

Materiality Scrape Meets the Absence of Changes Representation: Delaware Superior Court Establishes Order of Operations for Deal Attorneys

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In *JanCo FS 2, LLC v. ISS Facility Services, Inc.*, the Delaware Superior Court's Complex Commercial Litigation Division issued a post-trial opinion interpreting the interaction between a materiality scrape provision and a contractually defined "Material Adverse Effect" qualifier in the context of an absence of changes representation. The decision provides important and unusually explicit guidance for deal attorneys on how materiality scrapes actually operate when applied to Material Adverse Effect-qualified representations, and it should prompt practitioners on both sides of a transaction to pressure-test their drafting.

Background

ISS Facility Services, Inc. (ISS) sold its cleaning business to JanCo FS 2, LLC (JanCo), a subsidiary of the Argenbright Group, for \$80 million under an asset purchase agreement (APA). The APA contained a standard suite of seller representations, including an absence of changes representation in Section 4.10, which provided that since June 30, 2021 (several months prior to the closing date), ISS had not suffered any change or event that had, or could reasonably be expected to have, a "Material Adverse Effect" on the business.

The APA defined term "Material Adverse Effect" was itself circular, using "material adverse effect" (lowercase, undefined) within the definition. This is not an unusual drafting convention; many acquisition agreements define the capitalized Material Adverse Effect term by reference to a lowercase "material adverse effect," intending the lowercase usage to carry its ordinary meaning under Delaware law.

The APA also contained a materiality scrape in Section 7.5(f), which provided that for indemnification purposes, "all qualifications and limitations set forth in the Parties' representations and warranties as to 'materiality,' 'Material Adverse Effect,' 'Material Adverse Change' and words of similar import shall be disregarded" in determining whether a breach of the representations and warranties had occurred.

After closing, JanCo alleged ISS breached the absence of changes representation based on a significant increase in temporary labor costs and operational disruptions caused by a botched rollout of ISS's new HR system during the pre-closing interim period. The key interpretive question was how the materiality scrape interacted with the defined Material Adverse Effect term in the absence of changes representation, and whether the scrape reduced the buyer's burden to showing merely *any* adverse effect, rather than a *material* one.

The Court's Interpretation: Order of Operations

The court sided with JanCo and adopted what amounts to a two-step “order of operations” for applying the materiality scrape to representations that reference a defined Material Adverse Effect term.

Step one: Insert the definition. Because “Material Adverse Effect” is a defined term, functioning as “a convenient substitute for the definition,” the court first replaced the capitalized term in Section 4.10 with its full contractual definition. After this substitution, the absence of changes representation effectively provided that ISS had not suffered any change that had a “material adverse effect” (lowercase) on the business.

Step two: Apply the scrape. The court then applied the materiality scrape, which removed “materiality” and “words of similar import” from the representations. With “material” scraped from the now-expanded text, the representation was reduced to a warranty that ISS had not suffered any change that had an *adverse effect* on the business, a dramatically lower threshold.

The court rejected ISS’s competing interpretation, which would have struck the defined term “Material Adverse Effect” from the representation *before* inserting its definition, an approach that left a blank in the operative text and rendered the provision nonsensical. The court found this was simply the wrong order of operations: “Inserting the definition before employing the Materiality Scrape is the proper order of operations, as it prevents [the absence of changes provisions] from becoming illegible.”

Notably, the court observed that neither party’s briefing got the analysis exactly right. JanCo reached the correct result but “skip[ped] the key step of implementing the full definition of Material Adverse Effect before scraping ‘material.’” ISS’s approach produced illegible text. The fact that the parties themselves struggled to explain the mechanics of their own materiality scrape, a provision that appears in nearly every acquisition agreement, highlights the latent ambiguity these clauses carry.

Structural Reinforcement: Baskets, Caps, and the Risk Allocation Framework

The court did not interpret the materiality scrape in isolation. It bolstered its broad reading by examining the APA’s indemnification architecture, treating the basket, cap, and damage exclusions as evidence of the parties’ intended risk allocation.

