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From the Field

Scraping By

Private M&A negotiations in recent years have increasingly involved a pro-buyer provision, the "materiality scrape." Lawyers from Goodwin Procter help explain what that means

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Long ago, in markets that now seem prehistoric, the back and forth between buyers and sellers concerning representations and warranties in private M&A transactions was relatively simple. Buyers asked for representations, sellers made them, and the representations simply survived closing as in most venture capital deals today. If one or more representations proved untrue, the seller was liable to the buyer for damages caused by the breach.

Over time, buyer-seller discussions about representations and warranties became more complex. Detailed contractual indemnification rights became the norm. A set of well established parameters - time limits, baskets/deductibles and caps - assured sellers that most post-closing exposure would cease before expiration of relevant statutes of limitation. These parameters also assured sellers that buyers would not be able to recover all of a seller's proceeds and still own the acquired company, absent fraud or problems in a very limited number of areas, such as taxes.

But this was not good enough. As private M&A markets went from hot ('94-'97) to white hot ('98-'00) to frozen ('01-'03) to robust/white hot again ('04 to '07), both sellers and buyers devised ingenious new ways to gain advantage in negotiating representations, warranties and indemnification provisions.

So-called "anti-sandbagging" clauses emerged to forestall buyers from going after sellers following the closing for matters they knew about when they closed. Sellers began to ask for per claim "mini-baskets," sought to calculate damages net of tax benefits and insurance recoveries and argued to exclude consequential damages and, occasionally, "multiple based" damages from the calculation of losses.

Buyers pushed back by seeking expressly to recover "diminution in value" resulting from a breach of representation, and developed a set of "counter carve outs" from sellers' new arsenal of indemnity limits.

Trees died and ink poured forth as the increasing sophistication and length of indemnity provisions fueled the imaginations of lawyers and in some cases tried the patience of deal principals.

In the robust market conditions of the past few years, the evolution of private M&A terms tended to favor sellers. The concept of a "Material Adverse Effect," for example, narrowed considerably in scope - many acquisition agreements now provide that adverse effects on "prospects" and an ever-expanding litany of specified carve outs - industry changes, failure to meet projections, wars, terrorism, impacts from announcement of the deal, et cetera — will not constitute a material adverse effect for purposes of representations and warranties or closing conditions. Similarly, escrows and indemnity caps in private M&A deals became smaller on a percentage basis, albeit as deals became larger. Survival periods for representations and warranties and escrows became shorter.

The scrape arises

Amid this general pro-seller drift in the evolution of terms, private M&A negotiations in recent years have increasingly involved a pro-buyer provision, the "materiality scrape." A materiality scrape is a contractual provision, usually part of the indemnity section of a private M&A agreement that "reads out" materiality qualifications for purposes of determining whether a breach of representation and warranty has occurred and/or the amount of damages from that have resulted from such a breach.

A typical materiality scrape provision reads as follows:

> *Notwithstanding anything in this Agreement to the contrary, for purposes of the parties' indemnification obligations under this ARTICLE X, all of the representations and warranties set forth in this Agreement or any certificate or schedule that are qualified as to "material," "materiality," "Material respects," "Material Adverse Effect" or words or similar import or effect shall be deemed to have been made without any such qualification for purposes of determining (i) whether a breach of any such representation or warranty has occurred, and (ii) the amount of losses resulting from, arising out of or relating to any such breach of representation or warranty.*

Many of the representations and warranties in a private M&A agreement are qualified by phrases and concepts such as "materiality," "knowledge" and "material adverse effect." The effect of these qualifiers is to reduce the burden of the seller's disclosure obligations by eliminating the need to list immaterial exemptions to representations (though many sellers list them anyway, to be safe). The qualifiers also serve to reduce execution risk, since a set of representations with liberal exceptions and qualifications can more likely be remade at closing as a condition of closing than can an unqualified set of representations. Also, they make it less likely that a breach of a representation will occur, thus protecting the seller against a possible need to return part of the purchase price.

This cushion typically is made softer and deeper by a deductible or basket threshold, which must be reached before there can be any recovery for the buyer. Absent a materiality scrape, problems will not give rise to a clawback of any part of the purchase price unless the damages are in excess of the deductible threshold and the relevant matters are severe enough to rise to the level of a breach of representation, in many cases under a "materiality" or "MAE" threshold.

A materially scrape for purposes of determining breach thus eliminates a portion of the cushion sellers have generally enjoyed in the past. The various materiality qualifiers to the representations, carefully negotiated and establishing a standard for disclosure and closing, remain relevant for purposes of determining whether closing conditions have been satisfied, but in effect then vanish at closing for purposes of determining post-closing liability of the sellers. Thereafter, all representations are either right or wrong in the pure, unqualified form. The threshold or deductible stands as the seller's single line of defense against problems that relate to the time when the seller owned the company.

