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Direct vs. Consequential Lost Profits: Checking in Five Years After 'Biotronik'

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M&A agreements and other commercial contracts frequently contain a provision that bars the recovery of "consequential damages"—often referred to by courts and practitioners as a consequential damages bar. The term "consequential damages", however, lacks a precise definition, and thus, the question whether certain types of damages are recoverable in light of a consequential damages bar is a recurring subject of high-stakes litigation. In particular, there is an established body of New York law addressing whether lost profits constitute consequential damages or direct damages. The answer to this question often can mean the difference between a case that involves nominal damages, such as costs and expenses to cure a breach, and a bet-the-company litigation involving the potential recovery of millions of dollars of lost profits. Yet many sophisticated commercial parties continue to include a boilerplate consequential damages bar in their contracts, often on the assumption that it protects against a multi-million dollar lost profits award in the event of a breach. This may prove a dangerous assumption.

Consider the following example. Manufacturer enters into a contract whereby it agrees to sell widgets to reseller at a fixed price per unit that is periodically adjusted based on a pricing formula agreed to by the parties. The contract is governed by New York law and contains a provision barring the recovery of "consequential" damages. Manufacturer breaches the contract, and reseller sues for the lost profits it was expecting to receive from the resale of the widgets over the three-year term of the contract. Counsel for manufacturer, confident that the

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contract's consequential damages bar precludes recovery of lost profits, seeks dismissal. Are the reseller's lost profits, which flow from the pricing formula in the contract, "consequential damages"?

The starting point for this analysis is the New York Court of Appeals' most recent decision addressing the distinction between direct and consequential damages—*Biotronik*

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A.G. v. Conor Medsystems Ireland, 22 N.Y.3d 799 (2014). In *Biotronik*, the court found that lost profits flowing from the breach of an exclusive distribution agreement constituted general damages, not consequential damages, and thus, that lost profits were recoverable despite the parties' inclusion of a consequential damages bar. At the time, the *Biotronik* decision was regarded as a wake-up call to practitioners that a boilerplate consequential damages bar is not necessarily an iron-clad defense to a lost profits claim. But now, five years later, it seems that the lessons from *Biotronik* largely have been forgotten, and boilerplate consequential damages bars are still routinely inserted into commercial contracts. This article aims to serve as a reminder that although there is no bright line test under New York law for distinguishing between direct and consequential lost profits, a thoughtfully crafted limitation of liability provision that bars both direct and consequential lost profits could help avoid costly and protracted litigation.

The 'Biotronik' Decision

Biotronik involved an exclusive distribution agreement whereby the plaintiff was granted an exclusive territory to sell a medical device developed and manufactured by the defendant. The agreement contemplated a large degree of coordination between the parties regarding the marketing and sale of the device, and calculated the price received by the manufacturer based on the resale price that the plaintiff was able to obtain in the open market. When the defendant recalled the medical device, the plaintiff brought a breach of contract claim seeking to recover its lost profits on the resale of the medical device. The defendant moved for summary judgment, contending that the lost profits constituted consequential damages that were prohibited by the consequential damages bar in the agreement.

> The crafting of a consequential damages bar that captures the parties' intentions, without ambiguity, **requires bespoke drafting, not boilerplate language**; otherwise, the unintended consequence may be **expensive and protracted litigation** that could have been avoided.

The Supreme Court of New York found that the lost profits were barred by the agreement's consequential damages bar, and the Appellate Division affirmed. The Court of Appeals, however, disagreed, and held that the lost profits constituted general damages. Relying on decades-old New York precedent, the court found that "[l]ost profits may be either general or consequential damages, depending on whether the non-breaching party bargained for such profits and they are 'the direct and immediate fruits of the contract.'" Id. at 806. Turning to the contract at issue, the court emphasized that (1) the parties' agreement resembled a joint venture, indicating that the defendant anticipated and relied upon the plaintiff's resale, which is "significantly different from a situation where the buyer's resale to a third party is independent of the underlying agreement;" and (2) "the agreement used plaintiff's resale price as a benchmark for the transfer price," meaning that the profits flowed directly from the contract via the pricing formula. Id. at 808-10. Thus, the court held that the lost profits sought by the plaintiff were recoverable as general damages because they flowed directly from the contract itself, not from ancillary third-party contracts. Id.

NY Precedent Relied Upon in 'Biotronik'

To fully understand the *Biotronik* decision, a careful examination of the precedent the Court of Appeals relied upon is critical. Specifically, the Court of Appeals turned to its prior decisions in *Orester v. Dayton Rubber Mfg. Co.*, 228 N.Y. 134 (1920) and *American List v. U.S. News & World Report*, 75 N.Y.2d 38 (1989), as well as the Second Circuit's decision in *Tractebel Energy Mktg. v.*

AEP Power Mktg., 487 F.3d 89 (2d Cir. 2007).

In *Orester*, plaintiff sought lost profits from a tire manufacturer who had breached the parties' exclusive distribution agreement. As the Court of Appeals recognized in *Biotronik*, under the agreement in *Orester*, the "manufacturer sold and supplied tires at a reduced price, and plaintiff agreed to 'aggressively push' the sale of tires within an exclusive territory." *Biotronik*, 22 N.Y.3d at 806. The defendant in *Orester* thus sought to enter a market by taking advantage of the exclusive dealer's distribution network and by selling the product to the exclusive dealer at a reduced price. It followed, based on the nature of the relationship and the fact that the manufacturer understood that the sale to the exclusive dealer was at a reduced price, the loss of profits reasonably would be supposed to have been contemplated by the parties when the contract was made. *Biotronik*, 22 N.Y.3d at 806 (citing *Orester*, 228 N.Y. at 137). Thus, the court found that the damages—lost profits based on a specific purchase order for 1,000 tires—were not the result of "collateral engagements or consequential damages," and thus, were recoverable as general damages. 228 N.Y. at 136-38.

