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Let's Make A Deal

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The Game Is On: Are You In?
(You Have to Play or You'll Never Win)

This Article discusses a number of critical issues that are potential traps for the unwary in connection with merger and acquisition agreements (each an "Acquisition Agreement"), including: (I) Obligations of good faith and disclosures in negotiations, (II) Material adverse effect, (III) Exclusions of damages in mergers and acquisition transactions, (IV) Arbitration and (V) Mitigating risks with representations and warranties insurance. The authors recommend finding a middle ground on these issues between representing a purchaser and representing a seller with an eye toward knowing the upside and downside in litigation.

I. Obligations of Good Faith and Disclosure.

Buyers and sellers have an obligation of good faith when negotiating a merger and acquisition agreement (hereinafter "Acquisition Agreement"). But not all courts will look outside of the four corners of the Acquisition Agreement to determine evidence of a failure of good faith. Courts are more likely to look beyond the Acquisition Agreement in the case of fraud and misrepresentation in a transaction, either because the law will not permit a seller to protect itself contractually against its own tortious acts against the buyer, or because some jurisdictions, such as France, include statutes which require certain material disclosures.

A. <u>Good Faith Negotiations Or Is All Fair When Negotiating</u>?

1. Although an implied duty of good faith *performance* exists in most every agreement, in an arm's length negotiation for an agreement, the parties may engage in a broad array of assertions, promises, and assumptions during the negotiations.

2. Representations and warranties are a means of capturing the negotiation's "good faith" assertions, understanding, assumptions, and promises.

a. "Everyone knew that was the case when we closed the deal.…"

3. The assertions, assumptions, understanding, implications, and promises stated during negotiations that are not explicitly set forth in the agreement *matter not* when a dispute arises subsequently.

a. As a general rule, a court will not look behind the written agreement's plain language for additional assertions, understandings, assumptions, implications, conditions, requirements, or terms.

b. "Regardless of what the parties may allege in litigation, if the terms of the contract are facially clear, the parties must be held to those terms. It would violate the basic principles of contract construction to allow any other result." *Daystar Const. Mgmt., Inc. v. Mitchell*, 2006 WL 2053649, *9 (Del. Super. Ct. July 12, 2006).

c. Further, sellers explicitly attempt to limit a court's ability to look behind or outside the final agreement's plain language by inclusion of certain contractual provisions, such as integration clauses.

Sample integration clause: This Agreement, the Transaction Documents and the documents referred to herein and therein contain the entire agreement between the Parties and supersede any prior understandings, agreements or representations by or between the Parties, written or oral, which may be related to the subject matter in any way.

B. Is There Good Faith In Negotiations?

1. "The lie one tells to get a contract signed trumps the lie one tells when signing the contract itself." *Lower Fees, Inc. v. Bankrate, Inc.*, 74 So. 3d 517, 520 (Fla. 4th DCA 2011).

2. "We continue to believe that parties to contracts, whether experienced in business or not, should deal with each other honestly, and that a party should not be permitted to engage in fraud to induce the contract." *McEvoy Travel Bureau, Inc. v. Norton Co.*, 563 N.E.2d 188, 194 (1990) citing Restatement (Second) of Contracts § 164 (1981).

3. Nevertheless, agreements are merely promises which the law permits you to sue to enforce.

a. Hence, as a rule, assertions, assumptions, implications, conditions, understandings, requirements, or terms not reflected in the agreement are not actionable at law.

b. Well, unless you have good litigator (a/k/a paragon of fairness/purveyor of balderdash)…then maybe.

i. "A person guilty of fraudulent misrepresentation should not be permitted to hide behind the doctrine of caveat emptor." *Besett v. Basnett,* 389 So.2d 995, 997 (Fla. 1980).

ii. Lawsuits are the American way to address a lack of candor or "bad faith" in negotiations.

a) Claims, such as fraud-in-the-inducement, fraudulent misrepresentation, negligent inducement, intentional misrepresentation, negligent misrepresentation, and certain statutory claims such as deceptive and unfair trade practices statutes, are some of the most common means of addressing a lack of candor in the negotiations.

b) These claims may be combined with claims for aiding and abetting, civil conspiracy, and certain statutory claims thereby providing broad legal grounds for a dissatisfied contracting party to make off-contract attacks on the deal.

c) These off-contract and ancillary claims create the opportunity to expand the persons or entities potentially liable as well as expand potentially available damages well beyond the agreement's contemplation.

d) Nevertheless, even with a good litigator, off-contract claims require a wrong independent of mere breach of the contract.

e) If an issue or item is not addressed in the Acquisition Agreement, does that mean it is not an issue or item that is subject to a claim, or does that mean the issue is open season for off-contract claims? Well, it depends.

4. Locking into the Agreement

a. Integration/Merger clause: "…an integration clause prevents a party to a contract from basing a claim of breach of contract on agreements or understandings, whether oral or written,…that eventuated…the signing of a contract but that…[were] not written into the contract itself." *Vigortone AG Products, Inc. v. PM AG Products, Inc.*, 316 F.3d 641, 644 (7th Cir. 2002).

b. “But fraud is a tort, and the parol evidence rule is not a doctrine of tort law…so an integration clause does not bar a claim of fraud based on statements not contained in the contract. Doctrine aside, all an integration clause does is limit the evidence available to the parties should a dispute arise over the meaning of the contract. It has nothing to do with whether the contract was induced, or its price jacked up, by fraud.” *Vigortone AG Products, Inc. v. PM AG Products, Inc.*, 316 F.3d 641, 644 (7th Cir. 2002).

c. Beyond the integration clause

i. “We recognize the rule to be that fraud in the procurement of a contract is ground for rescission and cancellation of any contract unless for consideration or expediency the parties agree that the contract may not be cancelled or rescinded for such cause, and that by such special provisions of a contract it may be made incontestable on account of fraud, or for any other reason.” *Oceanic Villas, Inc. v. Godson*, 4 So. 2d 689, 690 (Fla. 1941).

