INSIGHT: Not so risky business—How to increase transaction closing certainty

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What do you do when a buyer backs out? One option is to have a liquidated damages clause in the agreement. William D. Davis II and Kaitlin L. McLellan of Norton Rose Fulbright explain how liquidated damages can be used to shift additional risk to the buyer and increase closing certainty.

So you've found a buyer for your business—great! You are negotiating the purchase agreement, but how do you protect yourself from the buyer backing out of the transaction between signing and closing and leaving you high and dry? Once you and your team have invested the time and resources into finding a buyer, executing documents and announcing the transaction to the market, as a seller you want to make sure that the deal is going to close or, if the worst should happen and the buyer walks, that you will be appropriately compensated. Closing certainty can be even more important if your transaction was conducted through an auction process where the sale of the company or its assets was presented to the general market and you have already sorted through a pool of potential buyers. If the deal falls through with the selected buyer, you may have to re-approach the market with the same company or assets.

Introduction

A seller seeking closing certainty has several tools that can be used in various combinations to build layers of closing protection. The seller can start by limiting the buyer's termination rights. The seller can then consider in which breach of contract scenarios it may be able to enforce specific performance. In addition, the seller can consider negotiating for liquidated damages. This article briefly addresses each of these tools, but we ultimately focus on liquidated damages and their enforceability. We address specific state law in a few instances, but we generally reflect positions taken by Delaware courts. Further, we are only addressing liquidated damages in the context of a private company deal.

Limited termination rights

Limiting the buyer's rights to terminate the transaction is a typical first step. The buyer's rights to terminate can be limited solely to breach on the part of the seller or combined with limited exit rights allowing the buyer only to terminate if, for example, certain financing or regulatory approvals are unable to be obtained. Limited termination rights thus provide the first layer of closing certainty. However, if the seller only relies on limited termination rights, then that seller's only remedy for the buyer's breach is traditional damages. Such damages can be delayed and worn away by expensive and/or protracted litigation or arbitration. The seller's damages can also be difficult to prove as many of the damages from the broken transaction may be intangible, such as reputational damage and loss of time and/or resources spent by

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employees and upper management. Once the seller has whittled down the list of buyer termination rights, a next step would be to assess for which breach of contract scenarios the seller would want to seek specific performance.

Specific performance

Through specific performance, a court can compel a buyer to close a transaction. This remedy can be used to address a situation where all closing conditions have been met, but the buyer still refuses to close. However, given this is an equitable remedy, the seller will usually need to go through a court proceeding to enforce a specific performance clause. The buyer seeking to exit a transaction would likely challenge the seller's right to specific performance. Moreover, if the buyer challenges the specific performance clause and prevails, the buyer could argue that the seller's entitlement to damages amounts to only the seller's transaction expenses. Buyers have successfully challenged the enforcement of specific performance clauses by arguing that monetary damages are an adequate remedy for sellers. Buyers have also successfully argued that the premium represented by the agreed purchase price was for the benefit of the stockholders of the seller and other third parties and, therefore, not recoverable by the seller itself. Conversely, the seller can argue that the uniqueness of the transaction prohibits specific performance, especially if there is stock consideration involved or significant access to sensitive information has been granted to a competitor, which Delaware courts have found persuasive.

A seller can attempt to prevent as many of these challenges as possible by drafting tighter specific performance clauses. To limit or deter the buyer's challenge to a specific performance clause, the seller can consider adding a "no challenge clause" to the agreement whereby the seller and the buyer agree not to challenge the availability or enforceability of the specific performance clause. The seller may also consider clarifying the language in the third party beneficiary clause to state that though no third party beneficiary (*e.g.*, stockholder, etc.) has rights to bring claims for damages and the seller can collect damages on behalf of third parties, which may include loss of expected share value premiums.

Even with the foregoing in mind, the buyer can still proceed to engage in protracted litigation regarding the specific performance clause that prevents or at least significantly delays the seller's remedy. As such, the seller may consider liquidated damages as an alternative remedy.

