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Contract Drafting

Revisiting Materiality



The ambiguity at the heart of a fundamental contract concept.

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THE WORD "material" crops up in many different legal contexts. As regards contract drafting, what has garnered most attention is the role of materiality in mergers-and-acquisitions transactions. Indeed, the literature on the M&A implications of the phrase "material adverse change" is quite voluminous, this author having contributed more than his fair share.[1]

Nevertheless, a fundamental issue regarding materiality has yet to be adequately addressed, namely what drafters mean when they use the word "material." This article explores that topic. Although most of the examples in this article are geared to M&A contracts, its analysis applies to any kind of contract.

The Source of Ambiguity

According to "Black's Law Dictionary," one meaning of "material" is "of such a nature that knowledge of the item would affect a person's decision-making process." (In this article, this meaning is referred to as the "affects a decision" meaning.) This meaning has been embraced in cases addressing securities laws violations,[2] suppression of evidence in criminal matters,[3] and a variety of other fields, as well as in the leading case on materiality in an M&A context, *IBP, Inc. v. Tyson Foods, Inc.*[4] In an M&A context, and from the buyer's perspective, this meaning of "material" refers to information that would have caused the buyer not to enter into the agreement or would cause the buyer not to want to close the transaction. Think "dealbreaker."

But according to "Black's Law Dictionary," another meaning of "material" is "significant," in other words "important enough to merit attention."[5] This meaning would encompass a broader range of significance than the "affects a decision" meaning—for something to be material to a contract party, it would simply have to be of more than trivial significance.

In any given provision, such as the representation "Acme's books and records contain no material inaccuracies," either meaning could conceivably be intended. In other words, "material" is ambiguous.

Which meaning was intended in any given provision would have significant implications. For example, a buyer and its counsel might assume that any non-trivial nondisclosure with respect to a given representation containing a "material" qualification would be sufficient to render the representation inaccurate. By contrast, a court could well hold that for purposes of that representation, "material" conveys the "affects a decision" meaning. That could result in the buyer's not being entitled to be indemnified for inaccuracy of that representation unless the seller's nondisclosure happened to meet the high standard associated with that meaning.

How 'Material' Is Used

Given that cases addressing materiality invariably invoke the "affects a decision" meaning, one would be entitled to wonder whether this ambiguity is more apparent than real. But corporate practitioners invoke materiality so often in drafts and in negotiations as to make it difficult to conceive that each time they do so they have in mind a dealbreaker level of significance. And indeed, two bits of evidence suggest that regardless of the case law, in many contexts drafters do in fact have in mind the "important enough to merit attention" meaning when they use the word "material."

First, attributing the "affects a decision" meaning to the word "material" would often strip a provision of much of its utility. Consider the following representation: "There is no material litigation pending against the Company." If in this representation "material" were given the "affects a decision" meaning, it would be inaccurate only if there was in fact litigation pending against the company and it was sufficiently significant that it would have affected the buyer's decision to go ahead with the deal.

But one suspects that that's not what the buyer had in mind, that instead it would want to be compensated for any losses it incurred due to any non-trivial pending litigation that it hadn't been informed of. For the representation to convey that meaning, "material" would have to mean "important enough to merit attention."

And consider the following example: A credit agreement requires the lender to deliver certain forms unless doing so would "result in the imposition on the Lender of any additional material legal or regulatory burdens, any additional material out-of-pocket costs not indemnified hereunder, or be otherwise materially disadvantageous to the Lender." It's unlikely that in this case the lender had in mind that it would be reimbursed only if the

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burdens, costs, and disadvantages imposed on the lender were sufficiently significant that it wouldn't have made the loan if it had known about them.

It's a straightforward matter to find in contracts containing materiality qualifications instances where similar logic would suggest that the drafter had in mind that "material" should mean "important enough to merit attention."

The second bit of evidence suggesting that drafters do in fact have in mind the "important enough to merit attention" meaning of "material" is that in some contexts one cannot, as a matter of semantics, say that "material" conveys the "affects a decision" meaning.

Consider the following representation: "The Seller is not in default under any Material contract to which it is party." The knowledge imparted by this representation relates to defaults under contracts to which the seller is party rather than to the contracts themselves, existence or nonexistence of which isn't at issue. Consequently, it wouldn't make sense to modify the phrase "contract to which it is party" (as opposed to, say, the word "default") with the word "material" if it's meant to convey the "affects a decision" meaning. In this context, "material" could only mean "important enough to merit attention."

Given that in such instances drafters would seem to have in mind the "important enough to merit attention" meaning, that could also be the meaning intended in other contexts. Or instead the "affects a decision" meaning could be the one intended. Although case law might suggest that one or other meaning is intended, from a semantics perspective one cannot know for sure, as agreements invariably fail to specify which meaning is intended.

Defining 'Material'

Given how fundamental a concept materiality is for purposes of contract drafting, this ambiguity is troubling. The clearest way to eliminate it would be to use two different labels for the two meanings. This article proposes that you use "material" to convey the "affects a decision" meaning and use "non-trivial" to convey a broader range of significance.