ii. “I find it difficult to fathom how it would be immoral for the Seller and Buyer to allocate the risk of intentional lies by the [Seller’s] managers to the Buyer, and certainly that is so as to reckless, grossly negligent, negligent, or innocent misrepresentations of fact by the [Seller]. Such an allocation of risk does not permit the [Seller] to engage in consciously improper conduct itself, it simply requires the Buyer to hold the [Seller] and its speaking managers exclusively responsible for their own misstatements of fact.” *Abry Partners V, L.P. v. F & W Acquisition LLC*, 891 A.2d 1032, 1063 (Del. Ch. 2006)

d. Disclaimer of Reliance clauses

i. "…the Court will not bar a contracting party from asserting claims for fraud based on representations outside the four corners of the agreement unless *that contracting party* unambiguously disclaims reliance on such statements." *FdG Logistics LLC v. A&R Logistics Holdings, Inc.*, 131 A.3d 842, 860 (Del. Ch. 2016) (emphasis added) citing *Abry Partners V, L.P. v. F & W Acquisition LLC*, 891 A.2d 1032, 1035 (Del. Ch. 2006).

ii. In some jurisdictions, disclaimer of reliance may be a surprisingly dynamic area of law.

a) The 11th Circuit recently found that "the Florida Supreme Court in *Oceanic Villas* held that where an agreement is procured by fraud or misrepresentation 'every part of the [ ] contract' is vitiated because '[i]t is well settled that a party cannot contract against liability for his own fraud.'" *Glob. Quest, LLC v. Horizon Yachts, Inc.*, 849 F.3d 1022, 1027 (11th Cir. 2017) quoting *Oceanic Villas, Inc. v. Godson*, 4 So. 2d 689, 690 (1941).

b) Yet the 11th Circuit's conclusion in *Global Quest* was far from certain or conclusive on the issue as there are Florida appellate courts arriving at diverse holdings on the issue: *Billington v. Ginn–La Pine Island, Ltd.*, 192 So.3d 84 (Fla. 5th DCA 2016) ("[W]e hold that the 'non-reliance' clauses in this case negate a claim for fraud in the inducement because Appellant cannot recant his contractual promises that he did not rely upon extrinsic evidence."); *Zuckerman-Vernon Corp. v. Rosen*, 361 So. 2d 804, 806 (Fla. 4th DCA 1978) ("while a contract can by its terms be made incontestable on grounds of fraud, the principle still remains that a party cannot contract against liability for his own fraud in order to exempt him from liability for an intentional tort"); *Lower Fees, Inc. v. Bankrate, Inc.*, 74 So.3d 517, 520 (Fla. 4th DCA 2011) (holding that a non-reliance disclaimer was insufficient to defeat a claim for fraud in the inducement because "'[i]t has been the law of this state for some time that a claim of fraud in the inducement will not be defeated by contract clauses'").

c) *M/I Schottenstein Homes, Inc. v. Azam,* 813 So.2d 91, 96 (Fla.2002) (Florida public policy prohibits "one who purposely uses false information to induce another into a transaction from profiting from such wrongdoing").

C. Duty of Disclosure by Seller – Should a Seller Disclose the Truth, All the Truth under French Law?

1. The current trend of laws is to extend the scope of the "good faith" obligations in both the formation and implementation of contracts. French law, with the reform of the law of contracts of February 10, 2016, part of which became enforceable on October 1, 2018, extended the scope of the good faith obligation in two ways examined below.

2. First, article 1104 of the French civil code extended the scope of the legal obligation of good faith. Before the reform, the sole obligation, but for specific provisions of law for specific contracts*, was that contracts be <u>implemented</u> in good faith*" (art. 1134 of the civil code). The new article 1104 of the civil code which substitutes in place of the previous article 1134 of the civil code now stipulates: "*Contracts must be <u>negotiated</u>, <u>formed</u> and <u>implemented</u> in good faith. This provision is of public order*." This new drafting reinforces the obligation of disclosure of important information at the time of the

negotiation and formation and now makes clear that such legal obligation cannot be waived by the parties.

3. Second, article 1112-1 of the French civil code extends the disclosure obligation – likely to give rise to damages or cancellation of the contract as follows: *"That of the parties who knows information which is so important that it is <u>decisive for the consent of the other party</u> must reveal such information insofar as such other party <u>legitimately ignores</u> it or trusts its <u>co-contracting party</u>.*

However, this duty of information does not concern the estimate of the value of performance.

Information is of decisive importance if it is directly and necessary linked to the content of the contract or the quality of the parties.

The parties can <u>neither restrict, nor exclude this duty</u>.

<u>Besides the responsibility of the party</u> that had an obligation of information, the failure to abide by this obligation can lead to the <u>cancellation of the contract</u> in the conditions provided for by article 1130, et seq.,"

Article 1130, *et seq.*, relate to the formation of contracts and what vitiates the formation of contracts. In France, there are three main causes that are deemed to affect the consent: mistake (unless it cannot be excused), mistaking actions (*dol*) and violence.

4. Impact of such reform. This new set of legal provisions was just recently adopted, and therefore lawyers cannot yet rely on case law to assess how the Courts will apply and construe those provisions.

a. First: Until now, in France, in the absence of contractual representations and warranties, the sole guarantees due under French law were the legal guarantees due by the seller to the buyer by law and (i) their scope was limited (basically those guarantees were (i) the existence of the shares, (ii) the peaceful use of the shares (guarantee of ousting) and (iii) the absence of defects of the shares (guarantee of hidden defects), and (ii) they only applied to the shares themselves (the envelop) and not to the content of the company, *i.e.*, its assets and liabilities but for exception (where such hidden defect is of such importance that it shall prevent the buyer from operating the company). The question, therefore, is whether the new article 1112-1 of the French civil code creates a legal obligation of disclosure as to the assets and liabilities if all the other conditions requested by such article are met?

b. Second, as seen above, share purchase agreements, before the reform and still now, can be judicially cancelled for vitiated consent (article 1130, *et seq.*). In particular, when a party contracted while it would not have contracted or would have contracted one the basis of substantially different terms, without a mistake caused by a misleading action (dol) of the other, such party is entitled to ask for the cancellation of the contract. The fact that such defect be decisive is a matter of fact and is appreciated depending on the persons concerned and circumstances. The regime of article 1112-1 of the French civil code on non-disclosure is different. Under such article, the non-disclosure does not need to be willful anymore, and it gives rise to damages, not to the cancellation of the agreement (unless article 1330, *et seq.*, do apply). Therefore, its cope of application can be much larger.

c. Third, certain specific laws had created disclosure obligations (*e.g.*, for contracts between professionals and consumers, for distribution agreements bearing exclusivity, for real estate sales with the obligation to provide certain diagnosis.…). The difference now is that French law has a text which is of general application and will apply to all contracts including contracts of sale of shares and warranties.

