Damages for Reps and Warranties Breaches

REPRESENTATIONS AND WARRANTY INSURANCE | MERGERS AND ACQUISITIONS | PROPERTY & CASUALTY INSURANCE | FEBRUARY 21, 2020

When one party to an M&A agreement alleges that the other breached its representations and warranties, the damages analysis can be complex, depending on the terms of the agreement. Generally, a claim for indemnification due to a breach of representations and warranties is treated as a claim for breach of contract. *Hudson's Bay Co. Luxembourg, S.A.R.L. v. JZ LLC*, 2011 WL 3082339, at *2 (Del. Super. Ct. July 26, 2011). Delaware courts generally award "expectation damages" for a breach of contract, which "are calculated by (1) the loss to the non-breaching party (2) plus any loss, including incidental or consequential loss, caused by the breach (3) less any cost or other loss that the non-breaching party avoided by not having to perform." *VICI Racing, LLC v. T-Mobile USA, Inc.* , 763 F.3d 273, 293 (3d Cir. 2014). Expectation damages are intended to put the non-breaching party in the position it would have been in if the other party had performed the contract. This can include direct damages, which are the direct and probable result of the breach, as well as consequential damages, which flow indirectly from the breach due to special circumstances the parties had reason to know.

In Delaware, contract damages are based on the parties' reasonable expectations "ex ante." "Therefore, the question … is what [the non-breaching party] could have reasonably expected to receive pursuant to the terms of the Asset Purchase Agreements at the time the agreements were signed." I*vize of Milwaukee, LLC v. Compex Litig. Support, LLC* , Nos. 3158-VCL, 3406-VCL, 2009 WL 1111179, at *10 (Del. Ch. Apr. 27, 2009). However, the non-breaching party must establish damages with reasonable certainty, and courts will not award damages that are remote or speculative. *Interim Healthcare Inc. v. Spherion Corp.*, 884 A.2d 513, 570 (Del. Super. Ct. 2005). Courts also avoid awarding a party a windfall. *See*, *e.g.*, *Henkel Corp. v. Innovative Brands Holdings, LLC* , Case No. 3663–VCN, 2013 WL 396245, at *5–6 (Del.Ch. Jan. 31, 2013). The damages determination is a fact-specific inquiry, and, importantly, the terms of the parties' agreement will govern. These terms generally define what constitutes loss under the agreement as well as what categories of damages are excluded.

Rescissory Damages

Based on the representations and warranties at issue, parties may seek a variety of different damages, including various direct costs incurred as a result of the breach, lost profits, or the amount allegedly overpaid for a business. Occasionally, a party will seek "rescissory damages," which are "the monetary equivalent of rescission." *Strassburger v. Earley,* 752 A.2d 557, 579 (Del. Ch. 2000). Rescission seeks to return the parties to the position they were in before the transaction occurred.

Unlike ordinary compensatory damages, which are measured at the time of the transaction, rescissory damages are measured at a point in time after the relevant transaction. As a result, "rescissory damages may be significantly higher than the conventional out-of-pocket damages, because rescissory damages could include post-transaction incremental value elements that would not be captured in an 'out-of-pocket' recovery." *Universal Enter. Grp. L.P. v. Duncan Petroleum*, No. 4948, 2013 WL 3353743, at *16 (Del. Ch. July 1, 2013). Because they may include factors unrelated to the breach, Delaware courts are extremely reluctant to award rescissory damages, especially outside the context of fraud. And, although they may be used in breach of contract cases where the breach goes to the heart of the parties' agreement, courts have found them otherwise inappropriate, especially where they would result in a windfall. *See*, *e.g.*, *Universal Enter. Grp. L.P. v. Duncan Petroleum,* No. 4948, 2013 WL 3353743, at *18, *16 (Del. Ch. July 1, 2013).

Causation

To recover damages for a breach of reps and warranties, the non-breaching party must also show that its losses are causally related to the breach, as a party is only entitled to the loss it suffered thereby. *See*, *e.g.*, *Twisted Ventures LLC v. Chandler,* No. N15C-02-030, 2016 WL 4409433, at *2 (Del. Super. Ct. Aug. 16, 2016 ("[T]he measure of damages is the loss actually sustained as a result of the breach of the contract."). This, again, is a fact-specific inquiry, and Delaware courts have repeatedly held that plaintiffs are not entitled to recover losses when they fail to make such a showing. For example, in *Universal Enter. Grp. L.P. v. Duncan Petroleum*, No. 4948, 2013 WL 3353743, at *13-14 (Del. Ch. July 1, 2013), the

seller of a gas station business breached representations related to compliance with environmental and other laws, absence of liabilities or investigations, and disclosure of all material information. The buyer sued for damages, including rescissory and diminution in value damages, but the court found that the damages sought were not reasonably certain, nor had the buyer identified which damages were attributable to the breaches. *Id*. at *20. As a result, the court limited recovery to the actual losses incurred to remediate the properties. *Id*.

The court similarly limited damages in I*vize of Milwaukee, LLC v. Compex Litig. Support, LLC* , Nos. 3158-VCL, 3406-VCL, 2009 WL 1111179, at *8-9 (Del. Ch. Apr. 27, 2009), which involved the breach of a representation that the acquired company was operating in the usual and ordinary course because key employees were planning to leave and start their own competing business after closing. The buyer based its damages on loss of goodwill. *Id*. at *10. However, the court found the buyer had not contracted for goodwill or the right to sign the employees. Instead, it only contracted for an opportunity to make employment offers. *Id*. at *10-11. Thus, while the court found the seller had breached the agreement, the buyer did not sufficiently prove any actual damages it had suffered because of the breach, and the court instead awarded nominal damages. *Id*. at *11-12.

Consequential Damages Waivers

In addition to the necessity of proving causation, contract language itself may otherwise limit the damages available under an acquisition agreement. One common limitation is a consequential damages waiver, which limits the non-breaching party's recovery to those damages that are the direct and probable result of the breach, while excluding those that were reasonably foreseeable but flow only indirectly from the challenged conduct. Without such a waiver, a plaintiff may ordinarily recover these amounts. *See*, *e.g., Cobalt Operating, LLC v. James Crystal Enterprises, LLC,* No. Civ. A. 714-VCS, 2007 WL 2142926, at *30 (Del. Ch. July 20, 2007) ("In Delaware, damages recoverable under indemnification provisions such as the one involved here include all injurious consequences that were within the contemplation of the parties at the time the contract was made.").

The exclusion of consequential damages may be significant, as this can include large categories of damages. For example, parties commonly claim lost profits due to a breach of representations and warranties. And although lost profits may qualify as direct damages where they are part of the bargain, they are otherwise a type of consequential damage that such a waiver would preclude a party from recovering. *See*, *e.g.*, *Certainteed Corp. v. Celotex Corp.* , No. Civ. A 471, 2005 WL 217032, at *15 (Del. Ch. Oct. 24, 2005) (dismissing claims for lost profits where asset purchase agreement contained consequential damages waiver). Damages waivers are also commonly used to exclude punitive damages, as well as other categories of damages, such as diminution in value.

For all of these reasons, the terms of the agreement are just as important as the relevant law when it comes to interpreting M&A provisions, and the language chosen can have a major impact on the calculation of damages for a breach.