If you wish to use "material" to convey the "affects a decision" meaning, you should make that meaning explicit, so as to purge "material" of its ambiguity. In doing so, you'd need to make clear whose perspective applies for purposes of determining materiality. In *IBP, Inc. v. Tyson Foods, Inc.*, the court considered materiality from the perspective of the "reasonable acquiror"; for this approach to apply in any context, one would need to refer to the perspective of a reasonable person in the position of the party in question.

To incorporate these concepts into the meaning of "material," it would be best to use it as a defined term. You might find it useful to also define "materially." For one thing, as a matter of logic it's the most appropriate choice for use in the bringdown condition[6] (see sidebar) rather than the phrase "material adverse change." The exact definition would depend on the context and on which parties are covered by the definition. The first version of the definition of "Material" stated in the sidebar would apply to the buyer in an M&A transaction. By referring to entry into the agreement and consummation of the transaction, the definition would address circumstances relating to the periods before and after signing.

It's commonplace for both the seller and the buyer to be subject to provisions containing a materiality standard. For example, if the bringdown condition to the buyer's obligations is subject to a materiality standard, often the bringdown condition to the seller's obligations will incorporate a materiality standard too. In such contexts, the definition of "Materially" (and perforce "Material") would need to apply to all parties; see the second version of the definition of "Material" stated in the sidebar. If you use that definition of "Material," each bringdown condition would need to make it clear from whose perspective materiality is determined. The sidebar contains two alternative versions of a buyer bringdown condition for use with the two alternative definitions of "Materially."

'Material Adverse Change'

The word "material" is commonly used in the phrase "material adverse change," or MAC. (MAC is preferable to the term "material adverse effect," as unlike that term MAC works equally well in all contexts.)[7] MAC is used to refer to a material adverse change in a party's fortunes, and for the sake of convenience and consistency MAC is generally used as a defined term. Courts and practitioners appear to accept that when used in MAC, "material" conveys the "affects a decision" meaning—any party invoking a MAC provision would need to make a strong showing.[8]

Regarding how you define MAC, this article recommends as the core definition the version

Recommended Materiality Language

Definition of "Material" and "Materially," Version One (Applies to the Buyer)

"Material" and "Materially" refer to a level of significance that would have affected any decision of a reasonable person in the Buyer's position regarding whether to enter into this agreement or would affect any decision of a reasonable person in the Buyer's position regarding whether to consummate the transaction contemplated by this agreement.

Definition of "Material" and "Materially," Version Two (Applies to the Buyer and the Seller)

"Material" and "Materially" refer, with respect to a given Person, to a level of significance that would have affected any decision of a reasonable person in that Person's position regarding whether to enter into this agreement or would affect any decision of a reasonable person in that Person's position regarding whether to consummate the transaction contemplated by this agreement.

Bringdown Condition Qualified by Materiality (Version for Use With Definition of "Material" and "Materially," Version One)

that individually and in the aggregate, the representations made by the Seller in article 2 were Materially accurate as of the date of this agreement and are Materially accurate as of the Closing;

Bringdown Condition Qualified by Materiality (Version for Use With Definition of "Material" and "Materially," Version Two)

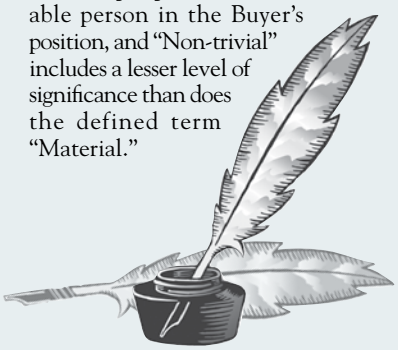
that from the Buyer's perspective, individually and in the aggregate the representations made by the Seller in article 2 were Materially accurate as of the date of this agreement and are Materially accurate as of the Closing;

Core Definition of MAC

"Material Adverse Change" means any Material adverse change in the business, results of operations, assets, liabilities, or financial condition of the Seller.

'Trivial' and 'Non-trivial'

"Trivial" and "Non-trivial" mean trivial and non-trivial, respectively, from the perspective of a reasonable person in the Buyer's position, and "Non-trivial" includes a lesser level of significance than does the defined term "Material."



in the sidebar. But explaining what is included in and excluded from this definition and its various permutations is beyond the scope of this article. Guidance on these issues is available elsewhere.[9]

Defining 'Non-trivial'

Using "non-trivial" to convey the alternative meaning of "material"—as in "Acme's books and records contain no non-trivial inaccuracies"—helps make it clear that one is dealing with a broader range of significance, namely all that is not trivial.

But as with the other meaning, this meaning of "material" raises the question of whose perspective applies for purposes of determining whether something is trivial or not. The cautious approach would be to make that clear: "Acme's books and records contain no non-trivial inaccuracies, as determined from the perspective of a reasonable person in the Buyer's position."

You could create a defined term for "non-trivial" so as to avoid having to specify whose perspective applies whenever you want to use the word. (As compared with the definition of "Material," it's less likely that both the seller and the buyer would be subject to provisions containing a non-triviality standard, so it's unlikely you would need to word the definition of "Non-trivial" so that it applies to all parties.)

