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## MERGER AGREEMENTS

### Trends in M&A Provisions: Exclusion of Consequential Damages



BY DANIEL AVERY AND KEVIN LIN

#### 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

*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 2013 ABA private company mergers and acquisitions deal points study referenced within this article. Mr. Avery can be contacted at [davery@goulstonstorr.com](mailto:davery@goulstonstorr.com). Kevin Lin is a first year law student at Boston University School of Law, JD candidate 2016. Mr. Lin can be contacted at [kl462@bu.edu](mailto:kl462@bu.edu). This article is part of a series of articles looking at trends in private company M&A transactions and co-authored by Mr. Avery. Other articles in the series can be accessed at <http://www.goulstonstorr.com/site/PracticesIndustries/Corporate/MergersAcquisitions/WhatsMarket>.*

and warranties, and related indemnification covenants, provided by the parties.<sup>1</sup> Buyers and sellers often negotiate the scope and types of damages covered by the indemnification obligations, including whether consequential damages suffered by the buyer as a result of the seller’s breach under the purchase agreement should be included in—or excluded from—the seller’s indemnification obligations.<sup>2</sup> This article examines trends in the prevalence of consequential damage exclusions in private company M&A transactions, as reflected in the American Bar Association studies.<sup>3</sup>

<sup>1</sup> 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.

<sup>2</sup> Generally, indemnification obligations in a purchase agreement are not applicable solely to the seller: i.e., the buyer also usually indemnifies the seller with respect to buyer breaches. As a practical matter, however, seller obligations under a purchase agreement (including representations, warranties and covenants) are typically much broader and more extensive than buyer obligations, and accordingly the seller is usually more inclined than the buyer to exclude consequential damages or otherwise limit indemnification coverage.

<sup>3</sup> This article looks at the usage of consequential damages exclusions in private company M&A transactions as reflected in the ABA studies. This article does not cover such provisions

**Consequential Damages Exclusions.** A typical seller indemnification provision in an M&A purchase agreement is as follows:

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. . . .

Since indemnification provisions shift liability from buyer to seller, the definition of “losses” within the purchase agreement is a critical for the parties. “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 is one category of damages, among others, such as special, incidental, and punitive damages, that are often the subject of negotiations between buyer and seller.

## Seller and Buyer Positions

In negotiating inclusion or exclusion of consequential damages within the scope of indemnified losses, 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. On the buyer side, the most common argument is that a buyer should not be required to waive and exclude damages which 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 its limitations, since buyers often do agree to waive and exclude some types of damages—most notably, special, incidental or punitive damages.<sup>4</sup>

## Consequential Damages

“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.

in other types of transactions or in public-to-public M&A transactions.

<sup>4</sup> 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*,<sup>5</sup> 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 the 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 resulting from the additional time the mill shut down from the delay delivery.<sup>6</sup>

The court denied Hadley’s claim for lost profits, concluding that damages must arise “naturally . . . from such breach of the 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.”<sup>7</sup> According to the court, Hadley’s lost profits could not be a consequence of a breach of contract if the parties did not reasonably consider the lost profits as a consequence during the contract’s formation.<sup>8</sup> 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.<sup>9</sup> 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.<sup>10</sup>

**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.<sup>11</sup> Generally stated, recoverable

<sup>5</sup> 156 Eng. Rep. 145 (1854), reproduced at <http://mtweb.mtsu.edu/cewillis/Hadley%20v%20Baxendale.pdf> (as viewed March 4, 2014).

<sup>6</sup> *Id.*

<sup>7</sup> *Id.*

<sup>8</sup> *Id.*

<sup>9</sup> Glenn D. West & Sara G. Duran, *Reassessing the “Consequences” of Consequential Damage Waivers in Acquisition Agreements*, 63 BUS. LAW. 777, 785 (2008).

<sup>10</sup> *Id.*

<sup>11</sup> 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”).

contract damages, absent specific language in the contract to the contrary,<sup>12</sup> are not impacted by the specific reasons or motivation underlying a party's breach.<sup>13</sup> 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.<sup>14</sup>

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]."<sup>15</sup> While "natural, probably and reasonable foreseeable" seems like a straightforward standard, the difficulty, of course, is always its application to specific facts.