Liquidated damages

General

Liquidated damages can be used to shift additional closing risk to the buyer, further protecting the seller. Liquidated damages can also be an alternative to specific performance clauses for other breaches.

Elements for enforceability

For a liquidated damages clause to be upheld (and not reclassified as an unenforceable penalty), most courts will consider the following elements:

- **Intent:** The parties' intent for the stipulated damages to be treated as liquidated damages.
- **Reasonableness:** The degree to which the stipulated damages represent a reasonable estimate of actual damages.
- **Difficulty of actual damages:** The degree to which actual damages are difficult or impossible to demonstrate.

One of the core principles behind upholding a liquidated damages clause is that the clause allows sophisticated parties to set forth an amount of reasonable damages that would make the aggrieved party whole in the case of breach without having to prove actual damages in a situation where doing so would be unduly burdensome. This concept typically works well in the mergers and acquisitions scenario as there are intangible costs and damages associated with broken deals that are difficult or at times impossible to document and evidence. When drafting a liquidated damages clause, the seller should seek to bolster the claim that liquidated damages are reasonable and appropriate because actual damages are difficult or impossible to prove. The liquidated damages clause should assert the reasonableness of the damages and support this assertion by detailing (as much as possible) the various losses remedied by the liquidated damages.

As a general example, see the following clause that uses a deposit/earnest money as liquidated damages (we have not defined all the capitalized terms, but they can be read in context):

> *If the [Closing] has not occurred on or before the [Outside Date] due to the Buyer's failure to close the [Transactions] when all conditions precedent to the Buyer's closing obligations set forth herein shall have been satisfied or waived in writing by the Buyer, then the Seller shall be entitled to retain the [Deposit] and any earnings thereon. The [Deposit] is not a penalty, but is liquidated damages in a reasonable amount that will compensate the Seller in the circumstances in which*

such fee is payable for the efforts and resources expended and opportunities foregone while negotiating this Agreement and in reliance on this Agreement and on the expectation of the consummation of the [Transactions], which amount would otherwise be difficult to calculate with any precision.

Further missteps can occur when the actual amount of liquidated damages is determined and presented in the agreement. As noted above, liquidated damages need to represent a reasonable estimate of actual damages that may be incurred by the seller in order for most courts to enforce the award. The seller must balance this reasonableness requirement with presenting an amount of liquidated damages that causes the buyer to be highly incentivized to consummate the transaction (or, rather, highly incentivized not to walk away and breach). It can be difficult to estimate what percentage of deal value is both reasonable and yet sufficient to deter the buyer from walking away. The seller's objective of achieving an amount of liquidated damages that creates an adequate disincentive for the buyer to walk away can sometimes be at odds with the principles behind allowing liquidated damages in the first place.

Courts generally seek to ensure that the parties have agreed to an amount of damages that does not allow for a large potential upside or windfall for the seller. Although, one of the factors of an enforceable liquidated damages clause is the difficulty of proving actual damages. If indeed the parties have difficulty in proving actual damages, this may limit a court's ability to question the reasonableness of the liquidated damages as compared to the actual damages sustained. In sum, a seller should not be overly aggressive when setting the amount of liquidated damages, but the seller should carefully consider a reasonable amount of damages given the seller's specific situation in addition to achieving its goal of deterrence.

When agreeing to the amount of liquidated damages, bear in mind that some states, such as Texas, may take a "second look" at the amount of these damages at the time of enforcement. In other words, the court may consider the elements of enforceability at the time of the agreement as well as the time of enforcement. In doing so, the court may weigh the reasonableness of the damages against the actual damages incurred (if determinable) when considering the enforceability of the award.

The seller should also consider the scenarios for breach of contract or termination in which the seller will be entitled to liquidated damages. Courts typically do not favor awarding liquidated damages for minor breaches, especially high dollar liquidated damages. Liquidated damages clauses should only be triggered by major breaches, such as failure to close the transaction when all closing conditions have been met (the primary situation we are addressing).