5. Drafting Considerations

The following considerations are recommended to attempt to mitigate risks of noncompliance with French law:

a. Clarifying that the buyer has an obligation to carry out reasonably proper due diligence to arrive at its own opinion about the company;

b. Listing or clearly indicate those statements which are decisive in the buyer's decision to buy; this way, anything which is not mentioned as decisive has a significant chance to be construed as being non-decisive;

c. Play the game and find the way to present things in such a way that:

i. any significant information which can reasonably be considered as decisive to the consent of a normal buyer be addressed; this will set aside risks attached to nondisclosure of decisive information;

ii. but be presented in a way which is as positive as feasible without constituting a false statement.

iii. EXAMPLE:

A classic statement required by buyers from sellers is that the seller is not aware that a major client (*e.g.* X% of the turnover) is in the process of being

lost or that a major contract with a client is in the process of being terminated.

Let's assume that the seller knows that one of its major clients just experienced a change of control and that the client will potentially launch competitive tendering to decide which supplier he will choose in the future.

Should the seller remain totally silent on this issue? In view of the above-mentioned articles dealing with "pre contractual obligation of information and good faith," it is prudent to disclose the issue to the buyer in a manner favorable to the seller.

Although the seller does not know at that stage what shall be the exact outcome of the competitive tendering, he may not hide the risks without exposure.

Provided that the seller did not receive any information that could reasonably lead him to believe that the company is likely to lose the contest, the seller will be better off by making a statement. The role of the lawyer is to help carving the statement adequately. The seller could, for instance, mention the knowledge it has on the client's desire to organize a competitive bid; that to its best reasonable knowledge nothing can be said about the outcome and that given past experience with client, he is quite confident in the company's competitive position as compared to other competitors.

This way, the seller makes no false statement and such statement shall prevent or make extremely difficult a legal action on the basis of bad faith or pre contractual misinformation.

d. Assisting the seller in its negotiations so that the scope of the seller's statements be as narrow as possible to limit the possibility of false statements and also the possibility for the buyer to allege concealment of information.

i. EXAMPLE:

Rather than accepting a very large and general statement such as "the Company is the valid title owner or licensee of all Intellectual Property Rights used for operating its business," the seller should attempt to limit the scope of such statement. For instance, it could be written, "The major intellectual property rights used by the Company to operate its business are those listed in Exhibit XYZ and the Company, on such Intellectual property rights, owns good title or valid use rights." Indeed, if the statement is narrower, it becomes more difficult for the buyer to allege a false statement and dissimulation of information in bad faith.

D. A Digression – The Litigation Perspective

1. "The most successful war seldom pays for its losses." – Thomas Jefferson

a. Consideration 1

i. Size of war chest/legal spend v. issue – "Well, let's just send them a demand letter, but we don't really want to litigate."

b. Consideration 2

i. Motion to Dismiss – Can the claim survive/Can the claim be defeated?

ii. Standard: Alleged facts support the claim's elements? Claim survives.

c. Consideration 3

i. Motion for Summary Judgment – Can the claim survive/Can we obtain?

ii. Standard: Unresolved issue material fact? Claim survives

a) A judge's recent statement: "Summary judgment is the most overruled issue on appeal. Why should I risk getting overruled for your client?"

d. Consideration 4

i. Survival of motion to dismiss and motion for summary judgment, so we will find out who is right at the end of trial.

ii. Intestinal fortitude and the size of your war chest.

iii. Waiver of jury trial = 1 juror (the Judge).

iv. Judges are people too. Seek a fair-ish result when possible.

v. Arbitrator: "Let's see how we can split the baby here."

II. <u>Materiality</u>

A. <u>Material adverse change clause ("MAC") / Material adverse effect clause ("MAE")</u>

1. Typically, materiality is a mixed question of law and fact. Only if the omissions are "so obviously important to an investor that reasonable minds cannot differ on the question of materiality" is the ultimate issue of materiality appropriately resolved "as a matter of law" by summary judgment. *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 439 (1976).

2. Factually specific determinations as to what is material, combined with factors for consideration in determining what is material = a lot work of litigation.

3. "Material adverse effect clauses are strange animals, *sui generis* among their contract clause brethren….Typically, conditions precedent are easily ascertainable objective facts…that a party performed some particular act or that some independent event has occurred. A material adverse effect clause does not easily fit into such a mold….Rather,…absent clear language to the contrary, the burden of proof with respect to a material adverse effect rests on the party seeking to excuse its performance under the contract." *Hexion Specialty Chemicals, Inc. v. Huntsman Corp.*, 965 A.2d 715, 739 (Del. Ch. 2008).

4. In the context of representations and warranties, "[a]ssuming for the sake of argument that a buyer who knew about a specific fact that rendered a seller's representation inaccurate should not be permitted to close a transaction and then recover damages based on that specific fact [a/k/a sandbagging], it does not necessarily follow that a buyer should be prevented from relying on a representation simply because the buyer knew about a risk. It also does not necessarily follow that a buyer should be prevented from relying on a representation when exercising a right not to close." *Akorn, Inc. v. Fresenius Kabi AG*, 2018 WL 4719347, *80 (Del. Ch. Oct. 1, 2018).

