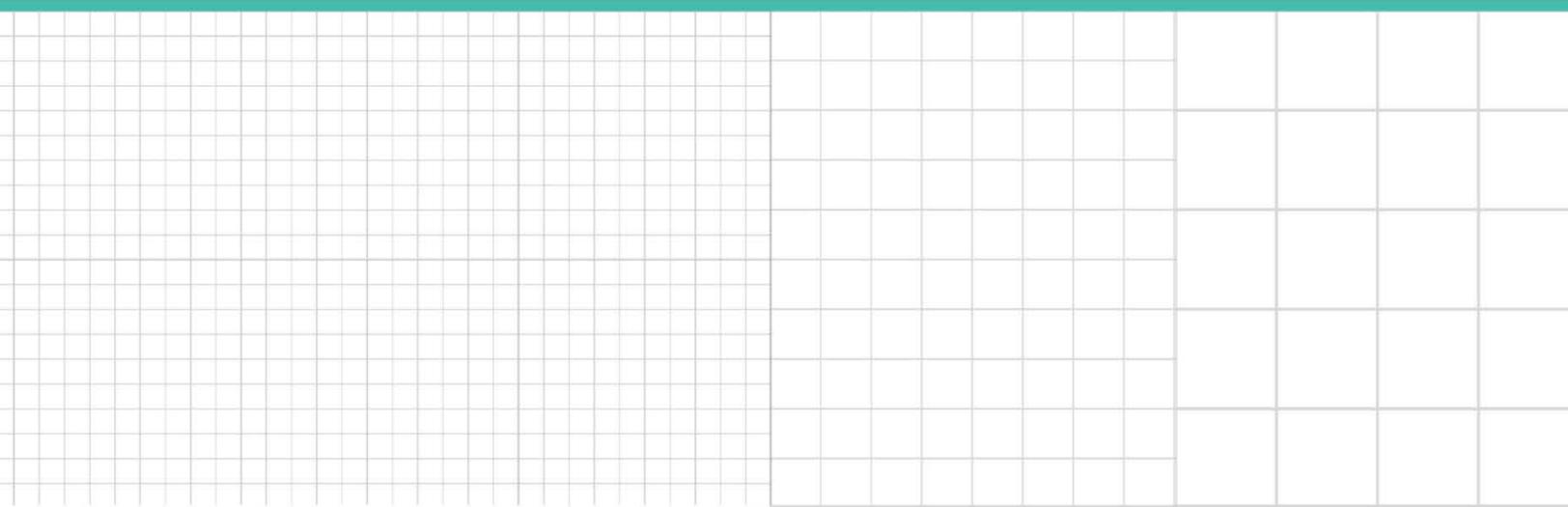


**Professional Perspective**

# **Exclusion of Consequential Damages**

*Daniel Avery, Goulston & Storrs*

Reproduced with permission. Published November 2020. Copyright © 2020 The Bureau of National Affairs, Inc. 800.372.1033. For further use, please visit: <http://bna.com/copyright-permission-request/>



# Exclusion of Consequential Damages

Contributed by *Daniel Avery*, *Goulston & Storrs*

## Market Trends: What You Need to Know

As shown in the American Bar Association's Private Target Mergers and Acquisitions Deal Point Studies:

- Only 2% to 9% of the merger and acquisition purchase agreements covered by the studies expressly included consequential damages within the scope of indemnified losses
- 26% to 39% of the purchase agreements expressly excluded consequential damages within the scope of indemnified losses
- 39% to 65% of the purchase agreements were silent on the issue

## Introduction

In M&A transactions, the definitive purchase agreement, whether asset purchase agreement, stock purchase agreement, or merger agreement, typically contains representations and warranties and related indemnification covenants. Buyers and sellers often negotiate the scope and types of damages subject to indemnification under the purchase agreement, including whether consequential damages that the buyer may suffer as a result of the seller's breach should be included in, or excluded from, the seller's indemnification obligations. This article examines consequential damage exclusion trends in private company M&A transactions.

