THE COST OF GUILTY BREACH: WILLFUL BREACH IN M&A CONTRACTS

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Abstract: The traditional framework of United States private law that every first-year student learns is that contracts and torts are different realms—contracts is the realm of strict liability and torts of fault. Contracts, we learn from the writings of Justice Holmes and Judge Posner, are best viewed as options; they give parties the option to perform or pay damages. The question we ask is whether, in the real world, that is indeed how contracting parties view things. Using a dataset made up of one thousand mergers and acquisitions (M&A) contracts and thirty in-depth interviews with M&A lawyers, we find that there is at least one significant area of transactional practice that rejects the perspective that fault is irrelevant to contract breach.

INTRODUCTION

The classic story of modern Anglo-American contract law characterizes contracting as a strict liability system.[1] In sharp distinction from tort law, where fault is a key element of determining liability and damages, contract law supposedly views fault as irrelevant to the determination of damages awarded following a breach of contract.[2] Disavowal of fault stands alongside deference to contracting party preference as one of the defining principles of modern contract law and is the foundation for a variety of contract law doctrines. As Judge Richard Posner put it, characterizing the (sometimes misinterpreted)

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[1] *See* Eric A. Posner, *Fault in Contract Law*, 107 MICH. L. REV. 1431, 1431 (2009); Robert E. Scott, *In (Partial) Defense of Strict Liability in Contract*, 107 MICH. L. REV. 1381, 1381–82 (2009).

[2] Omri Ben-Shahar & Ariel Porat, *Foreword: Fault in American Contract Law*, 107 MICH. L. REV. 1341, 1341 (2009).

theory of Justice Oliver Wendell Holmes, Jr., "[C]ontracts are options . . . to perform or pay damages."[3] The reasons for the breach are not supposed to matter to the parties. The non-breaching party, the theory goes, only wants to be made whole following its counterparty's failure to perform; the intentions and motivations of the breaching party have no place in the calculus.

Since the rise of strict liability as the defining feature of contract law, some scholars have insisted that fault is not entirely absent from the contract realm. These scholars differ in their assessments of the degree to which ideas of fault are left in contract law, with some arguing that notions of fault remain[4] and others insisting that contract law is infused with it.[5] The black letter of contract law and the presumptions of the courts, however, remain committed to the no-fault conception of contracts. This can be seen in first-year contracts hornbooks,[6] in courts' resistance to punitive damages in contract breach cases,[7] and even in the way practitioners conceive of their deals. The presumption against fault is so pervasive that courts resist punitive damages provisions even when sophisticated parties explicitly contract for them.[8] This distinction between tort law's focus on fault, and contract law's disavowal of it, is deeply embedded in both theory and court practice.

But do contracting parties in the real world truly not care about fault? That is, do they believe that what it takes to make them whole for breach of contract is the same regardless of the reason for or circumstance of the breach?

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[3] Richard A. Posner, *Let Us Never Blame a Contract Breaker*, 107 MICH. L. REV. 1349, 1350 (2009); *see* Joseph M. Perillo, *Misreading Oliver Wendell Holmes on Efficient Breach and Tortious Interference*, 68 FORDHAM L. REV. 1085, 1086–87 (2000) (explaining that Justice Holmes's opaque writing style has led to a misreading of his statement).

[4] *See, e.g.*, Saul Levmore, *Stipulated Damages, Super-Strict Liability, and Mitigation in Contract Law*, 107 MICH. L. REV. 1365, 1366 (2009) ("Contract law has been understood as deploying strict liability, but it is strict liability only to a point—because once the 'duty to mitigate' is at issue, fault comes into play as courts consider the reasonableness of the post- and even the prebreach mitigation efforts."); E. Posner, *supra* note 1, at 1431.

[5] *See* George M. Cohen, *The Fault That Lies Within Our Contract Law*, 107 MICH. L. REV. 1445, 1445–46 (2009) ("Fault plays an inherent, invaluable, and ineluctable role in contract law.").

[6] *See, e.g.*, E. ALLAN FARNSWORTH, CONTRACTS 761 (4th ed. 2004); ERIC A. POSNER, CONTRACT LAW AND THEORY 192 (2011).

[7] *See, e.g.*, *In re* Dollar Thrifty S'holder Litig., 14 A.3d 573, 614 (Del. Ch. 2010) (upholding a termination fee representing 3.9% of the transaction price as reasonable); *In re* Toys "R" Us, Inc. S'holder Litig., 877 A.2d 975, 1020–21 (Del. Ch. 2005) (upholding a termination fee representing 3.75% of the transaction price as reasonable); Phelps Dodge Corp. v. Cyprus Amax Minerals Co., Nos. 17398, 17383, 17427, 1999 WL 1054255, at *2 (Del. Ch. Sept. 27, 1999) (noting that a termination fee representing 6.3% of the transaction price is probably outside of the range of reasonableness as a compensatory damage figure); *see also* William S. Dodge, *The Case for Punitive Damages in Contracts*, 48 DUKE L.J. 629, 630 (1999); David Shine & Abigail Bomba, *Reverse Termination Fees Gone Wild: Legal Limit or Sky's the Limit*, 16 M&A LAW., Jan. 2012, at 7–10.

[8] *See* 11 JOSEPH M. PERILLO, CORBIN ON CONTRACTS § 59.2 (rev. ed. 2005); Seana Shiffrin, Could *Breach of Contract Be Immoral?*, 107 MICH. L. REV. 1551, 1551 (2009) (highlighting resistance toward punitive damages even for intentional breaches).

