

COMMENTARY



New York's High Court: Lost Profits May Be Recoverable For Breach, Even Where Contracts Preclude Consequential Damages

Many practitioners are quick to label potential claims of lost profits as consequential damages, and draw comfort from (i) contract provisions precluding recovery of consequential damages or, (ii) in the absence of such limitation provisions, challenging legal standards making recovery of such damages difficult. But a recent split decision from New York's highest court serves as a reminder that lost profits can sometimes be *general* (or direct) damages, and has created uncertainty by expanding the situations in which lost profits will receive that treatment.

In light of the case-specific factual analysis that the New York Court of Appeals undertook in the recent case, *Biotronik v. Conor Medsystems Ireland*,¹ it is unclear how broadly lower courts will interpret this expansion of the law. In the meantime, litigators will need to confront the possibility of much more involved damages disputes in commercial cases, while transactional lawyers may want to encourage their clients to use more explicit language if they seek to preclude recovery of lost profits, especially in agreements governed by New York law. Ignoring these developments may lead to unwelcome surprises.

Consequential Damages – A Primer

The *Biotronik* decision highlights an often overlooked distinction in New York law, between when consequential damages can be recovered, and what kinds of damages are consequential to begin with. New York's rule on the recovery of consequential damages is set out in a series of cases beginning with *Kenford Co. v. County of Erie*.² To recover consequential damages a party must show that damages of the type sought were within the contemplation of the parties at the time of contracting, that the damages were actually caused by the breach, and that the amount of the damages can be shown with reasonable certainty.³

The entire issue of how to go about recovering consequential damages is secondary, however, to the question of whether a particular type of damage is labeled as consequential or general/direct in the first place. The first step is critical since, if damages are considered general/direct, as opposed to consequential, a party could circumvent most limitation-of-liability provisions entirely, and sidestep challenging standards (as in *Kenford*) to recover consequential damages in cases where they are not contractually precluded.

¹ 2014 WL 1237154, 2014 N.Y. LEXIS 575 (N.Y. March 27, 2014).

² 73 N.Y.2d 312 (1989).

³ See *id.*; *Ashland Management v. Janien*, 82 NY2d 395, 403 (1993).

Although New York courts have noted that lost profits may be either general or consequential damages, the main focus in drawing that distinction has, for years, been on whether the non-breaching party's lost profits flowed from collateral transactions—separate agreements with third parties—rather than from a provision in the agreement between the two parties themselves. Thus, New York case law appeared to allow lost profits to be considered direct damages only where the profits at issue flow directly from the parties' relationship under the contract. The leading Court of Appeals case, before *Biotronik*, addressing lost profits as direct damages under this framework was *American List Corp. v. U.S. News & World Report*, decided 25 years ago.⁴

But the *Biotronik* decision now rejects a bright-line rule that would allow direct damages only where the lost profits were to be realized out of the transactions between the parties to the contract. In doing so, it expands the potential cases where lost profits can be considered general or direct damages, and injects a large dose of uncertainty into countless agreements with limitation-of-liability provisions.

***Biotronik* – The \$100 Million Question**

Biotronik involved an exclusive distributorship agreement under which the plaintiff, Biotronik (the distributor), agreed to purchase stents manufactured by the defendant Conor, for resale in a fixed territory. Biotronik paid Conor a transfer price for each stent, calculated as a percentage of Biotronik's net sales. In 2007, Conor recalled its stents from the market and paid Biotronik under provisions of the agreement related to a recall.

Claiming that Conor's withdrawal of the stent breached the agreement, Biotronik sued, seeking as its sole damages \$100 million in profits it claimed it would have made reselling the stents over the remaining term of the agreement. The parties' contract, however, contained a provision restricting the parties to general damages, prohibiting either from obtaining "any indirect, special consequential, incidental or punitive damage." Conor moved for summary judgment, arguing that Biotronik's lost profits were consequential damages explicitly barred by the agreement. The trial court granted Conor summary judgment on this theory, and a unanimous Appellate

Division affirmed, holding that the limitation-of-liability clause limited Biotronik's recovery to nominal damages. A divided Court of Appeals reversed, however, and held that, under this particular contract, Biotronik's lost profits were general, not consequential, damages, and therefore not barred under the parties' agreement.