5. When a party breaches a contract, the predominant approach is to determine whether the breach seriously affects the <u>value</u> of the contract before it can be considered "material."

i. “seriously affects the value” feels squishy = tends to mean litigation.

6. When examining materiality, the majority of courts look to and reference the factors set for in the Restatement:

In determining whether a failure to render performance is material, the following circumstances are significant:

i. the extent to which the injured party will be deprived of the benefit which he reasonably expected;

ii. the extent to which the injured party can be adequately compensated for the part of that benefit of which he will be deprived;

iii. the extent to which the party failing to perform or to offer to perform will suffer forfeiture;

iv. the likelihood that the party failing to perform or to offer to perform will cure his failure, taking account of all the circumstances including any reasonable assurances;

v. the extent to which the behavior of the party failing to perform or to offer to perform comports with standards of good faith and fair dealing.

Restatement (Second) of Contracts § 241.

7. Different courts examination of “materiality”

i. *Leazzo v. Dunham*, 420 N.E.2d 851 (1981).

a) “It is impossible to enunciate a rule that can be applied with mathematical exactness to determine when a failure to perform a promise discharges the duty to perform the return promise for an agreed exchange. Only such general principles based upon the inherent justice of the matter can be asserted." (*Restatement of Contracts s 275*, Comment a (1933).) "Where the failure is at the outset, a very slight failure is often sufficient to discharge the injured party." (Restatement of Contracts s 275, Comment a (1933).) While the willfulness of the breach may not enhance the injury, "it does so far increase the demerit of the wrongdoer that the law is less inclined if a breach is willful to require the injured party to perform." Restatement of Contracts s 275, Comment a (1933)."

ii. *Hansen Bancorp, Inc. v. United States*, 367 F.3d 1297, 1312 (Fed. Cir. 2004) citing *Stone Forest Indus., Inc. v. United States,* 973 F.2d 1548, 1551 (Fed.Cir.1992).

a) "With an eye to [Restatement] section 241, we have stated that the determination of whether a breach was material 'depends on the nature and effect of the violation in light of how the particular contract was viewed, of bargained for, entered into, and performed by the parties.'"

iii. *Hostway Services, Inc. v. HWAY FTL Acquisition Corp*., 2010 WL 3604671, *8–9 (S.D. Fla. Sept. 13, 2010).

a) "[M]any Florida courts have included 'material breach' as one of the elements of a breach of contract claim. *See, e.g., Abbott Labs., Inc. v. Gen. Elec. Capital,* 765 So.2d 737, 740 (Fla. 5th DCA 2000). Notably, in *Abbott Labs.,* the Florida district court injected the materiality requirement without explanation. *See id.* Moreover, the cases cited by *Abbott Labs.* do not list 'material breach' as an element of a breach of contract action.…Furthermore, many of the Florida courts that have listed 'material breach' as one of the elements in a breach of contract action can be traced back to *Abbott Laboratories.*…Many federal courts applying Florida law have also included *'*material breach*'* as one of the elements of a breach of contract action.…Federal courts often cite *Abruzzo* when setting forth the materiality requirement for a breach of contract action under Florida law.…*Abruzzo,* however, does not mention materiality as an element of a breach of contract action. Because the materiality requirement appears to be the result of spontaneous generation, the Court is reluctant to require an aggrieved party to prove a *'*material breach*'* to establish a breach of contract under Florida law. Indeed, this Court has found no case where the Supreme Court of Florida has held that a party must prove a material breach to prevail in a breach of contract action."

iv. *Sublime, Inc. v. Boardman's Inc*., 849 So. 2d 470, 471 (Fla. 4th DCA 2003).

a) "To constitute a vital or material breach, a defendant's non-performance must be such as to go to the essence of the contract."

B. The Material adverse change clause ("MAC") provided for by French law.

In Common law countries, the rule of the parties is generally what is written in the agreement. In France this used to be the case until the Ordinance of February 10, 2016 which made the rule of the Party more instable and weak. Article 1195 of the French Civil Code dealing with "unforeseeable circumstances at the time of execution of the contract" is the perfect example.

1. The issue is that this article provides that:

> Should a change of circumstances, which was not predictable at the time of signing of the contract, make the enforcement of the

> contract extremely onerous for one party who had not accepted to take such risk, such party may ask the other party for a renegotiation of the contract. Such party must continue to abide by the contract during the renegotiation. Should the renegotiation fail or be refused, the parties may agree on the termination of the contract, at the date and terms they agree upon, or, by joint agreement, ask the judge to amend it. Should the parties not come to an agreement in a reasonable deadline, the judge may, at the request of one of the parties, amend or terminate the agreement at the date and according to terms set by him.

2. As you may decide to refuse a MAC provision in a contract which is too large, if you have no interest in the fact that the contract can be revised, which is generally the case for share purchase agreements and representations and warranties, the application of this article 1195 of the French civil code can be set aside contractually and should be set aside by a specific provision of the share purchase as well as representations and warranties agreements.

III. Exclusion of Damages in Mergers and Acquisition Transactions

A. Damage Exclusions. Sellers typically attempt to exclude from the definition of “Losses” or “Damages” in merger and acquisition agreements numerous categories of damages, including without limitation, punitive, exemplary, consequential, special, incidental, indirect, lost profits and diminution in value. Exclusion of such damages through restricted definitions of such terms or through separate waiver clauses included in merger and acquisition agreements often have a material impact on the purchaser or seller and are often a trap for the unwary. The purpose of this Section is to highlight these exclusions and to adopt a strategy for purchasers and sellers when negotiating Acquisition Agreements.