You might want to define "trivial" too. For one thing, defining only the negative form would be a little awkward. Also, you might have use for "trivial" in addition to "non-trivial," as in "Acme's books and records contain no inaccuracies other than Trivial inaccuracies." Creating a defined term would also give you the opportunity to state explicitly that "Non-trivial" establishes a lower threshold of significance than does "Material."

These issues are reflected in the definition of "Trivial" and "Non-trivial" contained in the sidebar.

Limiting Qualifications

A buyer that wishes to close a transaction without delay may be particularly amenable to having a given provision be subject to a materiality or non-triviality qualification if the alternative is having the seller devote an inordinate amount of time to compiling a schedule of exceptions. Beyond that, whether to make a representation, obligation, or condition subject to such a qualification is essentially a function of each party's bargaining power. A buyer would always prefer to give a non-triviality qualification rather than a materiality qualification.

Of the two standards, non-triviality seems the more dispensable. Determining whether a given issue merits the buyer's attention would seem prone to arbitrariness, given the low threshold involved. And any party could reasonably claim that if it's willing to go to court to recover damages that it claims arose from, for example, inaccuracy of a representation subject to a non-triviality qualification, then by definition the inaccuracy was non-trivial.

So you might want to avail yourself of bright-line alternatives to a non-triviality qualification. Instead of having a party make a representation as to absence of "breach of any Non-trivial agreement to which Acme is party," you could instead refer to absence of "breach of any agreement to which Acme is party that is listed on Schedule 2.4." And rather than having a party make a representation as to absence of any pending "material litigation," you might want to refer to absence of litigation involving an amount in excess of a stated dollar amount.

And in some contexts it would be appropriate to dispense with a non-triviality qualification and do without any alternative. For example, rather than imposing on Acme a duty to notify Widgetco of non-trivial changes in an agreement that Acme has entered into with some non-party, you could impose a flat obligation, as it's unlikely that the agreement would be amended sufficiently extensively, and sufficiently often, to render that obligation a burden. So in this instance, a significance qualification would accomplish nothing other than add an unnecessary element of uncertainty.

And more generally, you could omit some or all significance qualifications—whether using "material," "non-trivial," or more precise alternatives—if you incorporate a materiality qualification in the seller's bringdown condition and make any seller indemnification obligations subject to a "basket."[10] (A basket is a threshold, expressed as a dollar amount, that indemnifiable losses must reach before the seller becomes liable. Baskets come in two forms: In the case of a "first-dollar" basket, the seller is obligated to pay all indemnifiable losses once those losses exceed the basket. With a "deductible" basket, the seller is obligated to pay only those indemnifiable losses that exceed the basket.)

Incorporating a materiality qualification and a basket, particularly a deductible basket, should eliminate any concern on the part of the seller that giving a "flat" (in other words, unqualified) representation could result in the transaction's not closing due to, or result in that party's incurring liability for, a relatively minor inaccuracy. (You might want to make these changes apply to both the seller and the buyer.)

Basic Protection

The recommendations contained in this article don't reflect the conventional wisdom regarding materiality. That shouldn't come as a surprise, given that when it comes to contract drafting, the conventional wisdom is often flawed. But if you're reluctant to adopt wholesale the definitions recommended in this article, here's a more rudimentary way to avoid coming to grief due to the ambiguous "material": Use "material" only to convey the "affects a decision" meaning. Use some other means of expressing a lesser level of significance. And where circumstances permit, dispense with qualification relating to significance.

1. See Kenneth A. Adams, "A Manual of Style for Contract Drafting," 94-114 (2004); Kenneth A. Adams, "Understanding 'Material Adverse Change' Provisions," M&A Law, June 2006, at 3 [hereinafter Adams, "Understanding MAC"]; Kenneth A. Adams, "A Legal-Usage Analysis of 'Material Adverse Change' Provisions," 10 Fordham J. Corp. & Fin. L. 9 (2004) [hereinafter Adams, "Legal-Usage Analysis of MAC"]. The analysis in this article supersedes the corresponding analysis in these sources.
2. See, e.g., *TSC Industries, Inc. v. Northway, Inc.*, 426 US 438, 449 (1976).
3. See, e.g., *U.S. v. Bagley*, 473 US 667, 682 (1985).
4. 789 A2d 14, 68 (Del. Ch. 2001).
5. The New Oxford American Dictionary 1335 (2001).
6. See Lou R. Kling & Eileen T. Nugent, Negotiated Acquisitions of Companies, Subsidiaries and Divisions §14.02 (2007) (discussing the bringdown condition).
7. See Adams, "Understanding MAC," supra note 1, at 5; Adams, "Legal-Usage Analysis of MAC," supra note 1, at 17.
8. See Adams, "Legal-Usage Analysis of MAC," supra note 1, at 27.
9. See Adams, "Understanding MAC," supra note 1, at 5-8; Adams, "Legal-Usage Analysis of MAC," supra note 1, at 20-49.
10. See Negotiating and Drafting Contract Boilerplate 279-81 (Tina L. Stark ed. 2003) (discussing baskets).

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