The first notable aspect of the decision is what all seven judges of the court agree on; both the majority and the dissent start from the proposition that lost profits *are* direct damages when, under the contract at issue, loss of those profits is the "natural and probable consequence of the breach," citing both New York and federal case law.⁵ A sobering reminder for those who hastily assume that lost profits are consequential damages.

The majority then rejected a bright-line rule to determine whether lost profits were general or consequential damages. Rather, it stressed that "damages must be evaluated within the context of the agreement," requiring "a careful look at the underlying agreement to determine whether lost profits were general damages." It did acknowledge that the "distinction at the heart of" cases to date evaluating whether lost profits were consequential damages was "whether the lost profits flowed directly from the contract itself or were, instead, the result of a separate agreement with a nonparty." The Court explained, however, that "[t]his distinction does not mean that lost resale profits can never be general damages simply because they involve a third party transaction. Such a bright-line rule violates the case-specific approach we have used"

The Court then examined the *Biotronik* contract and determined that, based on the "nature of the agreement" and the structure of the payments provision, Biotronik's lost profits were general, not consequential, damages from Conor's alleged breach. The majority focused on the fact that the agreement used Biotronik's resale price as a benchmark for the transfer price it paid to Conor. Thus, the Court reasoned, the contract would not work unless Biotronik was engaged in the resale of the stents ("[t]he purpose of the agreement was to resell"—"that was the very essence of the contract"), and concluded that its profits flow directly from the transfer price formula. It further described the agreement as "not simply

⁴ *American List Corp. v. U.S. News & World Report*, 75 NY2d 38 (1989).

⁵ *Id.*; *Tractebel Energy Marketing, Inc. v. AEP Power Marketing, Inc.*, 487 F.3d 89 (2d Cir. 2007).

one between a seller and a buyer who is in the business of reselling,” but something more akin to a “joint venture.” The Court also noted that the limitation provision in the agreement “does not specifically preclude recovery for lost profits, nor does it explicitly define lost profits as consequential damages”—effectively a roadmap (and warning) for parties to agreements who wish to stamp-out any likelihood of recovery of lost profits.

A sharply worded dissent—accused by the majority of espousing “form over substance”—bemoaned that the Court was effectively disavowing the general principle that profits a nonbreaching party loses under separate contracts with third parties are consequential rather than general damages. The dissent further criticized the majority for letting “Biotronik slip the noose of the . . . limitation-of-liability provision” by devising a creative reading of the payment provisions in the agreement. “Creativity on this scale,” the dissent warned, “circumvent[ed] the natural meaning of the limitation-of-liability provision” and would lead to ambiguity and unpredictability in the commercial world.

Lost Profits and Consequential Damages - What Now?

The *Biotronik* decision leaves a number of questions unanswered, but it is likely to have some immediate effects. Not only has the entire Court of Appeals reaffirmed that lost profits can be direct damages under New York law—a point that is often overlooked—but the majority rejected a rule that would have allowed lost profits to serve as direct damages only where the profits at issue were to be had out of transactions between the parties to the contract. No more bright-line rules; parties will now need to closely examine “the nature of agreements” and conjure, or respond to, creative readings of provisions.

It will take time for lower courts to address, and harmonize their approaches to, the Court of Appeals’ ruling. In the meantime, parties to existing and prospective agreements, and litigants in breach of contract actions, will have to

consider the possibility that lost profits may be recoverable, even where consequential damages have specifically been curtailed. Although the most direct impact will be to disputes involving exclusive distributorship contracts, like the one at issue in *Biotronik*, the decision is open-ended enough that it will inevitably invite arguments that lost profits should be direct damages under many other types of contracts (such as sale contracts to known resellers or contracts with a profit sharing component).

As a result, lawyers litigating breach of contract actions, and those advising clients in situations that may lead to disputes, will need to be sensitive to this potential loophole in standard limitation-of-liability clauses. For transactional attorneys, the result of the *Biotronik* decision may be simpler. The Court of Appeals has not suggested that it is backing away from New York’s fairly liberal rules permitting limitations-of-liability. But because a clause excluding “consequential damages” may no longer be enough to bar lost profits claims, clients should consider including more specific provisions in their contracts; if parties want to exclude lost profits for breach of contract, a clause specifically excluding “lost profits” may be the solution.

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