

# Black Belt Jujitsu Techniques for Enforcing & Defending Contract Liability Claims

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# Jeryl Bowers

Jeryl Bowers is a corporate M&A and commercial transactions lawyer and served in numerous management roles, including as Global Corporate Practice Group Leader of Sheppard Mullin, a global law firm with over 900 lawyers and 15 offices in 6 countries, including key offices in New York, Washington D.C., Silicon Valley, San Francisco, Los Angeles, Orange County, Beijing, Shanghai, Seoul and Brussels.

Mr. Bowers represents public and private companies in the fields of healthcare, entertainment, real estate and other sectors in connection with corporate mergers, acquisitions, dispositions and commercial transactions.

Mr. Bowers obtained his J.D. from the University of Chicago, where he served with distinction as the Managing Editor of the University of Chicago Law Review and also served as a law clerk to the Honorable Judge Joseph Hatchet, Chief Judge of the U.S. Court of Appeals for the Eleventh Circuit.

# TOPICS

- Risk Allocation Provisions
  - Indemnification Clauses
  - Liability Carve-Outs
    - Consequential Damages, Insurance, Taxes
  - Enforceability Issues

# INDEMNIFICATION

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# Typical Indemnification Clause

“Seller shall fully indemnify, hold harmless and defend Buyer from and against all Losses which arise out of or relate to [contract breach, contract performance, negligence or other specified conditions]



# Indemnification Clauses

- Indemnify, defend and hold harmless
  - What's the difference!



# Indemnification: Duty to Indemnify

- **Duty to Indemnify:** Pay or compensate the indemnitee for its legal liabilities or losses.
- **Timing of Obligation:** The obligation to indemnify does not occur until **AFTER** the indemnitee has suffered a judgment entered against it for damages, or has made payments or suffered actual loss. It is a reimbursement “after the fact.”
- **Attorney’s Fees:** Most states automatically permit recovery of attorney’s fees; but, some require that duty to be expressly stated in the contract.



# Indemnification: Duty to Defend

- **Duty to defend:** Duty to pay costs of preparing and defending lawsuit brought by a third party.
  - In contrast to the obligation to indemnify, a contractual obligation to defend requires the party to **immediately** and **actively** defend or fund the defense of any claim which would give rise to indemnification.
  - The contractual duty to defend thus arises **before** the duty to indemnify.
- **Default Common Law Rule:** Indemnitor does not have a duty to defend (absent express contractual duty to defend).
- **California Exception:** Indemnitor has duty to defend unless contract expressly waives the duty.





# Indemnification: Duty to Defend

- **Important Considerations**
  - What if counter-party can't afford the defense
  - What if counter-party chooses cheap unqualified counsel which results in judgment it can't afford
  - When does duty arise if breach is not proven?
- **Drafting Note:** Consider specifying list of qualified law firms or ensuring counsel is reasonably acceptable to Indemnatee
- **Drafting Note:** Include language stating duty to defend arises upon “alleged breach” or third party claim based upon “facts that, if true, would constitute breach”



# Indemnification: Duty to Hold Harmless

- Duty to Hold Harmless: Conflicting Authorities
  - Some courts claim it is identical to duty to indemnify
  - Some courts (including CA) indicate there is a difference:
    - Duty to Indemnify: Obligation to reimburse indemnitee
    - Duty to Hold Harmless: Prohibits indemnitor from bringing suit against indemnitee
- **Drafting Note:** Hold harmless is the weakest of the three provisions and might not be construed as a duty to defend or indemnity
  - Sellers should try to limit obligation to “hold harmless” under CA law
  - Buyers should ensure all three duties are specified



# Indemnification: Putting it All Together

- **Drafting Note:** Define term “indemnify” or “indemnification” to include all three duties to defend, indemnify and hold harmless
  - Avoids potential ambiguity when using references to indemnification in limitation of liability, indemnification procedures and other contract provisions





# Indemnification Clause

- Additional Drafting Note: Definition of “Losses”
  - Ensure definition includes losses, damages, claims AND **liabilities**
    - Losses/Damages – Generally not payable until indemnitee pays or is compelled to pay
    - Liabilities – Obligation arises as soon as indemnitee is liable. No actual payment or compulsion to pay is required.





