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The Impact of the Duty to Mitigate on Diminution of Value Claims

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Buyers in M&A deals often contend that they value a target company based on the seller's representations and warranties. If the buyer later determines those representations and warranties were false, it may argue that, as a result, the business is worth less than what the buyer paid. Where the buyer has representations and warranties insurance (RWI), it may seek coverage under the policy in the amount of the difference. In other words, the buyer will ask its insurance company to cover the diminution in value of the seller's business.

But what happens when the breached representation or warranty masks some operational problem or other issue with the selling company, which the buyer fixes? In this situation, the insured may claim that the damages should not contemplate the fix. However, both the common law of mitigation of damages and the insurance policy wording itself support the argument that, in fact, mitigation is required and should reduce the insured's recovery under the policy.

The Common Law Duty to Mitigate Damages

As a general rule of contract law, a party cannot recover damages for losses that it could have avoided by reasonable efforts. See Restatement (Second) of Contracts § 350 (1981). The purpose of this rule, referred to as the duty to mitigate damages, is to promote a policy that encourages the injured party to attempt to avoid loss. Id. In addition, the rule has the effect of tying compensation to causal responsibility for the loss.

The reference to this as a ''duty'' is somewhat imprecise, because the aggrieved party "incurs no liability for his failure to act. The amount of loss that he could reasonably have avoided by stopping performance, making substitute arrangements or otherwise is simply subtracted from the amount that would otherwise have been recoverable as damages." Id. In other words, under the common law, the duty to mitigate damages is less a requirement of affirmative action than a rule for calculating damages.

Mitigation Provisions in RWI Policies

In addition to this common law duty, many RWI policies contain mitigation provisions. For example, the policy may state:

> With respect to any Loss or potential Loss, the Insureds shall, and to the extent reasonably practicable under the circumstances shall cause their respective Affiliates to, take all commercially reasonable actions necessary and within their control to mitigate such Loss or potential Loss after any Specified Person obtains Actual Knowledge of any event which would reasonably be expected to give rise to any Loss; provided that the failure of any Insured to so mitigate shall only reduce the rights of the Insureds to recover for Loss under this Policy to the extent of the Loss that would have been avoided by such mitigation.

The policy may also specify that the insured's reasonable costs of efforts to mitigate will be covered.

Provisions such as the one excerpted above generally mirror the common law duty to mitigate, while also spelling out other limitations and requirements based on reasonableness under the circumstances and knowledge of the potential loss.

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As a practical matter, coverage disputes involving mitigation under RWI policies may not be about whether the insured has failed to mitigate. Indeed, business realities typically require a profits-driven company to take whatever measures necessary to fix identified problems. Rather, where the insured buyer argues that the value of the purchased company has been reduced due to breaches of the representations and warranties, the buyer may also contend that any actions it took to fix operational problems should not reduce its damages.

Based on the common law and policy provisions described above, insurers may respond to this argument in the following ways:

1. The insured was obligated to mitigate, so if it did, of course that reduces loss.

   The duty to mitigate is most accurately understood as a doctrine of common sense. This reality is reinforced by the fact that if the duty to mitigate were rejected, an injured party would be incentivized to increase, rather than decrease, its damages post-injury. Just as insurance generally does not cover “moral hazards” such as fraud or unlawful conduct, insurance also should not (and does not) cover an insured’s decision to sit idly by while incurring avoidable damages. Mitigation asks no more of the insured than to act reasonably under the circumstances to lessen its own harm. That is an entirely reasonable expectation, and requires no more than what any prudent company would do under the circumstances.

2. Under expectation damages, it isn’t just the problem but also the solution that should have been reasonably expected.

   The duty to mitigate is also tied directly to the insured’s business reality, in that it only requires the insured to take reasonable actions based on what it knows and can reasonably avoid (or, more accurately, calculates damages as if such actions had been taken). This corresponds with the concept of expectation damages, where the goal is to put the injured party in as good of a position as if the breaching party fully performed its contractual duties. Thus, an accurate measure of damages must account for the fact that the buying company should have reasonably anticipated solving the problem, rather than ignoring it and continuing to knowingly suffer harm.

3. The reduced actual damage is the only damage.

   Perhaps most fundamentally, representation and warranty insurance is intended only to compensate the insured for actual losses incurred – not to provide a windfall after a bad deal. Where a buyer takes measures to reduce its damages, and does so successfully, it should not be compensated for losses avoided. Such a result would contradict the dual purposes of the mitigation of damages rule – incentivizing damage reduction and tying compensation to causal responsibility – and would ultimately reward a windfall beyond the insured’s actual damages.

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