Some experimental research suggests—contrary to the standard story—that contracting parties in the laboratory setting *do* care about fault and intentionality when considering what damages are appropriate.[9] For example, experimental subjects say that if the reason for the breach is that the breaching party is trying to take advantage of some better deal, breach is wrong and damages should be higher than if the breach was due to circumstances out of the parties' control.[10] The experimental findings call into question whether actual parties operate according to the efficient breach and strict liability concepts. If, in fact, contracting parties would prefer to embrace fault-based concepts in their deals, then it may be that the two bedrock foundations of modern contract law—strict liability and deference to party preference—are in tension.

Although the role of fault in contract law has received considerable theoretical and doctrinal analysis, there is much less scholarship on the behavior of actual contracting parties.[11] In looking at the behavior of actual contracting parties, we find that notions of fault frequently appear in sophisticated mergers and acquisitions (M&A) transactions. In our examination of one thousand M&A contracts, we observed a frequent recurrence of parties differentiating between "willful breach" and other types of breach. We find, based on an examination of ten years of data, that over sixty percent of contracts tie the amount of damages liability to the extent to which the breaching party was at fault for the breach. Essentially, if the breach in question was "willful," liability increases. To understand what appears to be a robust and pervasive incorporation of fault as a determinant of the level of liability despite the strict liability paradigm seen in black letter contract law, we interviewed thirty senior M&A practitioners.

At least for a subset of contracts, sophisticated parties view the default strict liability rules as suboptimal and prefer a fault-based system. This Essay proceeds as follows. In Part I, we describe our data collecting methods and our results.[12] Part II details our conversations with sophisticated transactional law attorneys.[13] Part III analyzes our findings and argues that fault-based liability is more present in M&A contracts than theory would suggest.[14]

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[9] Tess Wilkinson-Ryan & Jonathan Baron, *Moral Judgment and Moral Heuristics in Breach of Contract*, 6 J. EMPIRICAL LEGAL STUD. 405, 405 (2009) (showing that experimental subjects believe that ethical culpability should affect contract damages).

[10] *See* Dave Hoffman & Tess Wilkinson-Ryan, *Breach Is for Suckers*, 63 VAND. L. REV. 1001, 1005 (2010) (suggesting that no one wants to be exploited and feel like a "sucker").

[11] For a recently published exception, see Uri Benoliel, *The Impossibility Doctrine in Commercial Contracts: An Empirical Analysis*, 85 BROOK. L. REV. 393, 395 (2020).

[12] *See infra* notes 15–22 and accompanying text.

[13] *See infra* notes 23–41 and accompanying text.

[14] *See infra* notes 42–49 and accompanying text.

I. THE DEALS

The M&A deals we examine are typically worth many millions, if not billions, of dollars. Parties are advised by the most sophisticated financial and legal firms. Given that the losses from a failed deal can be substantial, we can assume that the parties and their advisers are motivated to think carefully about the types of damages provisions that would work best for them. And in these real-life deals, parties explicitly differentiate between the damages in play for different types of breaches. Damages are limited if the breaching party is less at fault, and expansive where the breaching party is more at fault. Section A of this Part describes our methodology in selecting and analyzing deal provisions. Section B analyzes the findings.

A. Deal Selection Methodology

We used both quantitative and qualitative data sources for this project. In keeping with our data collection practices from a prior project on M&A deals, we used the What's Market database on Westlaw to locate summaries of publicly available deals.[15] Additionally, this database contains links to the underlying agreements filed with the Securities and Exchange Commission in compliance with the disclosure requirements for public reporting companies.[16]

We randomly collected fifty contracts from the public acquisitions database and fifty contracts from the private acquisitions database for each of the years between 2010 and 2019, making a dataset of one thousand deals.[17] The public acquisition database contains data for purely public deals—transactions between two companies that have securities trading on a public exchange. The private database showcases deals with at least one non-public party.[18]

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[15] Theresa Arnold, Amanda Gray Dixon, Hadar Tanne, Madison Whalen Sherrill & Mitu Gulati, *Lipstick on a Pig: Specific Performance Clauses in Action*, 2021 WIS. L. REV. (forthcoming). The What's Market database aggregates deals to enable comparison between deal features. *What's Market*, THOMSON REUTERS: PRACTICAL L., https://content.next.westlaw.com/Browse/Home/PracticalLaw/WhatsMarket?transitionType=Default&contextData=(sc.Default)&firstPage=true (last visited Apr. 10, 2021).

[16] Public companies are required to file a Form 8-K with the Securities and Exchange Commission upon entering a material definitive agreement. *See* Jennifer S. Fan, *Regulating Unicorns: Disclosure and the New Private Economy*, 57 B.C. L. REV. 583, 606 (2016).

[17] The deals used in this analysis are the same used in our prior project on specific performance clauses. A new data collection, however, was undertaken to assess the contracts for the terms relevant to this paper. *See* Arnold et al., *supra* note 15.

[18] We note that acquisitions consummated by a certain class of public companies, large public companies that are serial acquirers, are not reflected in our data set. Because filing is only required for "material" transactions, corporations of a certain size (Facebook for example) will rarely have to file, because very few acquisitions would meet the "materiality" threshold. In addition, the "private" acquisition database is still not fully private because a Form 8-K is only filed when one of the parties to the transaction is required to file as part of their obligation as a public company. Data on purely private deals is difficult to obtain since parties do not make these public.

We collected information specifically on the use of willful breach for the purposes of this Essay. Although other terms like "intentional breach" or "willful misconduct" are sometimes used for the same purpose as willful breach, we recorded only the use of the term "willful breach" to minimize the possibility of mixing concepts.[19] This means that the use of fault-based measures that approximate willful breach may be slightly higher than the figures cited here.