# LIABILITY CARVE-OUTS

# Consequential Damage Waivers

- Common Negotiated Exclusion
  - Few People Understand What Waiver Means
  - Common Misconception
    - True or False: Consequential Damages compensate party for remote or speculative losses



# CONSEQUENTIAL DAMAGES

FALSE!



# Typical Consequential Damages Waiver

“No party hereto shall be liable to any other Person for any consequential, incidental, indirect, special or **punitive damages** of such other Person, including **loss of future revenue, or income or profits**, or any **diminution of value or multiples of earnings damages** 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.”





# Note Expansion of Definition

- Lost Profits are Not Consequential Damages (Direct Damage)
- Diminution in Value is Not a Consequential Damage (Direct Damage)
- Punitive Damages are Not Consequential Damages (Tort Damage: Not a Contract Remedy)



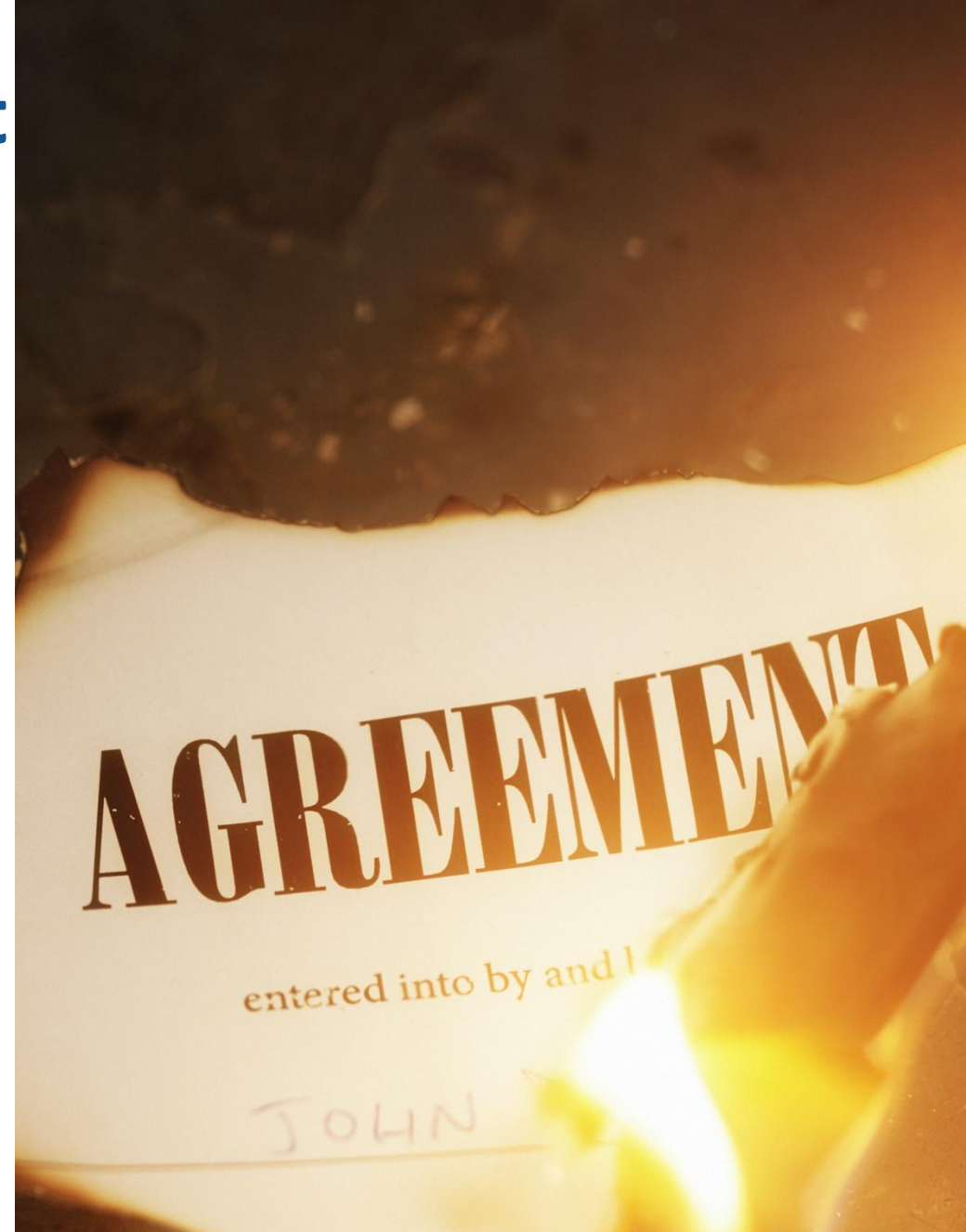
# What are Consequential Damages

- No clearly established meaning
- Courts will enforce contractual definition even if it excludes all damages resulting from breach of contract
- Example: M&A Transactions
  - **Lost Profits Exclusion:** What if acquisition was based upon enforceability of a customer or supplier contract
  - **Diminution In Value:** What if acquisition was based upon multiple of earnings resulting from customer contract
  - **Debarment:** What if Seller's breach causes Buyer to Lose its license or become subject to a Corporate Integrity Agreement



# Consequential Damages in Context

- Limits of Common Law Contract Damages
  - Damages are based upon whether the contract was performed or breached
  - **General Goal:** Award all monetary damages to the extent necessary to place non-breaching party in the position it would be in if breaching party performed agreement
  - **Limitations:** Damages must be natural, probable and a reasonably foreseeable consequence of the breach
    - Speculative remote losses are already excluded
    - Liquidated damages clauses are specifically designed to address this exclusion



# Hadley V. Baxendale: 1L Basics

- **Facts:** Hadley hired Baxendale to deliver a broken crankshaft to repair shop within one day. Hadley did not inform Baxendale that he needed the crankshaft to reopen his flour mill shop. Baxendale delayed delivery for five days.
- **Claim:** Hadley sued for lost profits caused by the delay.
- **Holding:** Court denied the claim because the damages were not a reasonably foreseeable or natural “**consequence**” of delaying delivery of a crankshaft.





# Contract Damages Vs. Indemnification

- **Contract Damages:**  