B. **<u>Typical Damage Waiver</u>**.

1. The following is a typical waiver of damages negotiated by sellers in an Acquisition Agreement:

> Under no circumstances shall either party be liable to the other party for an indirect, incidental, consequential, special, punitive or exemplary damages, even if either party has been advised of the possibility of such damages, arising from this Agreement, such as, but not limited to, loss of revenue or anticipated profits of lost business. (hereinafter the "Damage Waiver")
>
> *Westlake Financial Group, Inc. v. CDH-Delnor Health System*, 2015 IL App (2d) 140589

2. The remainder of this Section analyzes the effect of above damage waiver and the impact on sellers and purchasers.

C. **<u>Common Categories of Damages by Definition.</u>**

1. "Direct" or "General" damages are damages that are best understood as damages that one would reasonably expect to arise from the breach in question, without taking into account any special circumstances of the nonbreaching party. They are damages which may fairly and reasonably be considered as arising naturally from the breach of any similar contract in the great multitude of cases. <u>See</u> *Hadley v. Baxendale*, 9 Exch. 341 (1854); *Roanoke Hosp. Ass'n v. Doyle & Russell, Inc.*, 214 S.E.2d 155, 160 (Va. 1975); *Devereux v. Buckley & Co.,* 34 Ohio St. 16, 20 (1877), citing *Hadley v. Baxendale,* 9 Exch. 34. Direct or General damages can, but do not always, include "lost profits" depending on the facts. See *Westlake*, 2015 IL App (2d) 140589.

2. "Incidental" damages are damages that are typically defined with respect to rejection of nonconforming goods by a buyer or wrongful rejection by a buyer of conforming goods. The Uniform Commercial Code defines "Incidental" damages as

damages resulting from the seller's breach including expenses reasonably incurred in inspection, receipt, transportation, and care and custody of goods rightfully rejected, any commercially reasonable charges, expenses, or commissions in connection with effecting cover and any other reasonable expense incident to the delay or other breach. See ORC 1302.89(A). Incidental damages are not consequential damages. They are a limited category of damages comprised of the costs and expenses incurred by the non-breaching party to avoid further direct and consequential damages caused by the breach.

3. "Consequential" or "Special" damages are best understood as including all losses sustained by the nonbreaching party that are attributable to any special circumstances of the nonbreaching party that the parties were aware of when they entered into the contract where such damages would not have normally and necessarily have resulted from such breach in the absence of such special circumstances. See *Hadley*, 9 Exch. 34; *Roanoke Hosp. Ass'n v. Doyle & Russell, Inc.*, 214 S.E.2d at 160. Consequential damages do not include unlimited losses. Consequential damages "include those damages that, although not an invariable result of every breach of this sort, were reasonably foreseeable or contemplated by the parties at the time the contract was entered into as a probable result of the breach." *City of Milford v. Coppola Construction Co., Inc.*, 891 A.2d 31, 39 (2006) (quoting 24 S. Williston, Contracts Section 64:12 ((4th Ed. Lord 2002).

4. A noted above, "Lost Profits" can be categorized as "Direct" damages or "Consequential" damages depending on the facts. See *Westlake*, 2015 IL App (2d) 140589; *Midland Hotel Corp. v. Reuben H. Donnelley Corp.*, 118 Ill.2d 306, 319 (1987).

Whether lost profits are direct or general damages, on the one hand, or consequential damages on the other hand, depends on whether (i) the damages naturally flow from the breach absent the special circumstances of the nonbreaching party (in which case lost profits are direct damages) or (ii) the damages were not the invariable result of such breach but were reasonably foreseeable or contemplated by the parties as a probable result of a breach when the contact was entered (in which case lost profits are consequential damages). Accordingly, an exclusion of consequential damages in an Acquisition Agreement does not prevent the purchaser from being awarded lost profits where the lost profits are determined to be direct or general damages as opposed to consequential damages. *Id.* In the context of a business acquisition priced at a multiple of revenue, lost profits may be the only true basis upon which to determine market-measured direct damages for breach of a representation affecting that revenue. See Reassessing the "Consequences" of Consequential Damage Waivers in Acquisition Agreements, by Glenn D. West and Sara G. Duran, The Business Lawyer, Vol. 63, No. 3, May 2008.

5. "Diminution in Value" in the context of the sale of business is the difference between the value of the business actually received by the purchaser and the value of the business as warranted by the seller. "Diminution in value" is a claim for direct damages, so exclusion of consequential damages or lost profits will not preclude recovery of damages in the amount of diminution in value by a purchaser for breach of representations by a seller. See *Powers v. Stanley Black & Decker Inc.*, No 1:2014 Civ. 2052 – Document 69 (S.D.N.Y. 2015).

D. ***Hadley v. Baxendale* Test for Damages**. The *Hadley* case cited above is frequently cited in connection with cases involving a discussion of consequential damages notwithstanding that the decision was issued in 1854. See Section III above. *Hadley*, 9 Exch. 34. The following is a summary of the *Hadley* case.

1. **Facts**: Hadley operated a mill, which it was forced to shut down when the crankshaft of its steam engine broke. Hadley contacted the manufacturer of the engine, Joyce & Co. ("Joyce"), and Joyce agreed to make a new shaft from the pattern of the old one. A representative of Hadley went to the office of Baxendale, common carriers, to have the crankshaft taken to Joyce. Hadley's representative told Baxendale's representative that shaft must be sent immediately. The clerk informed Hadley's representative that if the shaft were given to them by noon on any day, it would be delivered by the next day. Hadley took the shaft to Baxendale the next day before noon. Due to Baxendale's negligence, the delivery to Joyce was delayed, and Hadley did not receive the new shaft for several days after they should have received it.

2. **Issue.** Can damages for a party's breach include reasonably foreseeable damages and damages resulting from special circumstances if the special circumstances were not communicate at the time the contract was formed?

3. **Held.** No. A nonbreaching party is entitled damages (i) arising naturally from the breach itself; or (ii) those that are in the reasonable contemplation of the parties at the time of contracting. Even though Baxendale's negligence was the actual cause of the lost profits of Hadley, it cannot be said that under ordinary circumstances such loss arises naturally from this type of breach. There is a multitude of reasons to send a crankshaft to a third party. Baxendale had no way of knowing that its breach

would cause a longer shutdown of the mill, resulting in lost profits. Most importantly, Hadley never communicated the special circumstances to Baxendale, nor did Baxendale know of the special circumstances.