The effect of a materiality scrape with respect to calculation of damages is to clarify that *all* losses arising from a breach of representation are potentially recoverable by the buyer, not just those that are material or would cause a material adverse effect.

For example, assume that a buyer and seller agree on a $1 million true deductible in a private M&A deal and $2 million of loss arises from an undisclosed liability, constituting a breach of the seller's representation that the target's financial statements fairly present the target's financial condition *in all material respects*. Generally, most parties' intent in such a situation would be to allow the buyer to recover $1 million of damages in excess of the deductible. Absent a materiality scrape relative to damages, some fear that the seller could argue that only the position of damages in excess of a material amount - say, $500,000 in our example - is recoverable. The materiality scrape relating to damages prevents such an outcome.

Inclusion of a materiality scrape for purposes of determining damages once a breach has occurred is not usually controversial. Indeed, it is thought by many to be merely a clarification of how typical indemnification arrangements have been and are intended to operate.

Real controversy in M&A negotiations arises over whether a materiality scrape will be allowed to "read out" materiality qualifiers for purposes of determining whether a breach has occurred. Whether such "materiality" scrape is included in a particular deal is a function of a number of factors. These include the relative leverage of parties, the size of the indemnity basket, the nature of the target's business, and the terms of the various representations. The scope of the representations and warranties in the purchase agreement is also relevant - if there are many materiality qualifiers on the representations, a materiality scrape with respect to breach is more likely to increase the risk of loss for a seller, and vice versa.

Materiality scrape provisions, while arising more frequently than in the past, still do not appear in most private M&A deals. A recent American Bar Association study found that in 2006 materiality scrape provisions appeared in 22% of the 143 transactions analyzed involving private companies being sold to public companies, up from 14% in 2004. Of these, 72% disregarded materiality both for determining whether there had been a breach of representation and for determining the amount of indemnifiable damages once a breach had been established, while 28% included a materiality scrape for purposes of determining damages but not for purposes of establishing breaches. The latter is a compromise approach adopted by buyers and sellers with (anecdotally) increasing frequency.

From a buyer's perspective, the principal benefit of a "materiality scrape" is that it provides a higher degree of protection by making it easier to recover against the seller for pre-closing problems. Such a buyer will say, "I am paying X. I am willing to absorb pre-closing problems of .5% or 1% of X without complaint. But once the problems exceed that amount, I no longer am buying the same company I agreed to buy. If I let the seller pile materiality and MAE qualifiers on top of one another and then have a basket or deductible to surmount as well, there is no telling how many problems that occurred on the seller's watch I'll have to eat."

From the seller's perspective, recovery for breach of representation or warranty is supposed to be difficult. A seller would say, "Every deal has its positive and negative surprises. There should be a claim only for something that fundamentally and significantly alters the substance of the transaction. There should not be an incentive to nickel and dime or to search for (and add up) small claims to see if the basket can be filled. Absent something truly material, something that makes the subject company essentially different, both the buyer and seller should get on with their lives, building value and focusing on opportunities and operations, not spending time paying lawyers to fight with each other."

Neither position is more correct as an objective matter. As noted, the data suggest that sellers in recent years have more often won the argument about whether M&A terms will exclude a materiality scrape with respect to breaches. This is perhaps due to the weight of historic precedent and certainly reflects conditions in recent (and probably future) markets, where too much capital chases too few good companies.

In practice, acquirers will do well to consider the "scrape" in the context of their overall bid. Insisting on a general materiality scrape together with every other possible buyer protection including, say, a 25% escrow, in a robust and competitive auction involving a target that is dependent on technology, growth, future cash flow and exit value, may not be a winning strategy, as contrasted with omitting materiality qualifiers for particular and negotiated matters. As a practical matter, omitting a materiality scrape will not create an impediment to bringing indemnity claims when truly serious problems arise. Freed from post-closing involvement with small matters, investors can focus on operations and company building.

On the other hand, there will be cases where a buyer's price is closely correlated to a set of very specific representations and negotiating leverage favors the buyer, and there will be buyers who as a policy matter wish to forgive only deductible amounts and not permit sellers to have materiality protection on top of that. In some of these cases, bank financing may depend on the existence of very tight representations and even modest recoveries are important. Here, insisting on a materiality scrape may well succeed and thus provide an enhanced ability to pursue indemnity claims for breaches of representations and warranties as soon as damages exceed the deductible or threshold.

Where is it all heading? It's not entirely clear, although seller- or buyer-favorable provisions tend to wax and wane as markets surge and retreat. Simplicity, smooth execution, full disclosure and avoiding unnecessary post-closing litigation should be central goals in every deal. To the extent a materiality scrape tends to promote these goals over time, it is more likely to become a more common feature of the M&A landscape. To the extent it does not, or to the extent sellers retain overall leverage in the market, it will not. In any case, it appears that the "scrape" has become a permanent fixture in the ongoing discussion between buyers and sellers in private M&A deals. M&A

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