Compensate for natural, probable and reasonably foreseeable damages caused by breach of contract

- **Indemnification Damages:**  
Compensate for all damages resulting from specified events set forth in the indemnification clause.
  - Simply payment of money if certain events occur
  - Might not involve breach of contract
  - Probability or Foreseeability is irrelevant
    - Delaware Law: Unless claim is for breach of contract and there is no clear and unambiguous indemnification provision.
    - Other Jurisdictions: Unclear whether foreseeability matters

# Incidental vs. Direct Damages

- Incidental Damages
  - Damages incurred by Buyer in connection with non-conforming goods in breach of contract (e.g., cost of returning or repairing goods)
  - Damages incurred by Seller in connection with wrongful rejection of goods by Buyer in breach of contract (e.g., storage costs of rejected goods)
  - In General: All costs and expenses incurred by non-breaching party to avoid other damages in sale of goods



# Incidental vs. Direct Damages

- Direct Damages
  - **NY Rule:** Value of the promised performance
  - **M&A:** Breach of Rep and Warranty would justify market value measured damages
  - **Back to Hadley Rule:** May also include all damages which would naturally or reasonably flow from breach of such contract in most cases (e.g. they don't arise from some unknown and unforeseeable special circumstance of non-breaching party)



# Consequential Damages

- Second Prong of Hadley v. Baxendale
  - Unusual damages that arise from the special circumstances of the non-breaching party (e.g., not typical result of a breach)
  - Such damages would not ordinarily be recoverable as a matter of contract law
  - They become recoverable if breaching party knew or should have known about those special circumstances at the time contract was signed





# Lost Profits: Direct or Consequential Damages

- Obvious Damages = Direct Damages
  - If breaching party does not pay vendor, lost profits are direct damages
  - If breach foreseeably and naturally prevents vendor from selling to other customers, lost profits are direct damages
- Special Circumstances = Consequential Damages
  - If breach caused some unusual loss that arose from special circumstance, lost profits would be consequential damages
- Lesson: Do not automatically exclude lost profits

# Drafting Lessons

- Consequential (e.g., special circumstances) Damages are not recoverable unless
  - Parties knew about special circumstances OR
  - **Contract makes clear such damages are recoverable**
- Waiver of Consequential Damages
  - Consider whether you want to waive damages even if special circumstances are known to breaching party



