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Trends in M&A Provisions: Damage Mitigation Provisions

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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, warranties, and covenants, along with related indemnification obligations. The scope of the parties' respective indemnification obligations is usually among the most heavily and intensely negotiated portions of the purchase agreement. One topic that often comes up for discussion between the seller and the buyer [1] is whether the indemnification obligations should be limited by, or whether the purchase agreement should otherwise contain, an express obligation of the indemnified party to mitigate damages. [2]

Damage Mitigation Provisions

General

The indemnification obligations under an M&A purchase agreement generally pertain to breaches of the representations, warranties, and covenants of the respective parties, but sometimes also apply to other legal or business matters on a standalone basis, regardless of whether such a breach has occurred. [3] The typical M&A purchase agreement includes indemnification from the seller to the buyer, and vice versa. However, because the seller's representations, warranties, and covenants, and related indemnification obligations, are normally broader in scope and substance than those of the buyer, it is usually the seller who seeks to include damage mitigation (because the seller is more likely to be the indemnifying party and therefore more interested in including provisions that reduce indemnification liability, even if the same limitations are applicable to the buyer as well). Accordingly, this article looks at damage mitigation provisions assuming that the seller is more inclined, and the buyer less inclined, to include such provision in the purchase agreement.

A typical indemnification provision 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, (iii) any Taxes of the Seller or its Affiliates; or (iv) the matters set forth on Schedule X.

Damages mitigation provisions may take different forms, including a provision drafted similar to the following:

Indemnitee shall be responsible for taking or causing to be taken all reasonable steps to mitigate its Losses upon and after becoming aware of any event that could reasonably be expected to give rise to Losses that may be indemnifiable under this Agreement.

The negotiation between the buyer and the seller generally focuses on whether the purchase agreement will include an express duty to mitigate or remain silent on the matter. Buyers generally do not ask for a provision that expressly states that the buyer has no duty to mitigate (and while undoubtedly such provisions have been negotiated, the authors, in their experience, have not seen such a request). [4] This is not surprising given that there generally is a duty to mitigate damages under common law contract principles in the absence of an express contractual obligation to do so, as noted below.

The Duty to Mitigate Damages

It is a general principle of contract law in the U.S. that a party cannot recover damages for losses if those damages could have been reasonably mitigated or avoided. [5] The reference to this as a "duty" is somewhat of a misnomer because the aggrieved party "incurs no liability for his failure to act. The amount of loss that he could reasonably have avoided by stopping performance, making substitute arrangements or otherwise mitigating the damages is simply subtracted from the amount that would otherwise have been recoverable as damages." [6]

If a duty to mitigate already exists under well-established contract principles, then why, as we will discuss below, do purchase agreements increasingly include damage mitigation provisions? In that context, aren't such provisions unnecessary?

The Issue Between Buyer and Seller

In the authors' experience, there is often little negotiation on this topic and, consistent with our experience, the ABA studies discussed below show that most purchase agreements do not contain an express duty to mitigate. The request to include a statement reflecting a buyers duty to mitigate damages seems innocuous on its face; perhaps not strictly required given the existing duty described above, so what is the harm?

The real issue is whether the parties desire to codify, through the damage mitigation provision, the common law duty to mitigate (or some version of the duty) in clear language that the parties are likely to understand. That damage mitigation provision may or may not exactly mirror the common law duty to mitigate already applicable to the parties. The savvy buyer may resist mirroring the common law duty because such duty is already well established and clearly articulated by courts. The buyer could argue that having two separate duties to mitigate **–**the damage mitigation provision and the common law duty – will create confusion and cause problems interpreting the purchase agreement.

For example, while the common law duty to mitigate simply states that a party cannot recover damages for loss if those damages could have been reasonably mitigated or avoided, the damage mitigation provision above states that the buyer must take "all reasonable steps to mitigate its Losses upon and *after becoming aware of any event that could reasonably be expected* to give rise to Losses." The two duties are different, and arguably the damage mitigation provision is more onerous than the common law duty, because it could be interpreted as creating a duty to act after the indemnified party becomes aware of an event that could reasonably be expected to give rise to damages. Essentially, the damage mitigation provision could be interpreted as creating an affirmative covenant on the part of the indemnitee that, if breached, could result in a direct claim by the indemnitor. This is inconsistent with the common law duty that, as discussed above, does not create an affirmative obligation or duty and for which no liability would attach for failing to act.

Andrew Gallo, a litigation partner in the Restructuring & Bankruptcy Group of Morgan, Lewis & Bockius LLP in Boston, agrees. He noted "[t]his is a perfect example of where lawyers, who dislike relying on legal principles outside of the four corners of an M&A agreement, seek to convert common law concepts into contractual language." However, Gallo continues, "that exercise, while seemingly innocuous, is much more complicated than most would expect. It can be very difficult or even impossible to fully capture the often nuanced aspects of long-standing common law principles within a sentence or two in a contract."