The APA contained a \$500,000 basket and a cap of 12.5% of the purchase price, along with exclusions for categories of damages, including lost profits and diminution in value. The court reasoned that the existence of a relatively low basket was inconsistent with a requirement to prove a material adverse effect, which Delaware courts have generally associated with declines in the range of 40% or more, because a Material Adverse Effect would produce damages far exceeding not only the basket but the cap. In the court’s view, the basket and cap structure “indicates the Parties did not intend for a material adverse effect to be proven before indemnification is available.”

The court further rejected ISS’s argument that the broad reading rendered the absence of changes representation overbroad, noting that the damage exclusions and indemnification limits reflected the parties’ negotiated risk allocation and provided meaningful constraint on JanCo’s recovery even under the lowered breach threshold. In the court’s words, it would “not punish JanCo for succeeding at the bargaining table.”

Proving Breach but Recovering Nothing

Despite finding a breach, the court denied JanCo any recovery. JanCo's fraud and willful misconduct claims failed because JanCo knew about the staffing and operational issues before closing, defeating justifiable reliance, and because the court held ISS could not knowingly breach a provision whose scope neither party understood. With fraud and willful misconduct defeated, JanCo's recovery was limited by the APA's indemnification framework, and JanCo's damages theory, an all-or-nothing diminution-in-value figure that was not apportioned among its various breach claims, was both untethered to the single breach it proved and independently barred by the APA's exclusion of lost profits and diminution in value from indemnifiable losses.

Takeaways for Deal Attorneys

This decision should change how practitioners approach materiality scrapes in several concrete ways:

- **Model the scrape before you sign.** The court's order of operations, insert the Material Adverse Effect definition first, then apply the scrape, means that any materiality qualifier embedded within a circular Material Adverse Effect definition will be stripped out for indemnification purposes. Practitioners should walk through this two-step exercise on every representation in the agreement that references the defined Material Adverse Effect term. The results may be far broader, or far narrower, than either side appreciates at the drafting table.
- **Circular Material Adverse Effect definitions create a trap for sellers.** When the defined Material Adverse Effect term contains a lowercase "material adverse effect" within its definition, the materiality scrape reaches through the defined term and removes the materiality qualifier at the definitional level. Sellers who agree to a materiality scrape without appreciating this dynamic may be making representations that are, for indemnification purposes, unqualified. Sellers seeking to preserve the Material Adverse Effect threshold should consider drafting the Material Adverse Effect definition to avoid using "material" or similar language internally, or should negotiate specific carve-outs from the scrape for the absence of changes representation.
- **Buyers can use this architecture intentionally.** For buyers, this decision validates the strategy of pairing a broad materiality scrape with a circular Material Adverse Effect definition to create a low-threshold absence of changes warranty for indemnification purposes while preserving the Material Adverse Effect standard for other purposes (such as closing conditions). Buyers should ensure their materiality scrape language expressly covers "Material Adverse Effect," "materiality," and "words of similar import" to capture both the defined term and any residual materiality language that survives the definitional insertion.
- **The indemnification structure must be internally consistent.** The court used the basket, cap, and damage exclusions as interpretive guideposts, reasoning that a low basket was inconsistent with a requirement to prove a Material Adverse Effect. Deal attorneys should ensure the indemnification architecture tells a coherent story. A seller who agrees to a low basket while resisting a materiality scrape may find that the basket itself is used as evidence that the parties intended a low breach threshold. Conversely, a buyer who negotiates a materiality scrape but agrees to narrow damage categories may win on the breach but have no avenue to recover, as JanCo discovered.
- **Consider scrape-specific exclusions for particular representations.** Rather than applying the materiality scrape uniformly across all representations, parties may benefit from negotiating tailored treatment. For example, a seller might agree to a full scrape on the financial statements representation but seek to exclude the absence of changes representation from the scrape or vice versa. This decision makes clear that a blanket scrape, applied to representations with embedded Material Adverse Effect qualifiers, can produce results that neither party anticipated.
- **Damages planning starts at the drafting stage.** While the materiality scrape analysis is the headline, this decision is also a cautionary tale about the gap between proving a breach and recovering for it. Buyers should ensure that the types of damages they are most likely to suffer in a downside scenario, including diminution in value and lost profits, are not excluded from the indemnification framework, and should develop breach-specific damages theories rather than relying on an omnibus approach. A materiality scrape that lowers the breach threshold is only valuable if the buyer can recover meaningful damages once a breach is established.

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