# Buyer Drafting Lessons

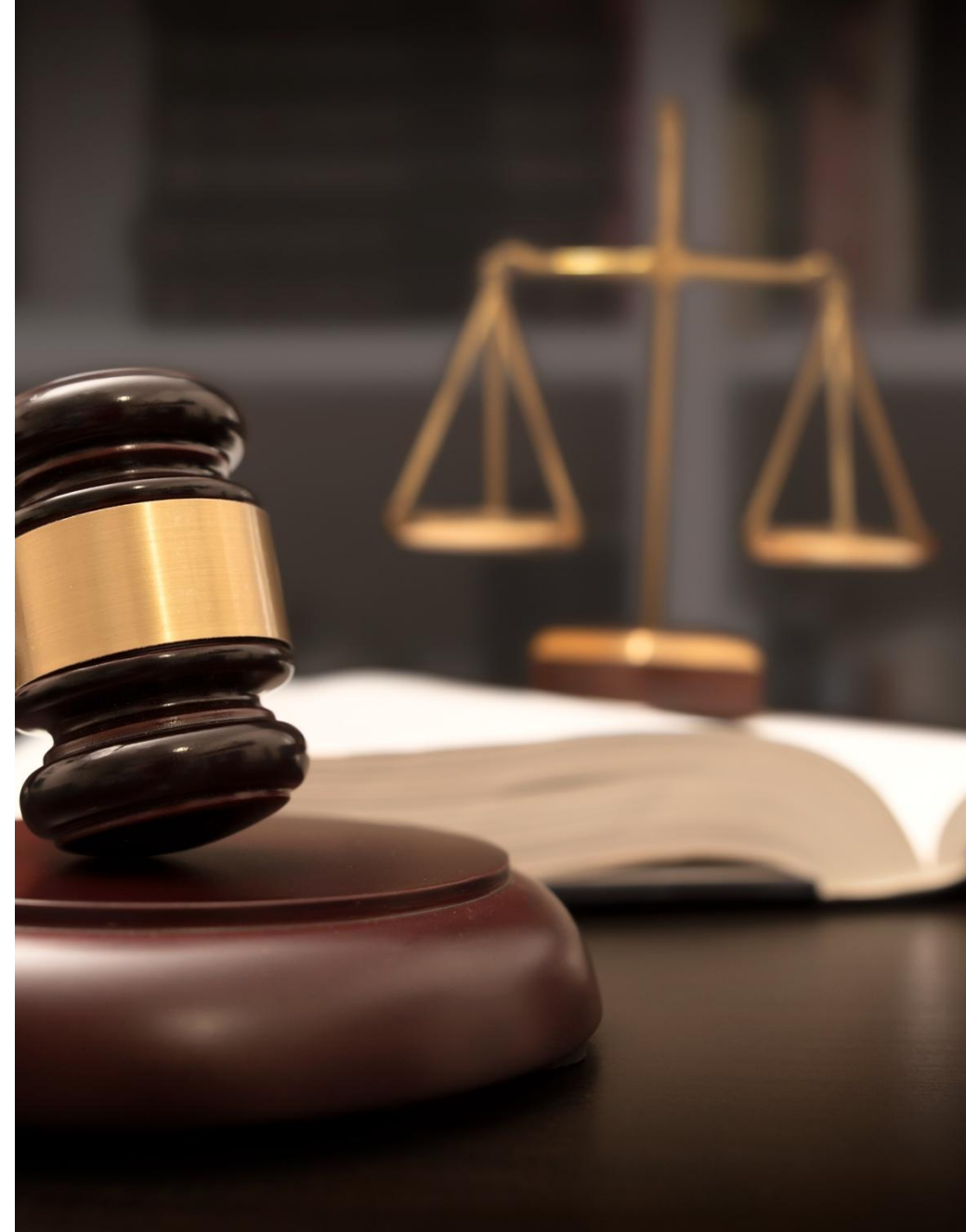
- Don't agree to expansive consequential damages waiver definition that include improper exclusions
- Define consequential damages to cover solely damages for which the law already provides no contract remedy (e.g., resulting from unknown special circumstances)
- Don't automatically include lost profits as consequential damages





