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MIDWEST BUSINESS BROKERS AND INTERMEDIARIES

MBBI Newsletter May 2017

The Rise of the Double Materiality Scrape in Mergers & Acquisitions

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A contentious trend in M&A terms negotiations, called the *Double Materiality Scrape*, can put your M&A deal at risk if not handled correctly.

Increasingly, Buyers looking to preserve returns on investment seek inclusion of the Double Materiality Scrape as a sort of "insurance policy." Big Law loves the issue for the cycles of negotiation it creates. Sellers and their attorneys, on the other hand, despise the Double Materiality Scrape, calling it out as a way to undermine a fair balance of representations, warranties and indemnities in a way that Seller becomes a post-closing guarantor for normal business risks that exist at closing.
Unfortunately, it's a byproduct of the "frothy" M&A market we have experienced over the last couple years where sale price premiums come with demands for an increased level of Buyer protection.

> ***"The Double Materiality Scrape is a newer market development gaining popularity due to price competition driving up multiples for reputable companies."***

For both Buyers and Sellers, it is important to understand the difference between the more common *(single) Materiality Scrape* and the increased presence of a Double Materiality Scrape, and how they are being used as a strategic tool.

This article addresses typical frameworks, but there can always be subtle or more overt differences in structure so it's not intended as "one size fits all."

First, some essential background information.

In any M&A transaction agreement, a Seller makes representations and warranties (R&Ws) about the condition of the business, its performance, and that there are no known or unknown undisclosed liabilities – many of these R&Ws include heavily negotiated materiality qualifiers so that, if there is an *immaterial* item that exists which contravenes the R&W, the Seller will not be responsible.

For example, a R&W saying "there are no 'material' liabilities not disclosed on the financial statements" allows for immaterial liabilities that normally arise in the course of business but either don't rise to the level of inclusion on a financial statement or aren't required by applicable accounting to be included.

Indemnification provisions of a typical M&A agreement then require the Seller to indemnify Buyer for Buyer's Losses arising from or caused by the Seller's breach of a R&W, and whether there is a breach might hinge upon whether the R&W is qualified by 'materiality'.

> ***"A Materiality Scrape provision is almost always Buyer-favorable, and an M&A agreement is not required to include one. There will usually be "horse-trading" of other important provisions if one is included in the deal."***

Now that we have materiality qualifiers on R&Ws, what is a (single) Materiality Scrape?

A (single) Materiality Scrape provision in a private M&A transaction agreement helps Buyer recover its Losses for a Seller's breach of R&Ws. One typical version states that for each Seller R&W breach *(determined with R&W materiality qualifiers intact)*, Buyer shall be entitled to recover its Losses flowing from that breach *counting all immaterial and material Losses flowing from the material breach*:

TEST 1 (breach) – Has Seller breached the R&W, reading it with all the negotiated materiality qualifiers included.

- ***If the answer is 'no' (i.e. there are immaterial liabilities at closing not disclosed in the ...***

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- ***… financial statements, but not material undisclosed liabilities), then there is no breach and Buyer doesn't recover Losses from Seller under the indemnification clause.***

TEST 2 (counting) - If the answer is 'yes' (i.e. there *is* a material liability arising from conditions/facts/liabilities existing at closing and not disclosed in the financial statements or in a disclosure schedule of exceptions), then are there Losses from the breach?

- ***Buyer counts/recovers associated Losses, whether material or immaterial, arising from that breach of R&W (*but remember, indemnification provisions may further limit the extent Buyer can recover from Seller the Losses caused by the R&W breach).***

Some logic behind this structure of (single) Materiality Scrape is that, once there is a breach of R&W established (e.g. by a condition or set of circumstances or liability that did exist at close), the Buyer doesn't have to argue with Seller over what part of the breach is material vs immaterial when counting related Losses that Buyer gets to recover.

> ***"While there are items to negotiate, such as the definition of 'liabilities' and 'qualifications,' scope and limitations of the R&W and indemnity provisions, it is arguable that a (single) Materiality Scrape has a centered and fair purpose and gives a Buyer some reasonable comfort that it won't have to duel over every little thing once a material breach has been established."***

Getting creative with the *Double* Materiality Scrape?

In a *Double* Materiality Scrape M&A transaction agreement, the Seller's indemnity provisions state Seller indemnification responsibility to Buyer for breach of R&Ws BUT *reading the R&Ws with all materiality qualifiers removed and determining Losses without regard to materiality*.

The effect is to increase Seller responsibility for condition of the business at closing, insuring to Buyer that there aren't surprise liabilities that existed in whatever form at closing.

If there is a benefit to Seller at all with this structure, it is that Seller technically didn't violate the R&W (when read with materiality qualifiers intact), Seller just allowed broader protection for Buyer under the indemnities (for indemnity purposes, reading the R&W without any materiality qualifiers.)

But Sellers may feel this places too much of the normal operating risk associated with a business onto Seller and circumvents the purposes of the negotiated R&Ws.

A Double Materiality Scrape can be a hotly negotiated provision, and there is typically "horse trading" of provisions and protections on both sides in the process. The trending issue seems to be more important to a financial buyer (e.g. private equity, buyout fund) vs. a strategic buyer.

> ***"As Double Materiality Scrapes become more prevalent, it becomes increasingly prudent to discuss any version of Materiality Scrape in the early stages of an M&A negotiation. A Seller faced with a Double Materiality Scrape might want to evaluate early-on the propriety of R&W insurance for the deal, which involves underwriting time."***

How does this change the M&A approach for Buyers and Sellers?

Related negotiations become even more important, for example, how Buyer sandbagging and Seller Fraud will be handled under the indemnities, and what types of fraud are Fraud for purposes of the M&A agreement. (That topic is outside the scope of this article.)

Depending on the circumstances of the specific deal, the Double Materiality Scrape may end up being the required arrangement. However; it's important to also understand that Materiality Scrapes can alienate a Seller so be prepared to make tradeoffs.

> ***"Discussing Materiality Scrapes – either double or single – in the developmental stages of an M&A negotiation can help reduce the deal risk for Buyer. Some Private Equity, Venture Capital and iBankers are negotiating over Materiality Scrapes as early as the Letter of Intent (LOI) stage."***

Inclusion of Materiality Scrape provisions can result in negotiation "stand-offs" and potentially stop a deal in its tracks, so don't risk the time and money invested in curating your deal by waiting too long in the negotiations before discussing them.

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