## Consequential Damages Exclusions

Consequential damages is one of those U.S. legal concepts that all lawyers learn about in law school, but nonetheless generates confusion and disagreement in legal practice.

A typical seller's indemnification provision in an M&A purchase agreement may read:

The Seller agrees to and will defend and indemnify the Buyer Parties and save and hold each of them harmless against, and pay on behalf of or reimburse such Buyer Parties for, any Losses which any such Buyer Party may suffer, sustain or become subject to, as a result of, relating to or arising from: (i) any breach by the Seller of any representation or warranty made by the Seller in this Agreement; (ii) any breach of any covenant or agreement by the Seller under this Agreement, or . . .

Because indemnification provisions shift liability from buyer to seller, the definition of "losses" within the purchase agreement is critical. "Losses" are normally defined broadly and may include, for example:

Any loss, liability, demand, claim, action, cause of action, cost, damage, royalty, deficiency, penalty, tax, fine or expense, whether or not arising out of third party claims (including interest, penalties, reasonable attorneys' fees and expenses) and all reasonable amounts paid in investigation or defense, and all amounts paid in settlement, of any of the foregoing.

Sellers, understandably, seek to limit the scope of the losses to which they provide indemnification. Consequential damages, along with special, incidental, and punitive damages, are often the focus of negotiations regarding the scope of damages.

## Seller and Buyer Positions

During negotiations, sellers often assert that they should not be responsible for "speculative" damages or damages which are not otherwise foreseeable. This common argument is likely misplaced insofar as it relates to consequential damage exclusions, since, as noted below, consequential damages do not normally include those which are not reasonably foreseeable in the first instance. By contrast, the buyer typically argues that it should not be required to waive and exclude damages that it would otherwise, absent such waiver and exclusion, be able to assert against a seller in a normal breach of contract claim. This argument has limitations, however, because buyers often do agree to waive and exclude some types

of damages—most notably, special, incidental, or punitive damages. A common formulation with respect to punitive damages is to exclude such damages from the scope of indemnified losses as to claims between buyer and seller, but not those payable to third parties as a result of third party claims otherwise covered by the indemnities.

### **The *Hadley v. Baxendale* Precedent**

The seminal case regarding consequential damages is *Hadley v. Baxendale*, an English contract case from 1854. [156 Eng. Rep. 145](#) (1854). This case serves as the precedent for our modern day understanding of consequential damages recoverable upon breach of contract. In *Hadley*, a broken crankshaft forced Mr. Hadley to shut down his mill which resulted in lost profits each day the mill stayed closed. Hadley hired Baxendale's delivery firm to deliver the broken crankshaft to the manufacturer for replacement.

Hadley did not communicate to Baxendale the reason for the delivery, nor did he inform the firm of the significant loss profits he would incur as a result of a delayed delivery. Baxendale's firm agreed to transport the shaft the day after it was received but did not actually ship the part until five days later. Hadley sued for breach of contract, seeking recovery for lost profits due to the mill's additional closure time.

The court denied Hadley's claim for lost profits, concluding that damages must arise “naturally ... from such breach of contract itself, or such as may reasonably be supposed to have been in the contemplation of both parties, at the time they made the contract, as the probable result of the breach of it.” According to the court, Hadley's lost profits could not be a consequence of a breach of contract if the parties did not reasonably foresee the lost profits as a consequence during the contract's formation.

The *Hadley* rule establishes two categories of recoverable contract damages: losses that would arise “normally and naturally” from a breach of any similar contract; and any other losses arising from the “special circumstances” of the non-breaching party, if those special circumstances were communicated to the breaching party when the contract was made. See Glenn D. West & Sara G. Duran, “Reassessing the ‘Consequences’ of Consequential Damage Waivers in Acquisition Agreements,” 63 Bus. Law. 777, 785 (2008). In both circumstances, recoverable damages must originate from a probable consequence of the breach of contract and therefore be “within the contemplation of the parties” during formation.