4. **Discussion.** Damages are limited to those that arise naturally from a breach and those that are reasonably contemplated by the parties at the time of contracting. Hadley failed to tell Baxendale that any delay in shipping would result in lost profits to Hadley. Since Baxendale did not know of Hadley's special circumstances (*i.e.*, that its mill was out of commission until the new shaft was delivered), the special circumstances were not reasonably foreseeable at the time of contracting. Even if Baxendale failed to include an exclusion of consequential damages in its contract with Hadley, such lost profits resulting from Hadley's special circumstances would not be recoverable (*i.e.*, they are not recoverable as consequential damages or direct damages).

E. <u>Example of Application of Damage Waiver in an Acquisition Agreement</u>

1. Assume that Acquisition Co. ("Purchaser") enters into an Acquisition Agreement with Enviro Co. ("Seller") for the purchase and sale of substantially all of the assets of Seller, an industrial cleaning service business. The Purchaser is a private equity firm, and it prices the acquisition at $10 million, computed based on a formula of 10 times trailing 12 months EBITDA of $1,000,000. The Acquisition Agreement includes representations that Seller has in place all permits necessary to operate its business and to service its customers and all such permits are assignable to Purchaser. After closing, Purchaser determines that Seller did not have the proper permit to transport

hazardous waste, Purchaser pays $5,000, including attorney's fees and costs, to obtain the permit 6 months after closing; and three (3) of the historical customers of Seller who became customers of Purchaser permanently terminate their service contracts with Purchaser due to the failure of the permit. The EBITDA from the business is reduced by $10,000 per year due to the loss of the three service contracts.

2. The Acquisition Agreements includes a Damage Waiver as described in II. a. above (including exclusions of incidental and consequential damages and exclusion of lost profits as part of such incidental or consequential damages). So what damages will be awarded to the Purchaser?

3. Direct damages are those damages that one would reasonably expect to arise from the breach in question, without taking into account any special circumstances of the nonbreaching party. They are damages which may fairly and reasonably be considered as arising naturally from the breach of any similar contract in the great multitude of cases. Consequential damages "include those damages that, although not an invariable result of every breach of this sort, are reasonably foreseeable or contemplated by the parties at the time the contract was entered into as a probable result of the breach. It is reasonable to expect that the three customers would terminate their contracts as a result of the Seller not holding the requisite permit to transport hazardous waste. There are no special circumstances of the Purchaser at issue here. These damages are therefore direct damages."

4. Purchaser has incurred $5,000 of incidental damages (*i.e.*, Purchaser's cost of cover to obtain the permit at issue). Purchaser will not be awarded the $5,000 in a claim against Seller because the Acquisition Agreement excludes incidental damages.

It is typically not reasonable for a purchaser to exclude incidental damages because incidental damages are real damages incurred by the Purchaser to effect a cure and to avoid other direct and consequential damages.

5. The damages sustained (in addition to the $5,000 of incidental damages described above) are the loss of EBITDA of $10,000 per year. Seller's position is that this is "lost profits," and Seller believes that Purchaser waived the right to collect "lost profits" pursuant to the Damage Waiver included in the Acquisition Agreement. A close read of the Damage Waiver, however, reflects that "lost profits" are excluded only as part of consequential damages and are not excluded as direct damages or as a separate category of damages. There are no consequential damages at issue here. Purchaser is entitled to receive lost profits as direct damages. See *Westlake*, 2015 IL App (2d) 140589. Further, the computation of Purchaser's damages from the breach of representation by Seller would likely be computed as 10 times the reduction in EBITDA of $10,000 ($100,000) because Purchaser determined the purchase price for the business based on 10 times EBITDA. A financial expert would likely compute the damages in the same manner.

6. From Seller's perspective, if Seller intended to fully exclude "lost profits" as damages, it should have included "lost profits" as a category of excluded damages separate and apart from consequential damages. In addition, Seller may have assumed that using a multiple of EBITDA to compute damages is a form of consequential damages, but in most cases, it would be considered direct damages. It is not prudent for purchasers to permit exclusions for diminution in value or multiples of earnings since they are forms of direct damages.

F. Strategies for Negotiating Damage Waivers in Acquisition Agreements. The following strategies are recommended for purchasers and sellers in Acquisition Agreements[1]:

1. At a minimum, purchasers should avoid the "kitchen sink" approach to the consequential damage waiver.

2. Purchasers should try to define "consequential damages" for the purpose of any waiver provision in such a manner that the term covers only those consequential damages for which the law already denies recovery for breaches of contract (*i.e.*, those damages that arise solely from the special circumstances of the purchaser that have not been communicated to the seller).

3. Purchasers should avoid including the broad term "lost profits" as a separate category of damages in the waiver provision.

4. Sellers should consider expressly limiting recoverable losses under their indemnification provisions to the "normal measure" of contract damages (*i.e.*, market-measured damages based on the difference between the value of what the purchaser received and the value of what the purchaser should have received if there had been no breach of a specific representation and warranty by the seller).

5. Purchasers should never include "incidental" damages in their waiver provisions. They are not a synonym for "consequential" damages.

6. Instead of waiving "consequential" damages, purchasers should seek waivers of "remote" or "speculative" damages.

[1] See Reassessing the "Consequences" of Consequential Damage Waivers in Acquisition Agreements, by Glenn D. West and Sara G. Duran, The Business Lawyer, Vol. 63, No 3 at 805, May 2008.

7. Purchasers should never agree to waivers of “diminution in value” or “multiples of earnings” damages.

IV. Arbitration

A. Is Arbitration A Good Idea?

1. Purportedly, arbitration is good because of:

a. Quicker results

b. Less costly proceeding than court

c. Privacy in resolving the dispute

d. Avoid “runaway” jury verdicts/less likely to obtain punitive damages

e. Simplified rules of evidence and procedure

2. Are these promised benefits realized in practice?

a. Preliminarily recall, a contract is just a set of promises the law allows you to sue to enforce.

i. Must the arbitrator comply with the law? If not, a set of promises the law allows you to sue to enforce, but the law only sort of controls.

ii. Arbitration binding with limited appellate recourse. But if you lose, do you really want no recourse?

iii. A forthright arbitrator: “Let’s see how we can split the baby here.” If that the agreement is breached, are you looking to simply split the baby?

iv. Often achieves substantially reduced chance of punitive damages. Is that a genuine worry in this transaction?