We also collected data on the pairing of fraud with willful breach. In contracts that contained the concept of willful breach, we looked to see if the concept was "paired" with fraud, determining that the two concepts were paired when they both triggered the same exception or otherwise were placed on equivalent footing within one clause.[20] Some contracts contained language

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[19] We did, however, include as an instance of willful breach where a deal included willfulness language alongside other modifiers. This means that language like "willful and intentional breach" was counted as a use of willful breach.

[20] A typical example of pairing can be found in the 2010 Hillenbrand, Inc. and K-Tron International, Inc. merger:

> Section 7.2 Effect of Termination. In the event of any termination of this Agreement as provided in Section 7.1, the obligations of the Parties hereunder shall terminate (except for the Confidentiality Agreement and the provisions of Section 3.22, Section 4.7, Section 7.2, Section 7.3 and ARTICLE VIII hereof, each of which shall remain in full force and effect) and there shall be no liability on the part of any Party hereto except (i) *liability arising from fraud or a willful and material breach of this Agreement*, or as provided in the Confidentiality Agreement, in which case the aggrieved Party shall be entitled to all rights and remedies available at Law or inequity and (ii) as provided in Section 7.3. The Parties further agree that notwithstanding anything to the contrary contained in this Agreement, in the event of any termination of this Agreement by Parent as provided in Section 7.1(c)(iv), the payment of the Termination Fee shall be the sole and exclusive remedy available to the Parent with respect to this Agreement for the breach or breaches underlying the termination pursuant to Section 7.1(c)(iv), and, upon payment of the Termination Fee, the Company shall have no further liability to Parent or Merger Sub hereunder for such breach.

Agreement and Plan of Merger Among Hillenbrand, Inc., Krushner Acquisition Corp. & K-Tron Int'l, Inc. § 7.2 (Jan. 8, 2010), https://www.sec.gov/Archives/edgar/data/1417398/000134100410000054/ex2-1.htm [https://perma.cc/7H2U-5NLD] (emphasis added). The language included in the 2010 Cardinal Health, Inc. acquisition of stock of Kinray, Inc. deal would also be considered "paired" despite being in different parts of the clause because both are exceptions to the cap on liability in the terminations/reverse termination fee:

> Section 8.2. Effect of Termination. (a) If this Agreement is terminated pursuant to Section 8.1 hereof, (i) all rights and obligations of the parties hereunder shall terminate and no party shall have any Liability to the other party under this Agreement, except for obligations of the parties hereto in Sections 6.1(b), 6.5, 8.2, 10.4, 10.5 and 10.6, which shall survive *the termination of this Agreement and (ii) subject to Section 6.4(c) hereof, termination shall not relieve any party from Liability for any intentional or willful breaches of this Agreement prior to the Termination Date*. (b) (i) In the event that either Seller or Buyer is entitled to terminate, and terminates, this Agreement pursuant to Section 8.1(b) or 8.1(c) and, at the time of such termination, the government approval which is the subject of the conditions to the Closing set forth in Section 7.1(b) has not been received, but all of the other conditions to the Closing under Section 7.1 and Sec-

such as "fraud and intentional and knowing breach" but, as noted above, we would not have coded this as an instance of willful breach and, therefore, would not have recorded this close-but-not-identical phrase as a willful breach-fraud pairing. Consequently, the number of contracts that expressed this same pairing sentiment of willful breach and fraud may, in actuality, be slightly higher than our data reflects.

B. Findings

First-year law students are taught in their contracts course that all breaches are created equal and that morality does not play a role in contract liability. Yet our data tells a different story—parties do indeed care about the motivations for breach. The concept of willful breach is ubiquitous, in both private and public M&A deals. Even at the lowest rate observed over the ten-year period reported in Figure 1—fifty percent in 2015—one out of every two contracts contained provisions concerned with willful breach. The use of willful breach is widespread and has generally increased over the last decade.

> tion 7.2 have been or are capable of being satisfied as of the date of termination or (ii) in the event that Buyer is entitled to terminate, and terminates, this Agreement pursuant to Section 8.1(f), then in either the case of (i) or (ii), Buyer shall pay to Seller a termination fee equal to $65,000,000 (the "Reverse Termination Fee") on or before the fifth Business Day following such termination by wire transfer of immediately available funds to an account designated in writing to Buyer by Seller no later than two Business Days after such termination. Seller agrees that, notwithstanding anything in this Agreement to the contrary, in the event that the Reverse Termination Fee is paid to Seller pursuant to this Section 8.2(b), *other than claims of and causes of action arising from fraud or willful misconduct, the payment of such Reverse Termination Fee shall be the sole and exclusive remedy* of Seller and its Affiliates against Buyer or any of its Affiliates, and in no event will Seller, the Company or any of their respective Affiliates be entitled to recover any other money damages or any other remedy, whether in law or equity or any other type, with respect to (A) any Loss suffered as a result of the failure of the transactions contemplated by this Agreement or any other Transaction Document to be consummated, (B) the termination of this Agreement, (C) any Liabilities arising under this Agreement, or (D) any claims or actions arising out of or relating to any breach, termination, or failure of or under this Agreement, and upon payment to Seller of the Reverse Termination Fee, Buyer shall have no further Liability to Seller or the Company relating to or arising out of this Agreement or any other Transaction Document or the transactions contemplated hereby or thereby. For all purposes of this Agreement, "willful misconduct" shall mean a conscious, voluntary act or omission taken with intentional disregard of legal or contractual duty and knowledge that such action or omission is a breach of such legal or contractual duty.

Stock Purchase Agreement Among Kinray, Inc., Stewart J. Rahr Revocable Tr. & Cardinal Health, Inc. § 8.2 (Nov. 17, 2010), https://www.sec.gov/Archives/edgar/data/721371/000119312510263607/dex21.htm [https://perma.cc/P4NA-WG3H] (emphasis added).