However, if the seller has enough bargaining power, there is no reason why a seller should not be free to negotiate for a damage mitigation provision that imposes an affirmative mitigation duty that is specific to the transaction and more stringent than the common law duty. While that may seem straightforward, Gallo warns that "too often, the intent is actually not to incorporate in the contract something materially different than the common law concept, though that may well be the unintended result."

A seller may argue that this issue is similar to situations where the seller and the buyer agree to define "fraud" in the purchase agreement even though fraud has a common law meaning. However, the situations are not completely analogous because the common law duty to mitigate is well-established and reasonably clear while the definition of common law fraud is more difficult to define in a manner that adequately captures its meaning in all jurisdictions. [7] In addition, most definitions of fraud in purchase agreements are narrow in scope, focusing on whether or not the fraud is "intentional," "actual," "constructive" and do not attempt to create a universal definition that captures the common law meaning. [8]

Trends in Damage Mitigation Provisions

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. [9] According to the ABA studies, damage mitigation provisions were included in 57% of the deals

reported in the 2017 study. This continues the upward trend witnessed over the previous five ABA studies that showed inclusion jump from 22% in 2007 to 40% in 2015.

Conclusion

The use of damage mitigation provisions in purchase agreements has increased and, as of the 2017 study, has become the majority approach. Counsel for sellers and buyers should understand and accept that the effect, even if not the purpose, of damage mitigation provisions, is to create an obligation that is likely different than the common law duty to mitigate (unless it simply incorporates or replicates the common law duty). There may be good and rational reasons for modifying the common law rules, but counsel for both sides should carefully assess the reason for and the impact of having two potentially different standards of mitigation applicable to indemnitees.

[1] Daniel Avery is a Director, and Thuy-Dien Bui is an associate, in the Business Law Group at Goulston & Storrs, in Boston, Massachusetts. Mr. Avery is a member of the ABA's working group which published the 2017 ABA private company M&A deal points study. This article is based on, and updates, the article of the same name co-authored by Mr. Avery and Nicholas Perricone, published in the Vol. 18, Number 392 edition of the Bloomberg Mergers & Acquisition Law Report (2015). 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 http://www.goulstonstorrs.com/WhatsMarket 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 company being acquired, but for consistency, we are using "seller" and "company" in a stock purchase setting.

[3] A previous article in this series looked at the usage of stand-alone indemnities in private company M&A transactions. See Daniel Avery and Ross Turner, Trends in M&A Provisions: Standalone Indemnities, Bloomberg Law, Feb. 2018, reprinted on Goulston & Storrs' "What's Market" web page at http://www.goulstonstorrs.com/WhatsMarket and on Bloomberg Law at https://www.bloomberglaw.com/page/infocus_dealpoints.

[4] Similarly, the ABA studies identify whether the reported transactions include an express duty to mitigate or are silent. They do not identify express exonerations of the duty (likely because such provisions rarely exist).

[5] See, e.g., Restatement (Second) of Contracts § 350, cmt. b. ("As a general rule, a party cannot recover damages for loss that he could have avoided by reasonable efforts…. he is expected to take such affirmative steps as are appropriate in the circumstances to avoid loss by making substitute arrangements or otherwise").

[6] Id. See also, 22 Am. Jur. 2d Damages §355 ("[References to a 'duty'] are inaccurate expressions of the doctrine of avoidable consequences, however, because, like other principles limiting recoverable damages, the failure to take reasonable action to limit damages does not create affirmative rights in anyone. The only result of such failure is that courts will not allow damages for consequences of an injury that they believe the plaintiff could reasonably have avoided")(citations omitted).

[7] See West, Glenn D., That Pesky Little Thing Called Fraud: An Examination of Buyer's Insistence Upon (and Sellers' Too Ready Acceptance of) Undefined "Fraud Carve-Outs" in Acquisition Agreements, 69 Bus. Law. 1049 (Aug. 2014).

[8] SeeDaniel Avery and Lauren Wilson, Trends in M&A Provisions: Indemnification as an Exclusive Remedy, Bloomberg Law, Mar. 2018 (noting an increased trend to define "fraud" in purchase agreements by references to "actual," "intentional," "constructive," etc. fraud). These articles are reprinted on Goulston & Storrs' "What's Market" web page at http://www.goulstonstorrs.com/WhatsMarket and on Bloomberg Law at https://www.bloomberglaw.com/page/infocus_dealpoints.

[9] This article looks at the usage of mitigation provisions in private company M&A transactions as reflected in the ABA studies. This article does not cover such provisions in other types of transactions or in public-to-public M&A transactions.