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Why I loathe materiality scrapes (unless I'm representing the buyer)

By DOMINIC A. DIPUCCIO

Buyers' lawyers increasingly are getting more successful in adding so-called "materiality scrape" provisions to acquisition agreements. As seller's counsel, this trend frustrates me. I find them awkward and risky. I push hard to resist them — not on philosophical grounds, but on grounds of improper agreement construction. Here's why.

As far as acquisition agreements go, what's "market" is constantly evolving. Understanding the history of materiality scrapes is important to a proper understanding of these provisions.

Fundamentally, every acquisition agreement allocates risks between buyers and sellers. Starting with the general premise that we don't live in a perfect world, it is well-accepted that buyers must assume some level of risk when it comes to unknown, unanticipated and immaterial matters that arise after an acquisition.

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Appreciating this, sell-side lawyers push hard to qualify seller's representations by concepts of materiality and to secure sizeable indemnity baskets that limit post-closing indemnification to amounts in excess of agreed-to thresholds. Most sophisticated acquisition agreements contain elements of both of these concepts.

Somewhere along the line, an astute buyer's counsel observed the unfairness of the outcome when both concepts are present. Since a seller representation qualified by materiality is not breached unless it crosses the materiality threshold and there is no indemnification for such breach unless it exceeds the agreed-to indemnity basket, it is tantamount to double materiality. Thus, the materiality scrape was invented.

These provisions generally provide that for purposes of determining post-closing indemnifiable losses, concepts of materiality embedded in representations will be ignored. Double materiality scrapes provide that concepts of materiality also will be ignored in determining whether a representation has been breached in the first instance. These provisions are the ultimate in take-backs.

While sympathetic to a buyer's objection to a double materiality standard, the materiality scrape seeks to resolve the issue in a clumsy way. It has unintended consequences (certain representations need to be carefully carved out from the effect of the materiality scrape); leads to unnecessary extra legal work (sellers are advised to over-disclose immaterial items that the buyer isn't interested in in the first place); and potentially adds confusion to already highly complex documents.

The issue the materiality scrape seeks to resolve is purely economic. Its essence lies in determining sellers' post-closing indemnification obligations. Artificially creating breaches when they don't exist to fill an indemnity basket is not good form. Unraveling the hard work to tighten and limit representations and warranties in one swoop of the pen is counterintuitive and risky from a drafting point of view.

More elegant resolutions are available through the indemnification baskets (amount or type) and mini-baskets.

Sellers, if you must agree to a materiality scrape, fight hard to resist the double scrape, increase the size of the indemnity basket and any mini-baskets, and be sure to exclude certain representations. Then, be ready to address the next new buyer-friendly provision proffered in response.

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