

The Unintended Consequences of Consequential Damages Waivers¹
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Hypothetical: Buyer purchased the stock of a company based on a multiple of EBITDA. (EBITDA is \$10 million, and the multiple is 7x, resulting in a purchase price of \$70 million). Seller made representations regarding the accuracy of the financial statements upon which the EBITDA was derived. Following the closing, the financial statements were found to be inaccurate, resulting in an actual EBITDA of \$8 million.

How much is recoverable based on the language below? Can Buyer recover \$2 million, \$14 million or some other amount?

- “Loss” means any liability, claim (including a third party claim) shortage, damage, **diminution in value**, settlement, deficiency (including legal, consulting, accounting and other professional fees) or loss of any kind.
- Except in the case of fraud or willful misconduct and except for indemnification for such damages incurred by a party and actually paid to a third party, the parties expressly waive and forego any right to recover punitive, exemplary, **lost profits, consequential or similar damages** in any proceeding arising out of or resulting from this agreement or the transactions contemplated hereby.

Does the waiver of “lost profits, consequential or similar damages” impact Buyer’s ability to recover direct, market-measured damages?

- Lawyers and judges frequently confuse the concepts of diminution in value, lost profits, consequential damages and incidental damages. It is important to remember that **these terms are not synonyms**.
- *What are consequential damages?* Generally understood to mean damages that do not flow directly or immediately from the act of a party, but only from the consequences or results of such act. In other words, losses that would not normally and necessarily result from a party’s breach in the absence of the non-breaching party’s special circumstances. Consequential damages are not direct damages or incidental damages.
- *What are incidental damages?* 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 (e.g., costs incurred in returning/rejecting defective goods, or repairing or installing defective equipment).
- *What is diminution in value?* In the sale of business context, the difference between the value of the business actually received by the buyer, and the value of the business

¹ For more information, 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. I relied on this article in preparing this practice tip.

had it been as warranted by the seller. Diminution in value is a claim for direct damages.

- *What are lost profits?* Lost profits are the most common form of consequential damages, however, not all lost profits are consequential damages.
 - An example of lost profits constituting direct damages is the wrongful termination of a performance contract (*e.g.*, a manufacturing contract). The non-breaching party has a claim for the net profit from the contract had full performance occurred.
 - Other examples in the sale of business context include breaches that result in the termination of long-term customer contracts (or favorable supply contracts), or the non-existence of warranted customer or supply contracts.
 - West and Duran state that “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.”

So, what do we do now?

- Buyers of businesses should be wary of the boilerplate “string” of consequential damage waivers.
- If waiving consequential damages, buyers should try to define consequential damages as those damages that arise solely from the special circumstances of the buyer that have not been communicated to the seller. Buyers should consider using the terms “remote”, “speculative” or “indirect” damages, rather than “consequential” damages.
- Buyers should avoid including “lost profits” or “incidental damages” as separate categories of consequential damages.
- Buyers should never waive diminution in value.
- Other than asking for the obligatory boilerplate “string,” sellers should try to limit indemnifiable losses to those losses that are the probable and reasonably foreseeable result of a breach.

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