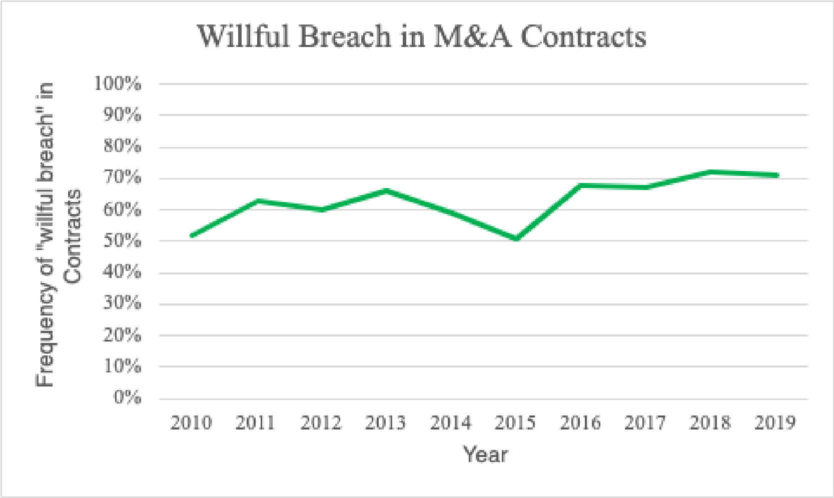

Figure 1: Willful Breach in M&A Deals

Given the widespread use of a concept suggesting fault-based liability, we wanted to make sure that there was no quirk in some small subset of the data that was skewing the results. As Figure 2 shows, however, we found that willful breach was extensive, even when the data set was divided between public and private deals and between financial and strategic deals. As seen below, willful breach provisions were found in 60%–85% of the public M&A deals we examined and in about 30%–70% percent of the private deals. Although the use of willful breach was more common in public deals, it generally increased across both public and private deals over the decade. In fact, in 2018, the use of willful breach was equal across public and private deals at over 70%.

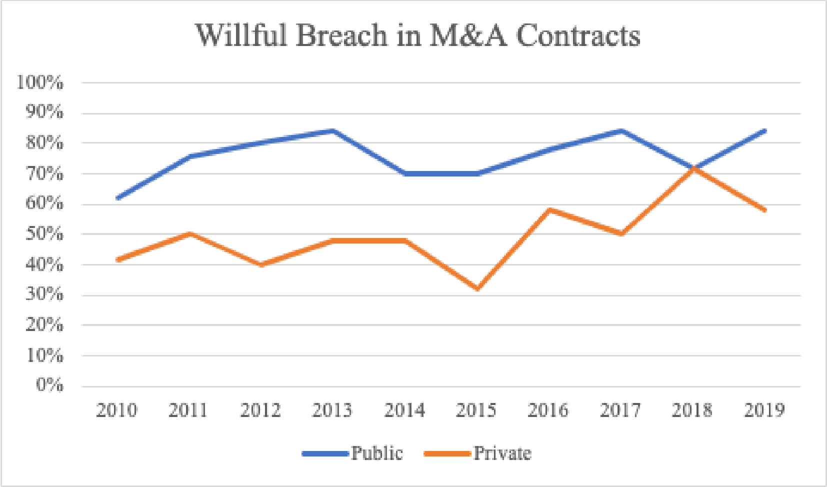

Figure 2: Willful Breach in Public Deals vs. Private Deals

One may have conjectured that parties to strategic deals, which represent the envisioned synergy between two companies, would care more about "guilty" breach by one party. Alternatively, one might imagine that only the targets of financial deals are worried about their buyer breaching opportunistically if the market changes. If willful breach was present in only one of these subsets, a theory about the incentives in that particular small pond could explain our numbers. We did not, however, find a meaningful difference between the rate of occurrence of willful breach in strategic deals and the rate in financial deals. The bottom line emerging from our data is that across a range of deal types, the term "willful breach" was prevalent and its use has increased over the last decade.

As noted, the use of willful breach in M&A deals is widespread. Despite that, it is difficult to tell based on the contract itself what the willful breach language is actually accomplishing. The term "willful breach" is rarely defined,[21] but the contract language indicates that parties distinguish between innocent and guilty breaches, and that a willful breach is a guilty breach. These contracts frequently—in about twenty percent of the deals that include the concept—pair willful breach with fraud, often as an exception from caps on damages.[22]

Parties carefully limit their liability for breach in M&A contracts; termination and reverse termination fees are the typically the exclusive damages remedy for a breach. It takes an extraordinary act for both sides to agree that liability should not be limited to these agreed-upon termination fees. Fraud, for example, is considered so out-of-bounds of acceptable behavior that parties often lift damage caps in its wake. Thus, for willful breach to be included under a similar exception—for it to be increasingly paired with fraud as a reason to abandon the carefully constructed caps on damages—indicates that willful breach is regarded as similar out-of-bounds behavior. If the breaching party is at fault, through fraud or willful breach, the damaged party may seek money damages in excess of the agreed-upon termination fee. And in the case of breach that does not rise to this level, the damaged party will be limited to the agreed upon cap. Our data shows that there was much variation in the rate at which fraud and willful breach are combined up to 2015. But after 2015, there was a steady increase in the rate of combination, with the terms combined roughly fifty percent of the time in both public and private deals by the end of 2019.

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[21] Willful breach is defined at most in only 46% of the deals of a certain year, and as low as 2% in some years. For further discussion of the vagueness of willful breach as a term, see *infra* notes 36–41 and accompanying text.