Relatedly, in both *American List* and *Tractebel*, the courts found that the damages were direct based on the fact that the non-breaching party was seeking what it was due under the contract. In *American List*, "[a] schedule of … the estimated losses and profits of plaintiff … was appended to the agreement." 75 N.Y.2d at 41. The Court of Appeals found that the schedule attached to the agreement "reflected the cost of [the] joint venture to defendant," and thus, the "lost profits were the natural and probable consequence of the breach." Id. at 43-44. Similarly, in *Tractebel*, the Second Circuit held that the lost profits sought by the non-breaching party constituted general damages because it sought "only what it bargained for—the amount it would have profited on the payments [the breaching party] promised to make for the remaining years of the contract." *Tractebel*, 487 F.3d at 110.

In all three of these cases, the courts recognized that lost profits may be considered general damages in certain circumstances. Synthesizing this prior precedent, the *Biotronik* court held that lost profits contemplated by the parties and flowing directly from the parties' agreement, as opposed to lost profits flowing from ancillary agreements with third parties, may be recoverable as direct damages.

Five Years After 'Biotronik': Still No Bright Line Test

Consistent with the historical precedent upon which it relied, the *Biotronik* court rejected a "bright line rule" for determining whether lost profits can be considered general damages. *Id.* at 808-09. Unsurprisingly, since the *Biotronik* decision, parties and courts have continued to wrestle with the distinction between direct lost profits damages and those that properly are classified as consequential damages. The oft-cited "test" from *Biotronik* is that lost profits are direct where they are "the natural and probable consequence of the breach." Id. at 807-08. But what exactly does this test mean?

Five years after *Biotronik*, that answer to that question remains elusive. Surprisingly, the *Biotronik* decision has garnered relatively modest attention in New York case law—only having been cited a few dozen times. And the decisions that have applied the *Biotronik* holding largely have focused on the specific facts of that particular case. Thus far, New York decisions applying *Biotronik* have recognized that lost profits from third-party transactions may be direct damages in the following principal circumstances: (1) where there is a joint venture, (2) where there is an exclusive distributorship or (3) where the contract contains a profit sharing formula. See, e.g., *First Niagara Bank N.A. v. Mtge. Bldr. Software*, 2016 WL 2962817 (W.D.N.Y. May 23, 2016); *PNC Bank*, 3 F. Supp. 3d 358 (S.D.N.Y. 2014); *In re ADI Liquidation*, 555 B.R. 423 (Bankr. D. Del.

2016) (applying New York law); *In re Lehman Bros. Holdings Inc.*, 544 B.R. 62 (Bankr. S.D.N.Y. 2015). Although these cases shed light on instances where lost profits may be considered direct, courts interpreting *Biotronik* have declined to develop any hard-and-fast rules.

Some plaintiffs seeking to recover lost profits in the face of a consequential damages bar have argued that recovery turns on foreseeability—i.e., the determination whether lost profits are direct or consequential turns on whether the damages were foreseeable to the parties at the time of contracting. However, in *PNC Bank, Nat'l Ass'n v. Wolters Kluwer Financial Services*, 73 F. Supp. 3d 358 (S.D.N.Y. 2014)—a post-*Biotronik* decision—Judge Engelmayer rejected this argument, expressly holding that "the distinction between direct and consequential damages does not turn on the foreseeability of downstream damages." Id. at 374-75. The court explained, "[r]ather, the concept of foreseeability is relevant where consequential damages are authorized because foreseeability serves as a limit on the extent to which consequential damages, when available, may be awarded." In other words, the argument that lost profits are direct damages merely because they were foreseeable improperly confuses the test for distinguishing direct from consequential damages with a requirement for the recoverability of damages that *already have been deemed consequential*. This is an important clarification, but even after this case, the fact remains that courts have offered minimal guidance that would allow parties to clearly differentiate direct lost profit damages from indirect or consequential lost profit damages.

Conclusion

Given the absence of a bright-line test, the distinction between direct and consequential damages will continue to be decided on a case-by-case basis based on the unique terms and circumstances of a commercial contract. New York courts thus routinely reject pleadings stage motions seeking dismissal of lost profits based on a consequential damages bar.

Therefore, the key lesson to be drawn from the *Biotronik* decision may be that provisions that seek to limit the recovery of certain categories of damages must be drafted with precision. To be sure, a boilerplate provision barring "consequential damages" is not precise. Nor are references to other categories of damages routinely included in boilerplate consequential damages bars, such as "incidental," "indirect," and "special" damages. Therefore, to the extent parties intend to bar the recovery of all lost profits, they should draft a consequential damages bar that explicitly refers to "lost profits."

However, even including the words "lost profits" within a boilerplate consequential damages bar may not be enough, depending on the full terms of the contract and the facts and circumstances. Therefore, if the parties intend to make clear that no form of lost profits may be recovered, they should, at a minimum, consider a stand-alone provision, not under the heading "Consequential Damages," as is frequently the case, that makes clear that all forms of lost profits, whether direct or consequential, may not be recovered.

In sum, the crafting of a consequential damages bar that captures the parties' intentions, without ambiguity, requires bespoke drafting, not boilerplate language; otherwise, the unintended consequence may be expensive and protracted litigation that could have been avoided.

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