

Trends in M&A Provisions: Exclusion of Consequential Damages

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Introduction

In merger and acquisition (“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.^[2] 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.^[3] This article examines consequential damage exclusion trends in private company M&A transactions.^[4]

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

When negotiating the inclusion or exclusion of consequential damages, sellers often assert that they should not be responsible for “speculative” damages or damages which are not otherwise foreseeable. As noted below, this common argument is likely misplaced. 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 also has limitations because buyers often do agree to waive and exclude some types of damages—most notably, special, incidental, or punitive damages.[5]

The Hadley v. Baxendale Precedent

The seminal case regarding consequential damages is *Hadley v. Baxendale*,[6] an English contract case from 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.[7]

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.”[8] 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.[9] The *Hadley* rule establishes two categories of recoverable contract damages: (1) losses that would arise “normally and naturally” from a breach of any similar contract; and (2) 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.[10] 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.[11]

Modern Day Consequential Damages

Many M&A sellers incorrectly believe that consequential damages include losses that are speculative or otherwise beyond the contemplation of the parties at the time of contract formation. Defining consequential damages as such would extend the recovery for breach of contract damages

beyond the judicially imposed limit of reasonableness, and more importantly, beyond the extent U.S. courts can provide legal redress.

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.^[12] Generally stated, absent specific language in the contract to the contrary,^[13] a party's specific reasons or motivations underlying its breach do not impact recoverable contract damages.^[14] 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.^[15] 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]."^[16] While natural, probable, and reasonable foreseeable seems like a straightforward standard, the difficulty is in its application to specific facts.

A leading scholarly article on the topic suggests 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."^[17] The authors go on to state that "[e]ven 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."^[18] In contrast, another commentator has opined that "[w]henver 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."^[19]

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).

Consequential Damages Exclusions According to the ABA Studies

Every other year since 2005 the American Bar Association ("ABA") has released its Private Target Mergers and Acquisitions Deal Point Studies (the "ABA studies"). The ABA studies examine purchase agreements of publicly available transactions involving private companies that occurred in the year prior to each study (and in the case of the 2017 study, including the first half of 2017). These transactions range in size but are generally considered as within the "middle market" for M&A transactions; the average transaction value within the 2017 study was \$176.3 million.

According to the 2017 ABA study, only nine percent of the agreements reviewed included a consequential damages "inclusion" provision (i.e., a provision that expressly includes consequential damages within indemnified losses), while 39% of the agreements expressly excluded

consequential damages from coverage, and 52% of the agreements were silent on the issue. Over the 11-plus years covered by the six prior ABA studies:[20]

- Only two to nine percent of the purchase agreements expressly *included* consequential damages within indemnified losses;
- 31% to 39% of the purchase agreements expressly *excluded* consequential damages within indemnified losses;
- 39% to 63% of the purchase agreements were silent on the issue.

Thus, in at least nine out of ten reported deals, the purchase agreement either: (i) expressly excluded consequential damages within indemnified losses; or (ii) 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 2010 to 2017 (despite remaining a strong minority approach during this period). However, in the 2017 study, the trend has again reversed, with silence again becoming the majority approach (with 52% of reviewed agreements remaining silent on the matter).



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 could materially impact a party's responsibility for breaches of the agreement.

[1] Daniel Avery is a director and co-chair of the Business Law Group at Goulston & Storrs, in Boston. Mr. Avery is a member of the American Bar Association's working group which published the 2017 ABA private company mergers and acquisitions deal points study referenced within this article. Mr. Lin is an associate in the Corporate & Business Transactions group at Morgan, Lewis & Bockius in Boston, where he assists clients with a broad range of corporate matters, including mergers and acquisitions, private equity transactions, venture capital financings, securities, and corporate governance. This article is based on, and updates, the article of the same name co-authored by Mr. Avery and Mr. Lin, and published in the Bloomberg Mergers & Acquisition Law Report, 18 MALR 414, 3/17/2014. This article is one of a series of over 20 articles co-authored by Mr. Avery looking at trends in private company M&A deal points. The series is currently being updated to reflect the 2017 ABA private company study and will be published throughout 2018. The articles can be found on Goulston & Storrs' "What's Market" web page at <https://www.goulstonstorr.com/whats-market/> and on Bloomberg Law at https://www.bloomberglaw.com/page/infocus_dealpoints.

[2] Note that within this article we use the terms "seller" and "company" in the context of a stock purchase transaction—the "seller" would be the selling shareholder(s) making the representations and warranties in the M&A purchase agreement, and the "company" would be the company being acquired. In an asset purchase transaction, the "seller" would be the target company itself but for consistency we are using "seller" and "company" in a stock purchase setting.

[3] Generally, indemnification obligations in a purchase agreement are not applicable solely to the seller: i.e., the buyer also usually agrees to indemnify the seller for its breaches. As a practical matter, however, the seller's obligations (including representations, warranties, and covenants) are typically much broader and more extensive than the buyer's obligations, and accordingly the seller is usually more inclined than the buyer to exclude consequential damages or otherwise limit indemnification coverage.

[4] This article looks at the usage of consequential damages exclusions in private company M&A transactions as reflected in the ABA private target deal point studies. This article does not cover such provisions in other types of transactions or in public-to-public M&A transactions.

[5] 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.

[6] 156 Eng. Rep. 145 (1854), reproduced at <http://mtweb.mtsu.edu/cewillis/Hadley%20v%20Baxendale.pdf> (as viewed Apr. 23, 2018).

[7] *Id.*

[8] *Id.*

[9] *Id.*

[10] Glenn D. West & Sara G. Duran, Reassessing the “Consequences” of Consequential Damage Waivers in Acquisition Agreements, 63 Bus. Law. 777, 785 (2008).

[11] *Id.*

[12] See *id.* at 782 (“The law of torts enforces society's desire that we be left free from the harmful conduct of others, while the law of contracts enforces society's desire that promises made between its members be performed”).

[13] For example, M&A purchase agreements sometimes carve-out from indemnification limitations intentional breaches of a party's representations and warranties.

[14] West & Duran, *supra* note 9, at 782.

[15] *Id.* at 783.

[16] *Id.* (quoting *Enter. Oil Ltd. v. Strand Ins. Co. Ltd.*, [2006] EWHC (Comm) 58 [2006], 1C.L.C. 33, 49).

[17] *Id.* at 788-789.

[18] *Id.* at 789.

[19] Ken Adams, *New Article on Consequential Damages*, Adams on Contract Drafting (July 23, 2008), <http://www.adamsdrafting.com/new-article-on-consequential-damages/> (last visited Apr. 23, 2018).

[20] References to the “ABA Study Years” are to the years in which the ABA studies were published, which have followed the year in which the reviewed transactions occurred (though the 2017 ABA study also included transactions occurring during the first half of 2017). The 2005 ABA study did not examine the exclusion of consequential damages, and therefore this study is not included within the chart.