

Consequential, Incidental, Direct, Actual and Compensatory Damages: What are they and who gets them? Measures of Damages in Domestic and International Transactions						
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Common Measures of Damages in Merger and Acquisition Transactions

Damages are the primary remedy for breaches of contract around the world.

However, there are many different types of damages and the terms used to describe them are not always fully understood by the lawyers using those terms.

Using a misunderstood term in a damage limitation provision can drastically limit your client's recovery or increase their liability.

Case study

Seller wants to sell Target to Buyer.

Rep & war: Manufacturing contract is in full force and effect. Contract had been breached by Seller and counterparty terminates contract post-closing. Contract accounted for 50 in EBITDA on an annual basis. Buyer complains that he overpaid for Target as a result.

Limitation of liability clause: excludes Seller's liability for any consequential, lost profits, incidental or indirect damages, including diminution of value or multiples of earnings' damages.

Buyer claims 5 times 50 as his damages (he calculated purchase price on the basis of 5 times EBITDA) and 10 as costs for report on restructuring Target to reach guaranteed profitability.

Compensatory Damages

The general concept of damages in contract is based on the idea of compensating the non-breaching party by putting him in the position he would be in had a breach not occurred.

Compensatory damages include most of the measures of damages that we see in contract law. Contract law does not, as a general rule, provide punitive or exemplary damages. It focuses on enforcing specific promises made, rather than punishing the motivations or outrageousness of a breach.

Differences in Germany/Civil Law Countries

Primary remedy: restitution in rem, i.e. Seller puts business in the situation as promised, e.g. by renewing an agreement which was guaranteed.

Compensation of damages: In principle, all damages are to be compensated.

Damages must have been adequately caused by the breaching party, thus excluding unforeseeable or highly unlikely circumstances.

The scope of protection of the provision on which the compensation of damages is based must cover such damages.

Basic Damage Definitions

Actual Damages

Essentially synonymous with compensatory damages.

The idea of actual damages is to put the non-breaching party in the position he would be in had there been no breach of the contract.

Basic Damage Definitions

Incidental Damages

Refers to a very limited category of costs incurred by the non-breaching party.

Expenses incurred by a buyer in connection with rejection of non-conforming goods.

Expenses incurred by a seller in connection with wrongful rejection of delivered conforming goods.

Example – Storage costs for wrongfully rejected goods, for the period in which a replacement buyer is sought.

Incidental damages seem of little concern, but can be very substantial in some situations, and should not be waived lightly.

Basic Damage Definitions

Direct or General Damages

Damages which, in the ordinary course of human experience, can be expected to naturally and necessarily result from a breach.

These damages are presumed to have been foreseen or contemplated by the parties as consequences of a breach, and as such are fairly straightforward.

Example

Market-measured damages – Difference between value of item as received and value of item had it been as warranted by the seller (i.e. difference between contract price and cover price).

Basic Damages Definitions

Consequential or Special Damages

These are damages that arise out of special circumstances not ordinarily predictable, rather than arising naturally in the ordinary course of events.

Consequential damages still result directly from the breach, but may not be obvious to one of the parties in advance without communication of the other party's special circumstances.

Landmark case – *Hadley v. Baxendale*.

Basic Damages Definitions

Speculative Damages

Damages that have not actually occurred, may never occur, and cannot be proven.

Remote Damages

Damages that lack an appropriately close causal link to the breach.

Neither of these types of damages are recoverable under contract law.

Basic Damages Definitions – comments from a European perspective

Calculation of direct or general damages

Buyer: 5 times 50

Seller: 50 (to “replenish” balance sheet)

German Federal Supreme Court: Balance between purchase price paid and value of Target with EBITDA 50 (expert opinion).

There is no established concept of what consequential damages mean – diminution in value considered as direct damages.

Excluding liability for diminution in value is valid.

Under German law special or consequential damages, as defined in the US context, will not be compensated, but consequential damages are considered as direct damages

Common Damages Misconceptions

True or False?

A provision specifying that only “actual” damages are recoverable limits recovery to direct or general damages.

Common Damages Misconceptions

				FALSE				

Actual damages include both general and consequential damages. Thus recovery would not be limited to just direct damages. Drafters should keep in mind that consequential damages will not be waived under such a provision.

Common Damages Misconceptions

True or False?									

Lost Profits are always consequential damages.

Common Damages Misconceptions

FALSE

This is a very common and dangerous misconception. Lost profits *can* be considered consequential damages. However, courts have regularly found them to constitute direct damages. The important question is whether the lost profits would follow naturally and necessarily from a breach of the contract. If the profits would have been earned in the ordinary course of business and not just under special circumstances, they then are direct, not consequential.

Common Damages Misconceptions

Drafters should be wary of specifically excluding lost profits along with consequential damages in limitation-of-damages provisions, lest they unwittingly deprive a client of what would otherwise be recoverable direct damages (and possibly the only damages).

In a business acquisition where price is determined based on a multiple of revenue, be particularly careful, as lost profits may be the only accurate basis on which to determine market-measured direct damages for a breach affecting that revenue.

Other Issues with Consequential Damages

If one party waives consequential damages, and both parties are aware of a special circumstance that might lead to damages for that party, that party is unlikely to recover any damages that would not have occurred in the absence of the special circumstance.

If a waiver is given with full knowledge of this consequence, the party must accept that this was simply the bargain that was struck.

However, it is likely that many parties agree to such waivers under the mistaken impression that they are simply waiving their rights to speculative or unusual damages, or to lost profits.

Incidental damages are not consequential damages. Drafters should be wary not to include them in waiver provisions under this mistaken assumption.

“Consequential damages” is a term that is so misunderstood and fraught with uncertainty in mergers & acquisitions application that it may be best to avoid it entirely in this context.

Consequential Damages Exercise

Take the following “boilerplate” consequential damages waiver clause:

“No Consequential Damages: Notwithstanding anything to the contrary contained in this Agreement or provided for under any applicable Law, no party hereto shall be liable to any other Person, either in contract or in tort, for any consequential, incidental, indirect, special or punitive damages of such other Person, [including][or any] loss of future revenue, [or] income or profits, [or any diminution of value or multiples of earnings damages] relating to the breach or alleged breach hereof, whether or not the possibility of such damages has been disclosed to the other party in advance or could have been reasonably foreseen by such other party.”

What problems can we find with this clause?

Other Sources of Damages

Damages in M&A transactions may not come solely from breach of contract

Other potential sources include:

- Tort claims for Fraud (of the “reckless” variety)

- Negligent Misrepresentation

Both of these sources of damages are subject to specific state case law

Specific Performance and Equitable Remedies

Specific performance is sometimes available in the US for breach of contract claims in the M&A context

Specific performance is available in Europe without the specific requirements existing in the US

However, in Europe it is often excluded as a remedy due to impossibility