A leading scholarly article on the topic suggests "consequential damages" include "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."<sup>16</sup> 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."<sup>17</sup>

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."<sup>18</sup>

The specific classification of damages among direct, consequential or other types of damages is likely to be determined by the laws of the state which govern the interpretation of the purchase agreement. Accordingly, the choice of law provision within the purchase agreement may have a material effect in a post-closing dispute as to whether a buyer's damages upon a seller's breach is included, or excluded, from recovery. This is particularly noteworthy as there seems to be a recent trend, shown below, in parties remaining silent on this point in the agreement (i.e., neither expressly including, nor excluding, consequential damages from recovery).

**Consequential Damages Exclusions Within the ABA Studies.** In 2005, 2007, 2009, 2011, and 2013 the American Bar Association (ABA) released its Private Target Mergers and Acquisitions Deal Points Studies. These studies look at certain publicly available M&A agreements for transactions that occurred in the year prior to each study. In each year, the studies reviewed 128, 143, 106,

<sup>12</sup> For example, M&A purchase agreements sometimes carve-out from indemnification limitations *intentional* breaches of a party's representations and warranties.

<sup>13</sup> West & Duran, *supra* note 9, at 782.

<sup>14</sup> *Id.* at 783.

<sup>15</sup> *Id.* (quoting *Enter. Oil Ltd. v. Strand Ins. Co. Ltd.*, [2006] EWHC (Comm) 58 [2006], 1C.L.C. 33, 49.

<sup>16</sup> *Id.* at 788-789.

<sup>17</sup> *Id.* at 789.

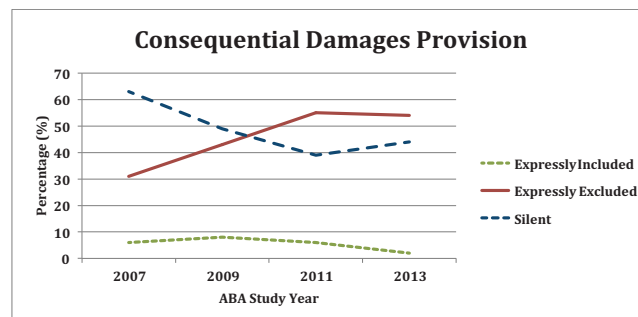
<sup>18</sup> Ken Adams, *New Article on Consequential Damages*, ADAMS ON CONTRACT DRAFTING (July 23, 2008), <http://www.adamsdrafting.com/new-article-on-consequential-damages/> (last visited March 6, 2014).

100 and 136 private company transactions, respectively. These transactions have ranged in size from \$17 million to \$4.7 billion, across a broad range of industry sectors.

According to the 2013 ABA study, only 2 percent of the agreements reviewed included a consequential damages "inclusion" provision (i.e., a provision which expressly *includes* consequential damages within indemnified losses), while 54 percent of the agreements expressly *excluded* consequential damages from coverage, and 44 percent of the agreements were silent on the issue. The ABA's similar review of private company transactions in 2011 for transactions in 2010 showed percentage levels among these three options at 6 percent, 55 percent and 39 percent, respectively. The ABA's 2009 review of private company transactions in 2008 reflected these options at 8 percent, 43 percent and 49 percent, respectively, and its 2007 review of private company transactions in 2006 reflected these options at 6 percent, 31 percent and 63 percent, respectively.

These figures reflect a slight recent downward trend (after a significant upward trajectory over the prior studies) in purchase agreements containing a consequential damages exclusion. Agreements expressly including consequential damages within indemnification coverage continue to be quite unusual (and even more so recently, at 2 percent in the 2013 study), and there has been a recent uptick in the percentage of agreements which are simply silent on the point.

The chart below shows these trends:<sup>19</sup>



## Conclusion

19<sup>th</sup> 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—whether any particular type of damages constitutes as 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 since the provisions could materially impact a party's responsibility for breaches of the agreement.

<sup>19</sup> References to the "ABA Study Years" are to the years in which the ABA studies were published, which are one year following the year in which the reviewed transactions occurred. For example, the 2013 ABA study looked at transactions which closed in 2012. The 2005 ABA study did not examine the exclusion of consequential damages, and therefore this study is not included within the chart.