3. Arbitrators are typically attorneys and are loathe to refuse requests continuances (continuances equate to increased legal spend). The arbitration pipeline dries up when words get around about such harsh actions. No more arbitrations or mediations business for you Mr./Ms. Arbitrator!

4. Typical panel of potential arbitrators has few, if any, gems.

a. "Where in world did this panel come from?"

i. Battle about inadequate panel (increased legal spend).

5. What is included in the arbitration?

a. Usually the arbitrator decides what is within the scope of the arbitration provision?

b. "[A]s a matter of federal law, any doubts concerning the scope of arbitrable issues should be resolved in favor of arbitration, whether the problem at hand is the construction of the contract language itself or an allegation of waiver, delay, or a like defense to arbitrability." *Moses H. Cone Mem'l Hosp. v. Mercury Constr. Corp.*, 460 U.S. 1, 24–25, 103 S. Ct. 927, 941 (U.S. 1983).

i. Off contract, must determine arbitration provision in contract and breach of contract can be accompanied by a claim "off the contract" (*i.e.* sounding in tort). If not, separate corollary lawsuit.

6. Simplified evidentiary issues: Let everything in or did you say arbitrary evidentiary rulings without recourse?

7. Privacy is usually a promised benefit of arbitration that is delivered.

B. **Paris France now has an international commercial chamber in its Commercial Court and its Court of Appeal**

1. On February 7, 2018, the Paris Bar signed protocols with the Paris Commercial Court and the Paris Court of Appeal in order to organize how the international commercial chambers set up in these two courts will work.

2. Thanks to the signature of these protocols, Paris now offers a tailor-made solution for the settlement of international trade disputes, according to the following procedures:

a. Use of the English language for evidence, hearings of parties, witnesses or experts;

b. Decisions in bilingual version;

c. Use of the articles of the procedural code allowing the hearing and examination of parties, witnesses and experts;

d. English-speaking and internationally competent judges

e. Benefit of the double degree of jurisdiction.

3. By establishing these international chambers, Paris met the expectations of international trade actors seeking an international, independent and high-level forum to settle their disputes.

4. As the United Kingdom prepares to leave the European Union, it guarantees the parties an easier enforcement of the court decisions it pronounces on the whole European area and other advantages offered by European treaties.

V. Representations and Warranty Insurance

A. Purpose

1. The purpose of the representations and warranty insurance is to cover the financial consequences of claims resulting from a breach of any representations and warranties made by the Seller.

2. The common goal of parties is to ensure that the commitments contained in the Acquisition Agreement matches with the provisions of the insurance contract as accurately as possible. If this condition is satisfied, the contract serves its purpose for both parties: for the guarantor, it transfers the risk of the representations and warranty insurance to a third party; for the beneficiary, it ensures effective coverage of the insolvency risk of the guarantor.

B. How does it work

1. There are two types of representations and warranty insurance: one subscribed by the Seller (a sell-side policy) which purpose is to operate as a civil liability insurance (indemnification of the Seller should the buyer be called as collateral; the other subscribed by the buyer (buy-side policy) which operates as a damage insurance (indemnification of the buyer for the financial consequences of the Seller's breach of representations and warranties).

a. <u>If the insurance is subscribed by the Seller,</u>

i. When carrying out the insured risk, the insurer shall indemnify the Seller up to the amount of the indemnities owed to it in respect of the implementation of the liability guarantee. For the sake of efficiency, the Seller may stipulate in the insurance contract a direct payment of indemnities to the beneficiary of the guarantee (this is a stipulation for others).

ii. Under a sell-side policy, the buyer must file a claim against the seller, and the seller then files a claim with the insurer only where the seller has incurred an insurable loss (*i.e.*, the buyer does not file a claim directly against the insurer).

iii. As the contract of insurance is a random contract, only uncertain events for the parties may be covered (article 1108 section 2 of the French civil Code); the policy cannot be put at stake in the event of deceptive or fraudulent behavior of the Seller at the time of the negotiation and execution of the liability guarantee since the hazard would be lacking here

b. <u>If the insurance is subscribed by the buyer,</u>

i. Unlike the policy subscribed by the Seller, the policy subscribed by the buyer allows the insurer to finance the indemnities due by the Seller before any recourse. Hence in case of claim under the warranty, the buyer files a claim directly with the insurer.

ii. As regards the scope of the insurance policy, it is more extensive than that of the policy subscribed by the Seller since the fraudulent behavior of the Seller cannot be automatically attributed to the buyer so that the damage remains covered by the guarantee.

2. Buy-side policies typically have coverage limits between 10% and 20% of the enterprise value (and can be much higher as negotiated for certain fundamental or critical representations and warranties). Sell-side policies typically have coverage limits

between 5% and 15% of the purchase price for non-fundamental representations and warranties. This typically approximates the seller's general cap on indemnification.

3. The insurance premium, which generally ranges between 2% and 5% of the total coverage amount, is paid on the date of completion of the transaction and its payment constitutes a condition precedent for the insurance coverage to become effective.

4. Most policies include a retention, which is the insured's deductible, which operates similar to an indemnification basket in an Acquisition Agreement (*i.e.*, there is not coverage until the amount of the loss exceeds the retention). The retention generally ranges from 1%-3% of the transaction value, depending on the risk involved. Buyers typically require that the seller fund an escrow at least in the amount of the retention so that the first dollars (after any indemnification basket) come out of the escrow.