# Buyer Drafting Lessons

- Don't automatically include "incidental damages" in a consequential damages waiver provision
- Don't include "diminution in value" as a proper carve out for the measure of damages
  - Common compromise is to remain silent on the issue and let court decide
- Punitive Damages: Solely a tort (rather than contract) remedy to discourage intentional misconduct. Acceptable to waive as contract remedy as long as Buyer clarifies waiver does not apply to fraud and other willful misconduct



# Buyer Drafting Lessons

- Indemnification Provision:  
Prudent approach is to expressly state that recoverable damages include all damages, whether such damages were reasonably foreseeable or their possibility was disclosed by the Buyer



# Seller Drafting Lessons

- Limit measure of damages to typical measure of contract damages: market measured damages based upon the difference between value had there been no breach of a representation
- Don't assume "Rule of Reasonableness and Foreseeability" will protect against broadly worded indemnification provision
  - Specifically limit claims to probable and reasonable result of breach
- Speculative Damages: Exclude damages that have not occurred, may never occur and can't be proven





# Indemnification Carve-Outs

- **Insurance:** Sellers try to reduce liability to the extent Losses are covered by insurance
  - Buyer should make sure contract does not require Buyer to exhaust efforts to obtain insurance recovery before bringing claim against Seller
  - Seller should request subrogation if Buyer has an insurance remedy

- **Taxes:** Sellers try to reduce liability to the extent Buyer receives tax benefits for Losses
  - Buyer should ensure language states that tax benefits are actually received before set off is allowed
  - Seller should ensure it has some mechanism to track if benefits are ever obtained

# Exclusive Remedy Clauses

- **Exclusive Remedy Clause:** Attempts to limit all remedies to carefully negotiated indemnification provisions
- What about Tort remedies?
  - Negligent misrepresentation
  - Fraud
  - Willful misconduct
- What about Equitable remedies



# Negligent Misrepresentation

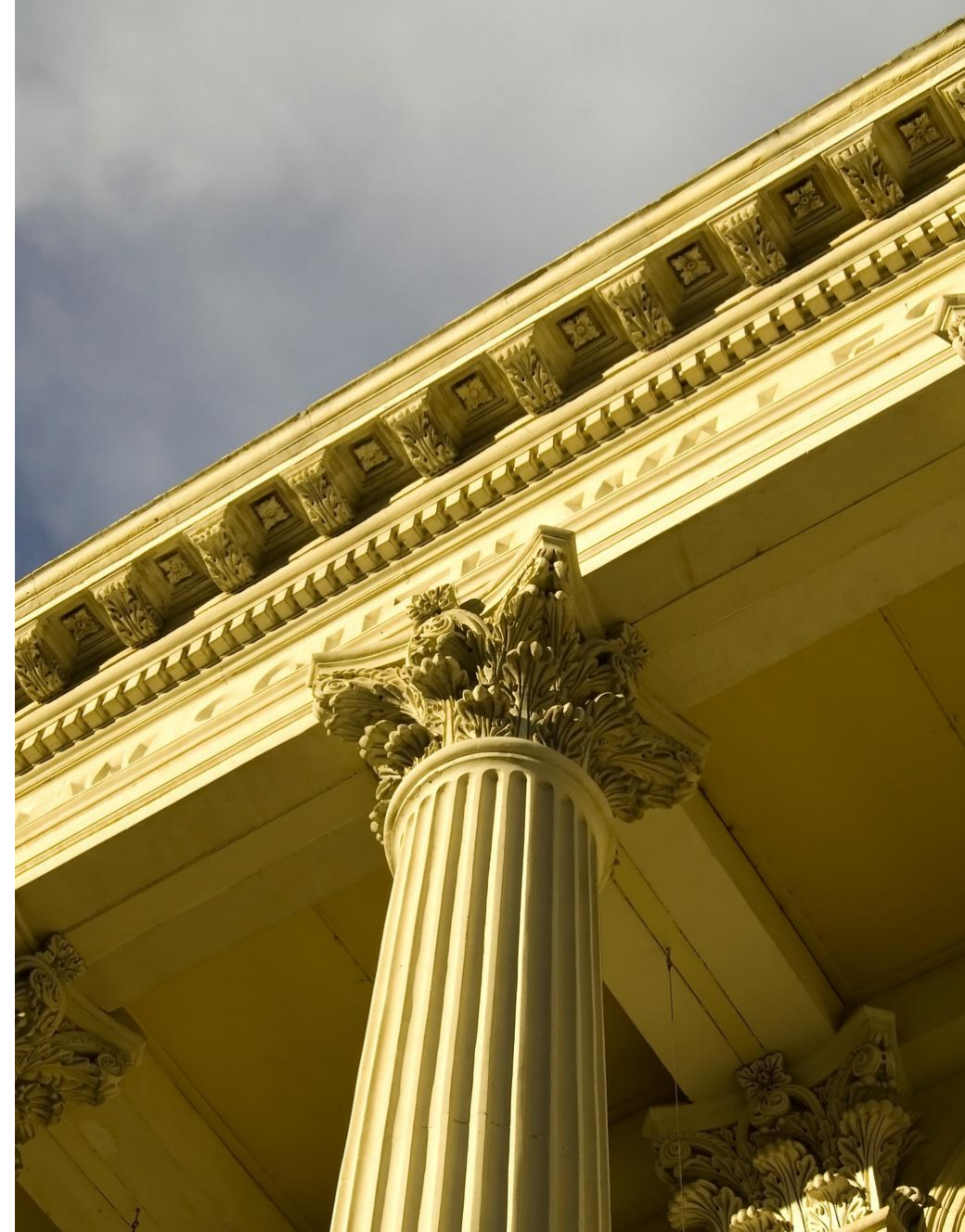
- What is difference between a representation and warranty?
  - Misrepresentation Claim is a Tort
    - Breach of common law duty to present honest facts to facilitate transaction
      - Requires negligence or fraud
      - Requires justifiable reliance by indemnitee
      - Requires material misrepresentation
      - No strict liability for inaccuracy if duty was fulfilled
  - Breach of Warranty is a Contract Claim
    - Breach of promise that a stipulated fact is true
    - Duty of care, intent and justifiable reliance by indemnitor are irrelevant