[22] As detailed above, by saying that the concepts are paired, we mean that fraud and willful breach were placed on equivalent footing within one clause.

II. "WHY DO YOU USE WILLFUL BREACH?"—THE INTERVIEWS

Given the striking and widespread incorporation of fault in damages provisions across the mergers and acquisitions (M&A) space, we turned to leading practitioners to explain this departure from traditional wisdom on contracts damages. Below we report on conversations with thirty senior M&A lawyers regarding the use of willful breach in M&A deals. Section A of this Part describes our interview methodology. Sections B discusses in detail the common explanations for fault-based distinctions in M&A contracting—foreclosing the idea that the contract is an option to pay or perform, setting the right incentives, and reserving room for negotiation, respectively.

A. Interview Methodology

In total, we interviewed over thirty senior M&A lawyers via Zoom, telephone, or e-mail.[23] Interviews via phone or Zoom averaged about thirty minutes, with some lasting up to an hour and a half. We first contacted these attorneys and shared our preliminary findings on the prevalence of willful breach in our data. Then, to begin our conversation, we explained that we were interested in understanding the incongruence between what is taught in the typical law school contracts class—that contract law in the United States is a strict liability system in which notions of fault and morality play little to no role in determining contract liability[24]—and the story revealed by our data, where at least sixty percent of the contracts include willful breach language. From that point, we allowed our respondents to talk, interjecting periodically to elicit additional detail on two core questions: (1) why they were including willful breach in their contracting at such high rates; and (2) whether they thought that the standard claims about strict liability as a basis for contract damages stands up in the real world.

B. Interview Responses: Not All Breaches Are Created Equal

Although respondents resisted framing their use of fault-based liability in moral terms, their explanations confirmed that concepts of fault play an im-

[23] We define "senior" as a lawyer with more than six years of experience. Over 90% of our respondents were partners at their firms with over ten years of experience. We initially tried to talk to a random set of the lawyers who were identified by name in the M&A contracts on What's Market. That strategy failed, in that none of them responded to our e-mails. We next turned to a random set of graduates of the Duke University School of Law in the M&A field and the authors of practitioner articles on the topic. Here we had success, in that everyone we contacted responded. All interviews were conducted between October 1, 2020, and January 31, 2021.

[24] FARNSWORTH, *supra* note 6, at 761.

portant role in M&A contracts.[25] They explained that conceptions of fault were included for practical reasons rather than moral ones, but agreed that they and the parties they represent differentiate between willful breach, which they consider out-of-bounds, and "innocent breaches."[26] Our respondents consistently framed the practical reasons for incorporating willful breach in three ways. Fault-based distinctions: (1) foreclose any notion that the deal is an option to perform or pay; (2) help to set the correct incentives for parties within the deal; and (3) reserve room for the parties to renegotiate. Even though the lawyers we interviewed framed these reasons as practical in nature, pervasive distinctions between "innocent" and "guilty" breaches have an unavoidable moral connotation. In the real world, it seems, the reason for breach *does matter*.

1. Rejecting the Option Conception

A common formulation in the scholarly literature is that a contract is simply an option to "perform or pay damages."[27] For M&A deals this conception of contracts is a core subject of dispute. In fact, our respondents indicated that it is the tendency of parties to treat deals in just this way that induced the introduction of willful breach clauses in the first place. Buyers in financial deals, like private equity firms, were likely to see damages as the price they set to walk away. Targets, concerned about the reputation costs of being jilted and the time invested in making the deal viable, did not view their deals as an option to pay or perform. The whole point of including the willful breach concept, they explained, was to make clear, to private equity buyers in particular, that the presence of a specific reverse termination fee amount did not give them an option to pay that fee and exit the contract.[28]

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[25] We do not purport to make claims about whether what our respondents said was an accurate reflection of the true reasons for why their contracts were the way they were. We think it helpful, however, to hear how these senior practitioners explain these provisions. The way contract drafters in sophisticated and high stakes deals understand these concepts is the clearest picture we can obtain of what role contracting parties actually believe that fault plays in their deals.

[26] Our respondents regularly used terms and concepts like "innocent breach" to distinguish between breaches that were entirely out of the parties' hands and those wrongful breaches that the willful breach language was aimed at preventing. Our respondents were less comfortable with formulations like "guilty breach" because of its moral overtone. As they discussed the distinctions between these innocent breaches and willful breaches, however, they clearly articulated that they and their clients did not see the two types of breaches as equivalent. We sensed that the willful breaches were so outside the bounds of acceptable conduct that these practitioners were attempting to get at the innocent versus guilty breach distinction without actually using moral terms.

[27] Douglas G. Baird, *The Holmesian Bad Man's First Critic*, 44 TULSA L. REV. 739, 741 (2008). This is the famous "bad man" theory from Justice Oliver Wendell Holmes, Jr. and Judge Richard Posner. *Id.*

[28] *See Drafting and Negotiating Reverse Break-Up Fee and Specific Performance Provisions*, THOMSON REUTERS: PRACTICAL L., https://ca.practicallaw.thomsonreuters.com/6-386-5096?transitionType=Default&contextData=(sc.Default)&firstPage=true&OWSessionId=e499c725a2ae4bf68daa8a715e16f193&skipAnonymous=true (describing a "pure option" reverse break-up fee clause versus a

The more senior respondents explained this point through a story about the origins of the willful breach clauses. Reverse termination fees originated in the mid 2000s, in a market where private equity funding was in abundance and targets were scarce. Targets, therefore, were able to demand that the private equity buyers commit to pay them a fee if they were unable to close the deal as scheduled, with the assumption that this would only occur because financing or regulatory approval fell through.