Optionality

The seller should also be wary of allowing the liquidated damages provision to be an optional recovery as courts may interpret the clause an unenforceable penalty. In other words, agreeing to an option scenario whereby the seller may choose its remedy, one of which being liquidated damages, presents an opportunity for the buyer to challenge the liquidated damages as being an unenforceable penalty. As noted, the main rationale underpinning the enforcement of a liquidated damages clause is that the damages reflect an amount of money that will make the aggrieved party whole when the parties are not able to otherwise prove actual damages. If the aggrieved party has an option as to its preferred path of recovery, such as accepting liquidated damages or pursuing specific performance (and/or another remedy), the incentives underlying the option are in competition with the rationale for allowing liquidated damages.

If specific performance is a necessary remedy to make an aggrieved party whole, then the liquidated damages clause would only be invoked by the aggrieved party when that party had reason to believe that it could collect the liquidated damages from the breaching party and then proceed to find another party with which to complete the contract. Therefore, there is a risk that a court would view the liquidated damages clause in this scenario as a penalty to the breaching party rather than an amount of money that would make the seller whole. Further, if the seller has the option to accept the liquidated damages or pursue other remedies, such as seeking recovery from the breaching party in court, then the liquidated damages clause would presumably only be invoked by the seller when the liquidated damages are higher than the seller's actual damages that would likely be awarded by a court. If the liquidated damages were a reasonable estimate of actual damages, then one could argue that there would be no need for an option to seek remedies from the court.

The seller can, however, have different enforceable remedies for different breaches. The issues outlined above occur when sellers seek to have optional remedies for the same breach. Even though most case law is fairly consistent that the seller cannot enforce liquidated damages as an optional remedy, some sellers may still desire the option. In this case, a potential solution to avoid the unenforceable nature of liquidated damages where an option exists is to add a savings clause to the provision. As an example:

If the optional nature of the liquidated damages clause causes a court or other adjudicator to determine that the liquidated *damages clause is penal in nature and unenforceable, such option shall be null and void.*

Of course, for the savings clause to be invoked, the parties must already be in dispute in front of a court or adjudicator. Moreover, there is no guarantee that the court would respect such a savings clause.

Forms of liquidated damages

Liquidated damages are often styled as reverse break-up fees whereby upon the "break up" of the deal based on the breach by the buyer, the buyer must pay the seller the agreed liquidated damages.

An earnest money approach can also be taken whereby the amount of agreed liquidated damages (or a portion thereof) is collected at signing to be held in escrow as earnest money, either by the seller directly or through a third party escrow agent.

Having the buyer deposit the liquidated damages with the seller as earnest money may achieve several things, the most important of which is shifting the burden of litigation to the buyer. If the seller already has the money in hand, they will not need to bring an action to enforce the liquidated damages clause; rather, the buyer will have the burden of bringing an action to have the liquidated damages declared unenforceable. Shifting the burden of the litigation, together with a well-crafted liquidated damages clause, can put the seller in a better position with respect to any buyer challenges.

Specific performance vs liquidated damages

As with many deal points, when to pursue specific performance or liquidated damages as the seller's remedy for a specific breach depends heavily on the subject seller's risk profile. If the seller's primary objective from the transaction is to receive cash, the seller may prefer to have the certainty of the receipt of liquidated damages in the case of the buyer's breach in certain instances as opposed to the uncertainty of seeking enforcement of a specific performance clause. If the seller's ultimate goal is to unload the assets or the company, then the seller may desire to forgo a certain recovery for the pursuit of specific performance for certain breaches.

Any seller who is or will be investing significant time and resources into a potential transaction should carefully consider how to protect against the risk of a buyer walking away in breach of the transaction documents. Adding a properly crafted liquidated damages clause can effectively increase closing certainty. Although, in doing so, the approaches and issues discussed herein should be kept in mind.

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