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Reassessing the "Consequences" of Consequential Damage Waivers in Acquisition Agreements

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Consequential damage waivers are a frequent part of merger and acquisition agreements involving private company targets. Although these waivers are heavily negotiated, the authors believe that few deal professionals understand the concept of consequential damages and, as a result, the inclusion of such waivers may have an unexpected impact on both buyers and sellers. The authors believe that this Article is the first attempt to define "consequential damages," as well as some of the other terms used as purported synonyms, in the merger and acquisition context. After tracing the historical derivation of the term and its current use by the courts, this Article considers the impact of such waivers in a hypothetical business acquisition and proposes some specific guidelines for the negotiation of these waivers.

All deal professionals evaluating a private company acquisition transaction should (and most do) fully appreciate the effect of contractual damage caps. Indeed, a fundamental part of today's private company deal market is that sellers frequently limit the maximum damages for which they may be held liable for breaches of their representations and warranties to a specified percentage of the purchase price.[1] Sellers rely upon these contractual damage caps in making distributions of sales proceeds to equity holders after the closing, and buyers take these caps into account in pricing the deal and approaching their due diligence.[2] Less understood by most deal professionals and many of their counsel, however, is the added limitation on a buyer's potential recovery resulting from certain "loss exclusions" commonly set forth in the indemnification provisions of acquisition agreements.

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1. *See* MERGERS & ACQUISITIONS SUBCOMM., COMM. ON NEGOTIATED ACQUISITIONS, SECTION OF BUS. LAW, AM. BAR ASS'N, 2007 PRIVATE TARGET MERGERS & ACQUISITIONS DEAL POINTS STUDY 68–71 (2007), *available at* http://www.abanet.org/abanet/common/login/securedarea.cfm?areaType=committee&role=CL560000&url=/buslaw/committees/CL560000/materials/matrends/2007_private.pdf.

2. *See* Glenn D. West, *Avoiding Extra-Contractual Fraud Claims in Portfolio Company Sales Transactions—Is "Walk-Away" Deal Certainty Achievable for the Seller?*, WEIL, GOTSHAL & MANGES LLP PRIVATE EQUITY ALERT, Mar. 2006, http://www.weil.com/news/pubdetail.aspx?pub=3368.

In our experience,[3] these "loss exclusions" are thought by many to exclude items that should not be recoverable losses in the first place. Losses that are not actually incurred by the buyer as a result of the seller's breach obviously are not recoverable regardless of any specific exclusion.[4] Nevertheless, losses covered by insurance, losses that could have been avoided or mitigated by the buyer, losses recoverable from a third party, and losses for which there is a corresponding tax benefit are all examples of the kinds of losses that are expressly excluded from the indemnification provisions of many acquisition agreements to limit recoverable losses beyond the understood and agreed-upon cap. Each of these exclusions can contain traps for the unwary and may unintentionally exclude out-of-pocket losses that the buyer sustains. Exclusions relating to any of these losses, therefore, need to be carefully and appropriately limited. But by far the most often included and overlooked of these loss exclusions (and perhaps the one with the most significant traps) is a provision excluding all "consequential" or "special" damages.

Contrary to popular belief, "consequential damages" do not compensate a buyer for remote or speculative losses that fall into the category of items that should not be treated as true losses at all; rather, consequential damages compensate the buyer for real losses that the buyer has sustained as the result of the seller's breach of a bargained-for representation and warranty.[5] It is critical, therefore, that both the buyer and seller understand and appreciate the effect of excluding consequential damages from recoverable losses.

The "Boilerplate" Consequential Damage Waiver Clause

While there is truly no "standard" consequential damage waiver clause, the following is an example of one we frequently see in initial drafts of private company acquisition agreements (with common variations bracketed):

> **No Consequential Damages.** Notwithstanding anything to the contrary contained in this Agreement or provided for under any applicable Law, no party hereto shall be liable to any other Person, either in contract or in tort, for any consequential, incidental, indirect, special or punitive damages of such other Person, [including] [or any] loss of future revenue, [or] income or profits[, or any diminution of value or multiples of earnings damages] relating to the breach or alleged breach hereof, whether or not the possibility of such damages has been disclosed to the other party in advance or could have been reasonably foreseen by such other party.

3. Our observations throughout this Article about "loss exclusions," consequential damage waivers in acquisition agreements, and the attorneys and deal professionals who draft and rely on them are based on our combined thirty-four years of experience representing clients in acquisitions and divestitures.

4. *See* Neb. Nutrients, Inc. v. Shepherd, 626 N.W.2d 472, 481 (Neb. 2001) ("Uncertainty as to the fact of whether damages were sustained at all is fatal to recovery . . . ."); *see also* 25 C.J.S. *Damages* § 40 (2008) ("Where it cannot be shown with reasonable certainty that any damage resulted from the act complained of, there can be no recovery . . . ."); 17A Am. Jur. 2d *Contracts* § 707 (2008) ("[T]he mere breach of an agreement that causes no loss to the plaintiff will not sustain a suit for damages . . . .").

5. *See infra* notes 50–55 and accompanying text.

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