Targets had thought that private equity buyers, who are repeat M&A players, care about reputation and would not try to escape contractual obligations unless they could not consummate the deal for reasons outside their control.[29] But when the financial crisis of 2008–2009 hit, a number of private equity buyers found themselves bound by contracts to purchase companies whose values were no longer anywhere close to what they had promised to pay. The incentives changed, and with the financial crisis so severe, some private equity shops became willing to take the reputational hit by walking away from a deal.[30] The fact that there were explicit reverse termination fees, according to our respondents, left open an exit route for the buyers. They could pay that fee and walk away from the deal, though our respondents made it clear that this was not the prevailing understanding of the purpose of the reverse termination fees when they first were negotiated into M&A contracts.[31] To remedy the failure of reputational sanctions to constrain this opportunism, contracts were revised in number of ways.[32] One strategy was to include a caveat in reverse termination fee provisions that left damages uncapped if breach was willful. As one practitioner said:

> [T]hat effectively gave [private equity] funds an option: if the deal became sufficiently unattractive between signing and closing but no [Material Adverse Effect] had occurred, the buyer could walk away with its liability capped at the reverse break fee. Up [until] the time of the financial crisis in 2007–2008, the conventional wisdom was that a [private equity] fund wouldn't just walk away from a deal like

"willful breach" break-up fee clause) (last visited Apr. 10, 2021); Beth E. Berg & Karen A. Dewis, *How the Type of Buyer May Affect a Target's Remedies*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Oct. 22, 2019), https://corpgov.law.harvard.edu/2019/10/22/how-the-type-of-buyer-may-affect-a-targets-remedies/ [https://perma.cc/FFZ2-T2ME].

[29] *See* Matthew D. Cain et al., *Broken Promises: The Role of Reputation in Private Equity Contracting and Strategic Default*, 40 J. CORP. L. 565, 566 (2015).

[30] *Id.*

[31] *See* Steven M. Davidoff, *The Failure of Private Equity*, 82 S. CAL. L. REV. 482, 515–22 (2009).

[32] *See* Francis J. Aquila & George J. Sampas, *Reverse Break Fees: From Private Equity to Mainstream*, LAW360 (May 21, 2010), https://www.sullcrom.com/siteFiles/Publications/Aquila-Sampas-Law-360-Reverse-Break-Fees-May-2010.pdf [https://perma.cc/A7TV-LTKE] (suggesting that the financial crisis would increase the likelihood of reverse break fees in strategic deals).

> that because the hit to its reputation would be prohibitive. Of course, events in 2007–2008 proved that idea mistaken; there were several deals in which [private equity] firms paid the fee and walked.
>
> One response to the problem . . . of a contractual cap on damages in effect creating an option for the buyer—was the willful breach provision. If the deal doesn't close because the buyer really tried ([for example], really "used commercially reasonable efforts") to secure financing, then the buyer can terminate and pay the reverse break fee without further liability. But if it has engaged in a willful breach ([for example], intentionally tanking its own financing or getting financing but just refusing to close), then the cap is removed and the buyer is liable for full expectation damages . . . or specific performance if available, or the fee increases, or whatever . . . .[33]

This incentive-setting explanation further exemplifies how far the drafter's conception is from the traditional no-fault formulation of contract law. It strongly mirrors the notion in tort law about how to appropriately calibrate liability to fault to induce the socially optimal level of care. Traditionalists insist that the relevance of fault-based liability is the classic differentiation between contract and tort. Yet in reality, the most sophisticated contracts transactions rely on fault-calibrated notions of liability, too.

2. Setting the Right Incentives

Most of our respondents explicitly rejected the notion that the inclusion of the concept of willful breach had anything to do with penalizing immoral actions with higher damages. Instead, they explained, this was about deterring counterparties (usually the buyers) from intentionally taking actions that would undermine the deal closing. Specifically, our respondents mentioned the need in many large M&A deals to obtain financing and antitrust approvals. If the buyer so desired, it could easily undermine the deal by purposefully tanking regulatory approval or deal financing. Thus, by providing a willful breach exception to the damages caps, opposing parties are incentivized to avoid such chicanery because it would be much more costly.

We asked why the termination fee provisions were not a sufficient penalty to deter such behavior, and why increasing these fees was not the simpler solution to setting incentives. Respondents answered that parties in such deals do not want to force the counterparty to pay some high amount if it is genuinely not able to do the deal. For example, there is no point in forcing a buyer to harm itself by taking out financing at an unreasonably high cost or having to

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[33] E-mail from Senior Practitioner at Large Law Firm, to Mitu Gulati, Prof. of L., Duke Univ. Sch. of L. (Dec. 15, 2020) (on file with author).

sell off crucial portions of its business to obtain antitrust approval. A merger is a collaborative venture where the parties want the other side to be healthy even after the deal is finished; no one wants to harm the other side unnecessarily. Therefore, there is no point in insisting on high damages if financing or regulatory approvals were genuinely unavailable. Termination fees and reverse termination fees are also limited because they bear the risk of being struck down if a court believes them to be punitive.[34] Thus, willful breach plays a specific incentive-setting role inside a package of liability-setting mechanisms. As one respondent noted:

> If a buyer's financing is available, then the buyer must close (and agrees that the seller can specifically enforce that remedy). If not, the buyer can get out of the deal by paying the reverse termination fee. A critical component to that risk allocation methodology is that the buyer must <u>try</u> to obtain its financing. Otherwise, the risk allocation is no different than the pre-2008 approach that led to sellers being left at the altar, so to speak.[35]

Distinguishing the kinds of damages based on the type of breach—innocent or willful—sets the appropriate incentives. Although a breaching party will not be liable for an exorbitant damage payment if the deal falls through for reasons out of the parties' control, it *will* be on the hook for much greater liability if it deliberately jilts its counterparty. This is diametrically opposed to the traditional conception of contract damages, in which the reasons for the breach are completely irrelevant to the damaged party, who simply wants to be made whole.