## **Modern Day Consequential Damages**

Contract law seeks to enforce promises made between parties. Unlike tort law, which compensates a victim for a wrongdoer's conduct, damages in contract law only consider whether a party performed or breached the contract. Generally stated, absent specific language in the contract to the contrary, a party's specific reasons or motivations underlying its breach do not impact recoverable contract damages.

The non-breaching party is entitled to recover all damages sustained to place the non-breaching party in a position where the party would have been had there been no breach of contract. However, recoverable damages, including consequential damages, are limited to those that are “natural, probable, and reasonably foreseeable [or within the contemplation of the parties as a] consequence of the [breach].” West & Duran (quoting *Enter. Oil Ltd. v. Strand Ins. Co. Ltd.*, [2006] EWHC (Comm) 58 [2006], 1C.L.C. 33, 49). While natural, probable, and reasonably foreseeable seems like a straightforward standard, the difficulty is in its application to specific facts.

West & Duran suggest consequential damages includes “all losses sustained by the non-breaching party to a contract as a result of the breaching party's default, beyond those losses that would normally and necessarily result from such breach in the absence of the non-breaching party's special circumstances.” The authors go on to state that even “more simplistically, ‘consequential’ or ‘special’ damages should be understood as encompassing all contractually recoverable damages that do not fit within the category of either ‘incidental’ damages or ‘direct’ damages.”

In contrast, another commentator has [opined](#) that whenever “you use in a contract a term of art such as ‘consequential damages,’ you're inviting confusion: any two people might have different ideas to what it means, assuming that they've given the matter any thought.” Ken Adams, [New Article on Consequential Damages](#), Adams on Contract Drafting (July 23, 2008).

The state laws governing the purchase agreement's interpretation are likely to determine the specific classification of damages among direct, consequential, or other types of damages. Accordingly, the purchase agreement's choice of law

provision may have a material effect in a post-closing dispute as to which buyer damages are included, or excluded, from recovery upon the seller's breach. This is particularly noteworthy considering a recent trend, discussed below, indicating that parties are remaining silent on this point in the purchase agreement (i.e., neither expressly including, nor excluding, consequential damages from recovery).

## The ABA Studies

Every other year since 2005 the ABA has released its Private Target Mergers and Acquisitions Deal Point Studies. The ABA studies examine purchase agreements of publicly available transactions involving private companies. These transactions range in size but are generally considered as within the "middle market" for M&A transactions; the median transaction value within the 2019 study was \$145 million.

According to the 2019 ABA study, only 8% of the agreements reviewed included a consequential damages "inclusion" provision (i.e., a provision that expressly includes consequential damages within indemnified losses), while 26% of the agreements expressly excluded consequential damages from coverage, and 65% of the agreements were silent on the issue. Over the 12-plus years covered by the seven prior ABA studies:

- Only 2% to 9% of the purchase agreements expressly included consequential damages within indemnified losses
- 26% to 39% of the purchase agreements expressly excluded consequential damages within indemnified losses
- 39% to 65% of the purchase agreements were silent on the issue

Thus, in about 90% of reported deals in the most recent ABA study, the purchase agreement either expressly excluded consequential damages within indemnified losses, or was silent on the issue. The trend for remaining silent on consequential damages has shifted over the past several years. According to the ABA studies, remaining silent on the issue (as opposed to excluding consequential damages) was the majority approach from 2006 to 2009, but was surpassed by express exclusion from 2011 to 2015 (despite remaining a strong minority approach during this period). However, in the 2017 study, the trend again reversed, with silence again becoming the majority approach (with 52% and 65% of reviewed agreements remaining silent on the matter in 2017 and 2019, respectively).



## Conclusion

Nineteenth century English case law aside, as a practical matter, it is often difficult to determine, or at least to have any two lawyers agree upon, which types of damages constitute consequential damages. Given the often blurred parameters between direct and consequential damages, M&A lawyers should carefully consider the potential impact of including or excluding consequential damages in M&A purchase agreements because the provisions can materially impact a party's responsibility for breaches of the agreement.