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The Building Blocks of Materiality

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Representations and warranties play an important role in M&A agreements by providing valuable disclosures and allocating risks between the parties. Representations regarding the target company's financial statements are particularly significant, as buyers consider these in entering and pricing a deal. A typical representation will state that the target company's financial statements were prepared in accordance with generally accepted accounting principles (GAAP), consistently applied, and that the financial statements fairly present, in all material respects, the company's consolidated financial position. Compliance with GAAP and fair presentation are interrelated, but different, concepts.

A consistent application of GAAP requires a company to use the same accounting methods in one period that it used in prior periods to allow for meaningful comparison of financial trends across time. A fair presentation of a company's financial position, on the other hand, goes beyond the application of GAAP and requires that financial statements, taken as a whole, provide a fair representation of a business' financial condition, at least as to material matters. Whether given financial statements "consistently apply" GAAP and "fairly present" a financial position are likely to turn much more on relevant accounting standards than legal ones. Yet the legal implications are important to understand at the time a deal is made, as these representations often end up the subject of post-acquisition disputes when a buyer believes the target has misrepresented its earnings or other financial information.

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Consistent Application of GAAP

A representation that a company's financial statements are prepared in accordance with GAAP, consistently applied, appears in most M&A agreements, and it is typically interpreted by reference to relevant accounting standards. Compliance with GAAP is essential, though courts have recognized that GAAP is a flexible construct that often permits a company to choose among multiple different

accounting methods, and they will defer to the professional judgment of accountants when it comes to such decisions. *See*, *e.g.*, *Marceau Investissements v. Sonitrol Holding Co.*, 1991 WL 202185, at *22 (Del. Ch. Oct. 17, 1991) ("Courts are not expert in the intricacies of accounting theory. They are not endowed with greater wisdom to decide whether one accounting principle is superior to another as a legal matter, where both principles fall within the highly discretionary range of accounting judgments denominated by the accounting profession as 'GAAP.'"); *see* also *Godchaux v. Conveying Techniques*, 846 F.2d 306, 315 (5th Cir. 1988) (noting the Supreme Court requires a court to defer to an accountant's judgment in determining which GAAP-compliant procedures to apply and "limits a district court, in reviewing such an accountant's work, to deciding only whether the accountant chose a procedure from the universe of generally accepted accounting principles."). Thus, a court is unlikely to find a seller or target company has breached this representation simply because the buyer prefers a different GAAP-compliant method of accounting.

Compliance with GAAP alone is not enough, however; typically these representations incorporate the consistent application of GAAP. Some courts in Delaware and elsewhere have construed such provisions to mean that a company has used the same methods of accounting from one period to the next. *See Marceau Investissements,* 1991 WL 202185, at *15 (finding that, "[f]or GAAP to be 'consistently applied,'" defendant was required to use the same method of accounting in successive periods); *Harvard Indus., Inc. v. Wendel*, 178 A.2d 486, 490 (Del. Ch. 1962) (agreement stating that financial statements at issue must be "prepared in accordance with accounting principles consistently applied" required the statements to "be prepared in accordance with the accounting principles that had been consistently applied in the past"). Thus, the "consistent application" requirement may limit the court's interpretation of GAAP, which is otherwise "flexible" and allows for the use of alternative methods of accounting, to include only those principles that had been applied in prior periods. *Godchaux*, 846 F.2d at 315-17.

Fair Presentation

The concept of a "fair presentation" is also grounded in accounting and auditing principles, though this requirement looks beyond compliance with GAAP to require some measure of fairnesss.
In *Mercury Cos., Inc. v. FNF Sec. Acquisition, Inc.*, 2015 WL 5920163, at *6 (Bankr. D. Colo. Oct. 9, 2015), the court determined that "the term 'fairly present' is clear and unambiguous and should be ascribed its ordinary meaning as set forth in Black's and Merriam-Webster: whether the Financial Statements presented the [companies'] information 'equitably, honestly, impartially, reasonably, and with substantial correctness." Consistent application of GAAP can be a factor in determining whether financial statements fairly present a company's financial condition; the court in *Mercury Cos.* determined that a seller had not breached this representation where, inter alia, the seller was following an accounting policy consistent with how its auditor previously conducted its reporting.

A financial statement's accuracy is also highly relevant to the concept of fair presentation. One Delaware district court found that, in order to prevail on its claim that the defendants' financial

statements did not fairly present its financial condition, a plaintiff had "to demonstrate that there was a material discrepancy that caused the Financial Statements to be an unfair and materially inaccurate presentation of the financial condition and results of the combined operation of the business." *S.C. Johnson & Son, Inc. v. DowBrands, Inc.*, 167 F. Supp. 2d 657, 672 (D. Del. 2001). The court determined that the misclassification of a small percentage of sales as foreign instead of domestic did not "materially turn the Financial Statements into an unfair presentation," though it noted that the accuracy of the numbers themselves were not at issue.

Materiality and Materiality Scrapes

However, the analysis does not end there. Indemnification provisions in M&A agreements — as well as representations and warranties insurance policies — often contain "materiality scrape" provisions, which remove references to materiality generally in the representations and warranties for purposes of determining whether a company has breached its representations and warranties or for the determination of loss caused by such a breach. (A provision that precludes consideration of materiality from both inquiries is known as a double materiality scrape.) In the typical example, then, the materiality scrape may remove the qualification that financial statements provide a fair presentation "in all material respects," thus in theory expanding the fair presentation requirement to all items in the financial statement, regardless of materiality.

Yet such provisions pose unique issues in the context of financial statement representations, as both GAAP and fair presentation contain inherent materiality components. Materiality is integral in financial reporting. GAAP advises that a company need not implement requisite accounting standards where items are immaterial. Similarly, a fair presentation requires a "materially accurate and complete picture of an issuer's financial condition." *City of Roseville Emps.' Ret. Sys. v. Horizon Lines, Inc.*, 686 F. Supp. 2d 404, 418 n. 21 (D. Del. 2009); *see* also *United States v. Arthur Young & Co.*, 465 U.S. 805, 818 n.13 (1984) (an auditor's report must indicate that a financial statement is not fairly presented where it contains material misstatements).

What, then, is the effect of such a scrape on a financial statement representation? One Delaware court addressed the issue in a case alleging a breach of representations in a securities purchase agreement. *Hudson's Bay Co. Luxembourg, S.A.AR.L. v. JZ LLC*, 2013 WL 1457019 (Del. Super. Ct. Mar. 11, 2013). In construing the requirements of Canadian GAAP, the court rejected plaintiff's argument that a contractual materiality scrape could remove the concept of materiality inherent in GAAP. *Id.* at *12. The court noted that "[m]ateriality is one of the most fundamental concepts underlying financial reporting. It is the term used to describe the significance of financial statement information to decision makers … To adopt Plaintiff's interpretation of the 'Materiality Scrape' would render GAAP virtually meaningless. Materiality is deeply engrained in almost every aspect of GAAP … Had the parties intended the 'Materiality Scrape' to apply with equal force to GAAP—thereby removing materiality from GAAP—they would and should have included such language to that effect. But such language was not included." Id. (internal quotations omitted).

Similarly, if “fair presentation” itself is deemed to include an inherent materiality limitation, a court may only consider an item to be “unfairly presented” if it is misrepresented in a material way. In this way, materiality scrapes — which can otherwise have significant consequences for a determination of breach or damages may not remove the materiality component inherent in the concepts of GAAP and fair presentation. The result, of course, would be to limit findings of breach and damages to those misrepresentations that have a material effect, which is important for parties to consider before and after a dispute arises.

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