3. Room for Renegotiation

The use of "willful" in a contract among sophisticated commercial parties is intriguing on its own, simply because the term is infamously vague. Willful breach is even less clear.[36] Conventional wisdom, after all, is that sophisticated

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[34] FARNSWORTH, *supra* note 6, at 760.

[35] E-mail from M&A Practitioner at Large Law Firm, to Mitu Gulati, Prof. of L., Duke Univ. Sch. of L. (Dec. 16, 2020) (on file with author).

[36] *See* Johnson & Johnson v. Guidant Corp., 525 F. Supp. 2d 336, 349–50 (S.D.N.Y. 2007) (discussing the ambiguity of the term "willful"). Expressing frustration with the ambiguous definition of willful, Judge Learned Hand stated, "It's an awful word! It is one of the most troublesome words in a statute that I know. If I were to have the index purged, 'willful' would lead all the rest in spite of its being at the end of the alphabet." United States v. Hayden, 64 F.3d 126, 129 n.5 (3d Cir. 1995) (quoting MODEL PENAL CODE § 2.02, at 249 n.47 (AM. L. INST., Official Draft and Revised Commentaries 1985)); *see also* Richard Craswell, *When Is a Willful Breach "Willful"? The Link Between Definitions and Damages*, 107 MICH. L. REV. 1501, 1501–04 (2009); Ken Adams, *"Willful"—It's Ambiguous*, ADAMS ON CONTRACT DRAFTING, (Sept. 4, 2007), https://www.adamsdrafting.com/willful/ [https://perma.cc/4VVF-QYFX].

commercial parties want clarity and predictability, something that vague contract terms do not provide. To this end, one would expect parties to negotiate and define their potential liability for a breach of contract with the utmost care and attention to detail. Our initial expectation, therefore, was that most M&A contracts would explicitly define what the parties meant by willful breach. Surprisingly, we found that the vast majority of M&A contracts do not define willful breach. In fact, less than one-third of public deals defined willful or willful breach. In private deals, it was just above one-tenth.[37]

Practitioners agreed that parties ordinarily would have an incentive to use clear, defined language. In this case, however, the vagueness was a deliberate choice, and actually helped facilitate the purpose of the clause—to disincentivize opportunistic breaches while allowing for the possibility that deals sometimes fall through. The parties in an M&A deal, they explained, have no desire to end up in litigation; indeed, they make every effort not to go there. Thus, contract provisions are not always drafted in anticipation of litigation. Instead, they are sometimes aimed at providing leverage and encouraging renegotiation. Using a term as vague as "willful breach" without defining it incentivizes the parties to try and renegotiate their deal rather than running to litigation as a first resort. As one practitioner put it, "[B]uyers just use [willful breach] to scare a seller and force a settlement."[38]

Put differently, the value of a term as vague and litigation-unfriendly as willful breach is that it creates room for renegotiation.[39] As one practitioner explained, "Leaving 'willfulness' vague is the equivalent of leaving 'material' vague. They both produce opportunities for renegotiation when an event occurs within a range of that vague standard."[40] Our respondents also pointed out that even in cases where a complaint is filed and there is a high likelihood of litigation success—the LVMH/Tiffany deal from 2020–2021 came up on mul-

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[37] Though definitions of willful breach are rare, when parties do define willfulness or willful breach, the language tends to refer to intentionality rather than volition as a definition of willfulness. Common language included "material breach," "actual knowledge," "intentional," and "deliberate." These definitions do little to clarify or meaningfully narrow the concept of willfulness.

[38] E-mail from Senior M&A Practitioner at Large Law Firm, to Mitu Gulati, Prof. of L., Duke Univ. Sch. of L. (Oct. 18, 2020) (on file with author).

[39] This explanation for why parties sometimes choose a vague term over a clearer one is mentioned in the classic treatment of the question by Triantis and Choi, based on articulations from practitioners in the M&A field that sound similar to the ones we heard. *See* Albert Choi & George Triantis, *Strategic Vagueness in Contract Design: The Case of Corporate Acquisitions*, 119 YALE L.J. 848, 887–88 (2010) (expressing skepticism about this "room for renegotiation" explanation, particularly among sophisticated parties); *see also* Jessica Hall, *Scuttling Deals? More a Threat Than Reality*, REUTERS (Sept. 18, 2007), https://www.reuters.com/article/column-deal-breakups/dealtalk-scuttling-deals-more-a-threat-than-reality-idUKN1845894020070918 [https://perma.cc/4E5C-8YXK] (noting that a buyer's claim that a target has suffered a material adverse change is more likely to be an attempt to negotiate a lower price than a threat to cancel the deal).

[40] E-mail from Senior M&A Practitioner at Large Law Firm, to Mitu Gulati, Prof. of L., Duke Univ. Sch. of L. (Nov. 5, 2020) (on file with author).

tiple occasions as an example—the expectation is still that there will be a renegotiation. [41] Attorneys can never promise their clients with one hundred percent certainty that a court will rule in their favor, and sometimes both the clients and the attorneys prefer not to risk the uncertainty of litigation.

No party enters into an agreement with the expectation and desire to walk away from it. So, although parties might not want the deal they signed, absent a total relationship breakdown or a material change in the circumstances of one of the parties that makes the transaction undesirable, there is generally a motivation to find a way to complete some deal. Finally, some respondents pointed out that it was objectively difficult to define willful breach and maintain its deterrence role. Although there is general agreement that the role that the concept is playing is to police "contract as option" behavior, it is hard to narrow this type of opportunism to a definition. And, in fact, doing so decreases the clause's utility as a deterrent.

