THE UNCERTAIN CONSEQUENCES OF WAIVING CONSEQUENTIAL DAMAGES IN M&A AGREEMENTS

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The Uncertain Consequences of Waiving Consequential Damages in M&A Agreements

Exclusion and limitation of liability clauses are a staple element of the indemnity provisions in merger and acquisition (M&A) agreements and other commercial contracts. These clauses help to allocate transactional risks among the parties in a very direct manner; by barring or limiting recovery for certain types of damages that arise if the contract is breached or a representation proves to be untrue.

In that sense, they are very straightforward. This is perhaps why they often receive so little attention in contract negotiations.

Indeed, even where the rest of the M&A agreement receives intense scrutiny and is intensely negotiated, it is not uncommon to see parties relying on boilerplate exclusion or limitations clauses with little or no discussion. These clauses often reference (and preclude recovery of losses for) "consequential" and "indirect" damages and subcategories such as "lost profits" or "lost revenue". Unfortunately, for deal lawyers, the ubiquitous use of these terms has given rise to the false assumption that they have universally understood meanings. The truth is quite a bit more complex and an examination of current commentary and Canadian jurisprudence reveals that these phrases lack stable legal definitions.

The underlying principles for recovery of damages for breach of a contract are anything but modern and go all the way back to the famous case of *Hadley v. Baxendale* ((1854) 156 E.R. 145), in which the plaintiff claimed recovery of damages in a dispute over a broken crankshaft. The court laid out the principle that a plaintiff's damages are those that were in the reasonable contemplation of the parties when the contract was formed. This approach does not necessarily completely compensate for all of a party's losses, but targets what a contract promised and attempts, as much as money can, to put the plaintiff in the position they bargained for notwithstanding the breach.

Courts and commentators since then have generally understood this approach as creating two branches of recoverable damages based on foreseeability and remoteness. The first are objectively foreseeable damages that could reasonably be said to arise naturally from the breach of contract itself or were reasonably

contemplated by the parties when they made their contract. The second are subjectively foreseeable damages that arise due to a party's special circumstances and are outside the usual course of things. This second branch of damages is only recoverable if the special circumstances were communicated to the breaching party and the claimed damages are the sort that would reasonably be expected to arise from the breach of contract under the circumstances. If the losses do not fall into either branch, they are not foreseeable and too remote to recover.

While the existence of these two branches is widely acknowledged, what (and how) particular losses fall into one category or another remains a matter of some debate and confusion. This has direct implications for damage exclusion clauses because the language courts and commentators use to describe damages falling under each branch is widely used by M&A deal lawyers when drafting contracts. The problem is that not everyone agrees on what these terms mean. In fact, there are multiple ways of both distinguishing between the branches and defining various terms used to describe the damages they include.

Phrases such as "general damages" and "direct damages" are widely used to describe losses within the first branch and "consequential damages" and "indirect damages" are widely used to describe those within the second branch. While Hadley based its discussion in foreseeability, for many these terms imply a distinction based on the damages' causal connection to the breach. In this understanding, damages under the first branch are the immediate or direct results of the breach. They are sometimes referred to as the natural or even physical consequences of the breach. Damages under the second branch are the less direct or subsequent consequences of the breach itself or even of those immediate consequences that fall under the first branch. Fortunately, most Canadian court decisions appear to follow *Hadley's* original dichotomy and distinguish direct and consequential damages on whether and how they were foreseeable. Nevertheless, explanations based on causality have still found favour with a minority of judges as well as with commentators and practitioners.

On a close look at the available jurisprudence, it becomes obvious that there is significant ambiguity and a real lack of consensus in how to use these terms and what they mean. Yet many deal lawyers treat them as widely understood concepts. This confusion over apparently basic terminology injects real risk into the simple boilerplate exclusion and limitations clauses commonly seen in M&A deals and other commercial transactions. *Hadley's* original foreseeability approach and the dueling causality approach do not always reach the same results when classifying damages and, when applied to the words of a contract, determining whether the parties agreed to bar or limit their recovery.

How the parties and the courts distinguish the branches and define these terms is hugely significant. For example, if a judge applies an exclusion of "consequential damages" on the basis of a particular loss's foreseeability, this could come as quite a surprise to one of the parties if they thought the term limited recovery to just the immediate losses caused by a breach and not any subsequent effects. If a purchaser acquires a

revenue-generating asset such as a piece of equipment that malfunctions or a business that must shut down temporarily, say due to COVID-19 pandemic restrictions, the lost revenue or profits from that asset is very likely a direct loss in that the damages are objectively foreseeable. These lost revenues or profits, however, are also arguably consequential damages in the sense that they are the consequences of a condition that was caused by the breach itself. Whether this helps the plaintiff or defendant in any suit for breach of contract will be highly fact-specific, but, regardless of who benefits, it might mean that the parties were forced to bear a different set of risks than those they thought they bargained for.

The consequence of this situation is that Canadian deal lawyers cannot rely on unconsidered boilerplate exclusion and limitation clauses because any provision that simply excludes losses such as “consequential damages” or “indirect damages” creates ambiguity in the purchase agreement. There are no presumptions or rules in Canadian law that predictably define these phrases, and practitioners should not act like there are. Deal lawyers must approach these phrases like any other term of the M&A agreement and, as appropriate for the deal, define exclusions from and limitations on recovery of losses more specifically. Any particular loss that can be identified should be expressly described. This avoids the question of whether or not a particular loss should be interpreted in light of another term (e.g., as a subset of it). Neither the parties to a transaction nor their lawyers can assume that the content of these common phrases will be understood by the other side or by a judge in the same manner that they do.

For a deep dive into the jurisprudence and commentary and an analysis of the issues surrounding these often poorly understood phrases and related terms such as such as “incidental damages” and “special damages”, we invite you to review our article (co-written with our colleague Charlotte Conlin) “The Uncertain Consequences of Waiving Consequential Damages” ((2020), 63 C.B.L.J. 178.) recently published in the Canadian Business Law Journal (subscription) and also available on our website.

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A Cautionary Note

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.