# Exclusive Remedy Clauses

- Ability to Preclude Tort Claims
  - **Honest Answer:** Courts are just as confused as practitioners. Struggle between policies of freedom of contract and punishment of wrongdoing
- Best Practice for Vendors:
  - Include statement that Buyer is only relying upon representations within four corners of the contract
    - Detrimental reliance is a necessary element to support a negligent misrepresentation or fraud claim based upon facts outside the contract
- Courts will generally not enforce liability waivers for fraudulent statements made by indemnitor within the four corners of the agreement





# Exclusive Remedy Clauses

- Applicability to Equitable Remedies
  - **Injunctive Relief:** Should be excluded from exclusive remedies clause (e.g. confidentiality provisions, non-compete)
  - **Specific Performance:** Should be excluded from exclusive remedies clause (e.g. must be able to require performance)
  - **Careful When Excluding All Equitable Remedies**
    - M&A Transactions: Rescission is an equitable remedy that could completely defeat the Seller's effort to cap liability.

# Choice of Law Provisions

- Common Choice of Law Provision:  
“This Agreement will be governed by, and construed in accordance with the internal laws of the State of New York”
- What’s wrong with this?



# Choice of Law Provisions

- **Good News:** NY provides more flexibility for contractually limiting tort claims
  - New York does not generally permit fraud and negligent misrepresentation claims when they arise from the same facts and circumstances as a breach of contract claim, seek identical damages and do not allege a breach of duty independent of independent of the parties' agreements.
- **Bad News:** Delaware and other states differ
- **Worse News:** Choice of Law provision was not broad enough to include claims brought in tort. Court may decide to apply law of jurisdiction where parties entered in to contract for tort to determine potential liability

# Drafting Lessons Learned

**Merger/Integration Clause:** Should disclaim existence of other agreements AND non-reliance on oral or written representations and warranties outside contract

**M&A Seller Representations:** Sellers and Company should not jointly make representations

- Sellers may avoid fraud liability if they just indemnify Company's representations

**Exclusive Remedy Clause:** Should encompass non-reliance on extra-contractual representations to avoid unexpected tort claims



# Drafting Lessons Learned

- **Fraud Exclusions:** M&A sellers should be careful before accepting a fraud exclusion
  - Define “Fraud” narrowly to mean intentional misrepresentation (rather than negligence or reckless conduct) relied upon by Buyer



# QUESTIONS?



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