III. The Departure from Strict Liability in M&A Contracts

The default rules of Anglo-American contract law, with a few marginal exceptions, impose strict liability on the party breaching a contract. Innocent and intentional breaches bring with them the same damages; fault is supposed to be irrelevant. Prominent contract theoreticians, primarily from an economic background, say that this perspective makes sense.[42] We find, however, that sophisticated contracting parties in at least one setting, that of mergers and acquisitions (M&A) contracts, incorporate fault-based differentiations in their damage provisions.

In our interviews, practitioners acknowledged this use of fault-based liability and suggested that it was justified by a few distinct practical purposes. It more accurately sets incentives within the deal, mirroring the use of fault in the tort realm to set appropriate incentives. It sets the table and provides leverage for renegotiation should the deal hit a snag. Perhaps most theoretically interesting, the inclusion of fault-based damages is also a repudiation, within a particular transaction, of the view of contract as option. It is a clear signal that the deal including a willful breach provision is a serious commitment, one that the parties expect to be completed. Put differently, what we see in the real world of M&A contracting is not the Holmes/Posner "pay or perform" option perspective, but a

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[41] For background on some of the shenanigans that went on in this deal, see Behind the Money, *LVMH, Tiffany and a Case of Buyer's Remorse*, FIN. TIMES (Oct. 14, 2020), https://www.ft.com/content/f91bc79e-fd4b-4879-928e-7b9aa4a02cb5 [https://perma.cc/4E26-UXQQ].

[42] *See* R. Posner, *supra* note 3, at 1350; Scott, *supra* note 1, at 1381–82. *But see* E. Posner, *supra* note 1, at 1431.

more hierarchical one where a contract has a primary obligation (to perform) and a secondary one (to pay damages if one cannot perform for good reason).[43]

The embrace of fault-based liability by actual contracting parties brings up a tension between the two pillars of modern contract law—the ability of the parties to set the terms of their deal, and the conception of contracts as a no-fault area of the law. It is possible that absence of fault as a defining feature of the contracts world was always a theoretical abstraction that did not match the behavior of contracting parties. It could also be that the use of fault-based liability is a repudiation of the modern conception of contracting.

The divide between strict liability in the contract space and fault in the tort realm is a modern development. Legal classicists insisted that this division was part of the nature of the system, and law and economics scholars have aimed to explain the rational basis for the divide through economic theory. Before the current system was entrenched in the late nineteenth century, fault was the domain of contract law while tort more closely resembled strict liability.[44] This older conception of contract law was based on a pre-packaged set of party obligations that came along with certain types of relationships and did incorporate fault.[45]

It is possible to conceptualize our findings as a return to this pre-classicist conception. If one sees buyer and target as a specific contractual pair, then the rising prominence of fault-based liability for willful breach—and its coming close to being market or industry standard—suggests that, at least in the M&A context, refraining from willful breach can be seen as part of a standardized obligation.[46] Then again, as one practitioner noted, there may be variance in parties' meanings when they refer to willful breach because the term is so vague, and thus is itself, a "creature of contract."[47]

Regardless of the theoretical takeaway of our findings, the empirical one is that fault is more present in sophisticated M&A contracts than theory would lead us to predict. Woven through our data points and practitioner explanations was a conception that not all breaches are created equal. These parties do, in fact, differentiate between innocent breach and guilty (willful) breach. Whether

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[43] *See* Baird, *supra* note 27, at 744 (discussing the alternative view that contracts give rise to primary and secondary obligations which is attributed to Holmes's disciple, Edward Harriman).

[44] *See* Roy Kreitner, *Fault at the Contract-Tort Interface*, 107 MICH. L. REV. 1533, 1536 (2009) (explaining that fault played a role in the law of contracts in the early nineteenth century).

[45] *See id.* (explaining that contract law "was understood in direct reference to the typical contractual relationships" contemplated by early contracts). Typical contractual relationships included, for example, master and servant, principal and agent, and vendor and purchaser. *Id.* Duties among these parties were standardized, and breach occurred where a party failed to meet the standard of care for a given role. *Id.* In the late nineteenth century, however, contracts shifted toward a strict liability system and tort embraced fault-based liability. *See id.* at 1533–34.

[46] *See id.* at 1536.

[47] E-mail from Senior M&A Practitioner at Large Law Firm, to Mitu Gulati, Prof. of L., Duke Univ. Sch. of L. (Dec. 15, 2020) (on file with author).

this differentiation is a result of economic incentives, the desire not to be made a fool of, or both, it is a clear and intentional departure from the strict liability conception of contracts.

Our study, in examining but a single area of contracting practice, may have identified an outlier area. Our own casual observations of the contracts we encounter on a daily basis though, tells us otherwise. Fault seems to matter quite often. What else are the ubiquitous *force majeure* provisions, other than clauses that excuse liability when there is no fault?[48] Or provisions that limit one's contractual obligations to best efforts or commercially reasonable efforts? We are optimistic that this project is just scratching the surface of an entire universe of fault-based contractual relationships. After all, these provisions do not exist in a vacuum. As an interviewee emphasized, "These provisions all work together, and the significance of one provision depends on the others."[49]

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[48] *See* Benoliel, *supra* note 11, at 395 (explaining that unforeseeable circumstances, such as a fire, may exempt a party from performing a promise because performance is impossible).

[49] E-mail from Senior Practitioner at Large Law Firm, to Mitu Gulati, Prof. of L., Duke Univ. Sch. of L. (Dec. 15, 2020) (on file with author).