquisition of HowStuffWorks, Inc. by Discovery Communications, LLC: "For purposes of calculating Losses (but not determining whether a breach has occurred), … any limitation as to material, materiality, material adverse effect, or similar qualification contained in the representations and warranties … will be ignored …" [See Exhibit 7.2 to Schedule 13D/A filed by HowStuffWorks, Inc. and Discovery Communications Holding, LLC with respect to HSW International, Inc. on January 10, 2008.]

[7] An example of this approach can be found in the asset purchase agreement with respect to the sale of a business unit by Avanir Pharmaceutical to Azur Pharma Inc.: "(provided that any "Material Adverse Effect" qualification limiting the scope of such representation or warranty shall not be given effect and any such representation or warranty so modified shall be breached only if such representation or warranty as modified is not accurate in all material respects)." [See Exhibit 10.49 to Form 10-K filed by Avanir Pharmaceuticals on December 21, 2007.]

[8] This approach could be used to address some of the results produced by a literal application of the materiality scrape provision to certain provisions as discussed above (e.g., 10b-5 representation, lists, etc.). An example of this approach can be found in the asset purchase agreement with respect to the sale of a business unit by Centex Corporation to Rollins, Inc.: "Solely for the purposes of the indemnification obligations of Sellers …, all Materiality Qualifications contained in such representation or warranty shall be disregarded; provided,

however, that there shall not be disregarded any Materiality Qualifications which are included in Section 4.7 [Financial Statements representation] or Section 4.9(a) [No MAE representation] or solely to the extent such Materiality Qualification modifies the identification on a schedule of a list of material Permits …" [See Exhibit 2.1 to Form 8-K filed by Rollins, Inc. on April 1, 2008.]