ALERT MEMORANDUM

Consequential loss exclusions in UK M&A – nebulous or clear?

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M&A transaction documents often contain an exclusion or limitation of the seller's liability for "consequential", "indirect" or "special" losses suffered by the purchaser. For instance, a purchase agreement will often provide that the liability of the seller under the warranties does not extend to these types of losses.

It appears that purchasers often agree to an exclusion or limitation of this type on the assumption that such exclusion has a well-established and relatively narrow meaning which excludes only losses which arise in a small minority of cases. This assumption, although historically supported by decisions of the UK courts, has appeared over the past handful of years to be increasingly less tenable. A recent UK High Court decision in *Star Polaris LLC v HHIC-Phil Inc.* now casts further doubt on the appropriateness of making this assumption.

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Background

UK courts have consistently held that it would be too harsh to make a contract breaker liable for all losses, however improbable or unpredictable, resulting from a breach and have therefore developed long standing limitations on the recoverability of damages.

These limitations include those developed in the seminal case of *Hadley v Baxendale*[1], which has been cited with approval in the UK, a number of Commonwealth jurisdictions and in the US. *Hadley* held that losses resulting from a breach of contract are only recoverable if they satisfy either of two tests (here referred to as limbs):

- Limb 1: losses that arise in the normal course of events – the court in *Hadley* appeared to equate these losses with those which would arise in the "great multitude" of cases;
- Limb 2: losses that do not fall within Limb 1 but which arise from special circumstances which have been communicated by the non-breaching party to the breaching party.

Other losses caused by the breach (that is more speculative or hypothetical losses not falling into Limb 1 or Limb 2) are not recoverable.

[1] Hadley v Baxendale (1854) 9 Ex. 341

In the context of M&A transactions, the table below summarizes in broad terms the application of these two limbs:

Hadley v Baxendale	**Description**	**Comment**
Limb 1	Losses which arise to purchasers in the great majority of cases	Limb 1 losses are often further divided into two sub-categories, here referred to as Limb 1a and Limb 1b. Limb 1a: represents what is referred to the "normal measure of damages", being diminution in value losses calculated as follows: A – B where A = value of assets had warranties been true B = value of assets acquired by purchaser (that is taking into account the breach of warranty) Limb 1b: represents other non-diminution in value losses arising in the great majority of cases
Limb 2	Losses which do not fall within Limb 1 but which arise from special circumstances communicated by the purchaser to the seller	For instance, the purchaser might intend to restructure the acquired business and then on-sell it for a particularly large profit. If the purchaser communicates this to the seller prior to the signing of the purchase agreement and the seller breaches the agreement causing the restructuring and on-sale to fail, the purchaser may have a Limb 2 claim.

To illustrate in relatively brief terms the application of Limb 1a, Limb 1b and Limb 2 losses in the context of M&A transactions consider the following example. Purchaser acquires a large asset management business (referred to as "target") from seller pursuant to a business purchase agreement. The purchaser primarily bases its acquisition price on a percentage of AUM (assets under management) of target. Purchaser intends following closing to restructure target and has had discussions with a large multinational to on-sell restructured target at a large profit – the purchaser communicates this to seller prior to signing of the purchase agreement.

In the business purchase agreement seller warrants that the target has complied with applicable law and regulation. Following closing, it transpires that target has not in fact distributed its products in accordance with applicable regulation and therefore that seller has breached this warranty. The applicable regulator initiates an investigation of the issue which requires purchaser to incur substantial legal and other fees. The regulator ultimately levies large fines on purchaser and refuses to approve any further sale of target pending improvements in target's compliance systems. In the meantime, the large multinational is concerned about the delay and compliance issues and decides

not to proceed with any acquisition of restructured target. Although target AUM is not adversely affected, target's customers successfully bring a number of damages claims against purchaser in respect of the distribution of target's products.