5. By its very nature, certain risks are excluded from the insurance coverage. These typical exclusions include the following:

i. Claims with a triggering event which took place after the effective date of the sale / capital increase;

ii. Claims triggered by a willful dissimulation or fraudulent behavior of the insurance subscriber (note that seller fraud is generally not covered under sell-side policies but can be covered under buy-side policies because in the latter case, the party committing the fraud (*i.e.*, the seller) is not the insured);

iii. Claims already covered by other insurance policies usually subscribed by a company, such as, for example, disputes arising from the sale of goods or services covered by product liability insurance contracts or professional indemnity insurance contracts, or dubious debts covered by credit insurance policies;

iv. Breaches of covenants;

v. Matters that are known to the insured, and possibly matters that should have been known to the insured, including matters included on disclosure schedules to the Acquisition Agreement and matters discovered during due diligence; but note that if the insured is the buyer, matters to which the seller had knowledge is not necessarily attributed as knowledge of the buyer and therefore can be covered;

vi. Punitive damages and non-monetary relief;

vii. Criminal acts (although certain penalties may be covered, such as tax penalties);

viii. Failure of the seller to meet financial projections; and

ix. Purchase price adjustments.

C. Advantages of the representations and warranty insurance

1. Whatever the party concerned

a. Propensity to pacify the relations between Seller and buyer.

b. In the specific case of private equity transactions, the guarantee given by the warrantor to the investor can quickly alter their relationship. The intercession of a third party, the insurer, as guarantor to resolve conflicts resulting from the enforcement of the liability guarantee, is likely to facilitate the maintenance of good relationships, the latter being an absolute condition to the success of a capital investment operation.

c. Utility for capital increases: the representations and warranty insurance is particularly suitable for equity-taking operations by capital increase. Indeed, in such operations granting a guarantee (*cautionnement*) or a first demand guarantee (*garantie à première demande*) can reveal difficult. Since the proceeds of the capital increase are paid to the company and not to the guarantor, the latter, except to dispose of other personal assets, will not have resources that can be made available to the benefit of a bank in return for the grant of a security or an independent guarantee to the investor...

d. Flexibility of the mechanism, since it can be subscribed indifferently by the buyer or the Seller.

e. Efficiency since the guarantor (insurance company) is solvent.

2. From the Seller's point of view

a. Contrary to traditional counter-guarantees, the insurance allows that the transfer price be fully apprehended by the Seller at the closing, with lesser or no amounts having to be immobilized in anticipation of a performance of the security (whether in the form of an escrow or of a guarantee of a first-demand bank guarantee for example). This therefore allows the Seller to secure its offer without being compelled to freeze the proceeds of the sale.

b. Insurance reduces the risk of liability for breaches of representations and warranties by lowering the cap on the indemnification obligations of the seller.

c. Insurance allows the Seller not to be exposed on a long-term basis.

d. Insurance may allow the Seller to organize its personal and patrimonial foresight without waiting for the end of the guarantee period; isolating the proceeds of the sale from all future claims is an efficient way to allow him to organize its inheritance through donations for instance.

e. Insurance can allow the protection of key relationships.

f. Insurance can enable strategic positioning in the context of an acquisition bidding process: by incorporating liability insurance coverage, the Seller can expect higher bids.

g. Insurance may be useful to compensate for the inability to make guarantee commitments (*e.g.* for funds or for a Seller who bought the company only recently): the Seller may be required to resell a business acquired just one year before and may therefore not be prepared to grant guarantees for a period prior to his date of acquisition.

h. During the period of validity of the liability guarantee, the insurance policy covers not only the financial consequences derived from the enforcement of the liability guarantee, but also the costs of expertise and litigation

3. From the Buyer’s point of view

a. The insurance contract allows the buyer to turn directly to the insurer in the event of a breach, without having to turn first to the Seller.

b. The transferor's credit is strengthened by a more effective risk coverage and such coverage can possibly be granted for a longer period of time.

For instance, the survival period for seller's representations and warranties may be extended which provides the buyer with more time to discover and recover losses.

c. The contract of insurance may allow a strategic positioning of the buyer in the context of a bidding process for acquisition: The buyer who opted for the insurance may differ from the other buyers by requesting a guarantee ceiling which is lower than its competitors and by offering to the Seller less a safer exit (clean exit).

d. The contract of insurance may allow the avoidance of contentious negotiations and legal proceedings (the Seller can be in possession of key skills or have a network which the buyer wishes to benefit of after the sale, or the buyer may be dependent on its future business relationship with the Seller once the deal is signed). This allows the Buyer to avoid jeopardizing his relationship with the Seller.

e. The insurance provides security to the buyer of collection upon a breach from a seller in cases where risk of collection may be higher, including financially distressed sellers and sellers who quickly distribute proceeds to investors in liquidation (such as a portfolio company of a private equity fund).

f. In the case of multiple Sellers, the contract of insurance can simplifies the management of the liability guarantee and the process of filing of claims under such guarantee (*e.g.*, in case of sale of a family business with several generations of Sellers, or in case of sale of a business partly owned by natural persons (managers or family shareholders) and partly owned by financial investors).

g. The contract of insurance can allow for the "repatriation" of the jurisdiction in the place that suits the buyer better. Indeed, international legal proceedings are much more complex and costly than domestic ones. If, at the buyer's request, the Seller subscribes to a contract of insurance governed by the law of the buyer and issued by an insurance company located in the same jurisdiction as the buyer, this will facilitate legal actions by the buyer.

D. Disadvantages

1. High cost of this technique (2 to 7% of the amount of the guarantee sought) compared to the traditional techniques of guarantee of the representations and warranty insurance (this insurance is applicable to operations of transfer of a certain volume: 50 million of €).

2. The subscription of a representations and warranty insurance is part of a complex mechanism. Particular attention should be paid to the harmonization and the proper articulation of the stipulations of the Acquisition Agreement and the insurance policy. For instance:

a. It is critical that the term “Loss” in the insurance policy is defined in a manner that matches the definition of “Loss” in the Acquisition Agreement. The insurance policy, however, typically excludes consequential damages.

b. In addition, parties should be careful to resist an insurer’s insistence on covering only “actual” breaches rather than all breaches of representations and warranties.

E. Subrogation. The insurance policy should prevent the insurer from asserting a claim against the buyer or seller to recover losses paid by the insurer where the buyer or seller is responsible for the loss. It is typical that an insurer will insist on these subrogation rights in the case of fraud by a party.