In this example:

- Limb 1a losses – so called diminution in value losses - will the difference in the value of the target business as warranted and the value of the target business taking into account the breach. As purchaser valued target based on a percentage of AUM and AUM has not been adversely affected, it is not obvious that purchaser would have paid less for target and therefore that it will be able to successfully claim any Limb 1a losses.
- Limb 1b losses – being non-diminution in value losses arising in the great majority of similar cases – are likely to include the purchaser's legal and other fees resulting from the regulatory investigation, regulatory fines and the damages paid to target's customers.
- Limb 2 losses – losses which do not fall within Limb 1 but which arise from special circumstances communicated by the purchaser to the seller - may include a claim for loss of the ability to effect the profitable on-sale to the large multinational.

Doubts being cast on past UK approach

Historically UK courts have held that an exclusion for "consequential" or "indirect" or "special" losses has a relatively well-established meaning and excludes only those losses falling within Limb 2 in the table above.

However there have been a number of relatively recent Commonwealth decisions (particularly in Australia) which have held that the meaning of the terms "consequential" or "indirect" or "special" losses varies depending on the context and should normally be construed to catch losses falling within Limb 1b (as well as Limb 2) in the table above. It appears that the position taken in these Commonwealth decisions has begun to attract some support in the UK. For instance, in 2016 the UK Court of Appeal in the case of *Transocean Drilling UK Ltd v Providence Resources*[2] said that it now doubted that the earlier UK cases on the meaning of "consequential" losses would be decided in the same way today.

Star Polaris

The recent High Court case of *Star Polaris LLC v HHIC-Phil Inc.*[3] has given further support to the position taken by the Commonwealth courts. In this case, a shipbuilder contracted to build a vessel called Star Polaris. Following delivery, the Star Polaris suffered a serious engine failure off the coast of Korea and had to be towed ashore for repairs. In the contract the shipbuilder guaranteed the buyer against "all defects which are due to defective materials, design error, construction miscalculation and/or poor workmanship" but excluded liability for any "consequential" or "special" losses.

The buyer of the Star Polaris claimed damages for, amongst others things, 1) the cost of repairs to the vessel, 2) towage fees, agency fees, survey fees, off-hire and off-hire bunkers and 3) other financial losses. An arbitral tribunal ruled that only the costs of the repairs to the vessel (the losses referred to in 1) were recoverable as the other losses claimed were excluded by the consequential losses exclusion. The buyer appealed to the High Court but was unsuccessful. In its judgment, the High

2 Transocean Drilling UK Ltd v Providence Resources Plc [2016] EWCA Civ 372
3 Star Polaris LLC v HHIC-Phil Inc. [2016] EWHC 2941

Court expressly stated that in the context of this contract the term "consequential losses" meant not just losses falling under Limb 2 but also certain losses falling under Limb 1 including diminution in value damages. By agreeing to an exclusion of "consequential" damages in this context, the buyer of *Star Polaris* appears to have accepted an exclusion for losses which went well beyond what it anticipated.

Key Learning Points

Depending on the context and underlying facts, the terms "consequential", "indirect" and "special" losses can mean different things to different people and there appears to be increasingly less consensus on the meaning of those terms in the UK Courts.

Some purchasers in M&A transactions may in fact resist agreeing to exclusions for these types of losses on the basis that their ability to claim for damages is already materially circumscribed by common law limitation principles (such as mitigation and the rules in *Hadley v Baxendale*) and by other common limitations in purchase agreements (such as thresholds, caps and time limits). If purchasers are willing to agree to exclusions for losses of the "consequential" or "indirect" or "special" type, it would be preferable to use more tailored language. For instance, if a purchaser is prepared to exclude Limb 2 losses – losses arising from special circumstances communicated to the seller, wording of the following nature would be preferable to language incorporating terms such as "consequential" or "indirect" losses:

> *"The Seller will not be liable for losses recoverable only under the second limb of the rule in Hadley v Baxendale except for…."*

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