Overview

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The analysis of damages in breach of contract disputes is often on the back burner because damages are determined at the end of a case. However, an early damages assessment can be crucial to developing a winning strategy. Among other things, expert witnesses are often required to address damages in complex business disputes; having those experts engaged early can help the lawyers develop the key factual evidence. We discuss here the basic damages that can be recovered under New York law for breach of contract, and how parties can limit or liquidate damages by contract.

The bedrock principle of contract damages is that “a party injured by a breach is entitled to recover damages that are the natural and probable consequence of the breach.”[1] The two basic categories of damages are general (sometimes referred to as market) damages and consequential (sometimes referred to as special) damages.[2] The winning party can also, in certain limited circumstances, recover attorneys’ fees and punitive damages. The plaintiff has the burden of proving that its damages were caused by the breach with a “reasonable degree of certainty”.[3]

General Damages Benefit of the Bargain and Expectation

General damages compensate a party for the lost benefit of its bargain. The general principle is that the non-breaching party should be put in the same economic position as if the breaching party had performed. A breach of a sale of goods contract is straightforward. The buyer is generally able to recover the difference between the contract price and the market price for the goods at the time of the breach if the market price was higher.[4] Of course, if the market price is lower, there are no damages and no claim for breach of contract, damages being an essential element of the cause of action.[5] Breaches of other kinds of contracts can create more complicated scenarios.

Latham Land I, LLC v. TGI Friday’s, Inc.[6] and Schonfeld v. Hilliard[7] illustrate the complexity that can arise in proving general damages and the value of creativity in formulating a damages claim.
The defendant in *Latham* had breached its agreement to construct and operate a TGI Friday’s restaurant on the plaintiff’s land. The contract did not contain a rent acceleration clause and the plaintiff had sold the land before the defendant had started paying rent. Moreover, the contract barred consequential damages. Lacking an ability to recover the most obvious damages caused by the breach—lost rent—the plaintiff sought to recover the lost market value of the property. The plaintiff offered expert testimony that there was a market for such properties in the triple-net lease market and that an accepted valuation method existed. The expert calculated the market value of the property had defendant performed. Ironically, one of the key elements of this calculation was the rent that plaintiff was precluded from recovering. The trial court rejected plaintiff’s damages, holding that they were consequential and barred by the contractual consequential damages waiver. But the Appellate Division reversed and held that the lost market value constituted general (direct) damages: “the loss asserted here is the very essence of the contract between the parties—i.e., the diminution in value of the actual property defendant promised to improve and lease.” The Appellate Division also held that the plaintiff had met its burden of attempting to mitigate its damage by demonstrating it tried and failed to find a new tenant.

Similarly, the Second Circuit in *Schonfeld* allowed the plaintiff to recover the market value of a license to distribute BBC programming in the United States, while holding that lost profits, a key element of that market value, were not recoverable. Unlike the court in *Latham*, the Second Circuit categorized the market value damages as consequential, but such damages were not excluded by the contract.

The plaintiffs in *Latham* and *Schonfeld* offered solid evidence of market value, including similar transactions and offers received, thus meeting their burden of showing “a ‘stable foundation for a reasonable estimate’ of the value of the bargain made.”

Mitigation

The plaintiff in a breach of contract case must make a reasonable effort to mitigate its damages. The plaintiff’s mitigation efforts do not need to succeed. Whether the plaintiff’s efforts were reasonable depends on the facts of the case. The Second Circuit has held that the standard of what constitutes a reasonable effort is lower than in other areas of the law. If a plaintiff fails to engage in a reasonable effort to mitigate, damages will be reduced by the amount that would have resulted from reasonable mitigation efforts. *Drummond v. Morgan Stanley & Co.* illustrates this point. In an action for breach of a contract to buy bonds, the court held the plaintiff had not mitigated his damages when he failed to accept an offer from another bank for the bonds Morgan Stanley had wrongfully refused to buy. The court pointed out that if the plaintiff had accepted the second bid, his loss would have been $500,000 rather than the claimed $3.9 million loss. By contrast, in *APL Co. PTE v. Blue Water Shipping U.S. Inc.* the Second Circuit reversed the District Court’s holding that the plaintiff had failed to mitigate despite the fact the goods involved had spoiled because plaintiff had misunderstood regulatory requirements:

[M]issing is an analysis of [plaintiff’s] shortcomings against the more forgiving standard accorded a party that has fully performed all of its contract obligations and is thrust into the shoes of the breaching party as it scrambles to mitigate the impact of the breach. The trial court’s obligation was to determine whether the mitigation efforts actually chosen in those unaccustomed shoes were reasonable, not whether hindsight suggests that an objectively better choice was available.

Reliance and Sunk Cost Damages

A plaintiff can recover reliance damages, or “sunk costs,” when benefit of the bargain damages cannot be calculated with reasonable certainty. Such damages seek to restore the plaintiff to its pre-contract position. They can include the amounts the plaintiff spent preparing for defendant’s performance and can include debt obligations. For example, in *McKinley Allsopp, Inc. v. Jetborne Intl., Inc.*, McKinley had contracted to help Jetborne obtain financing for the acquisition of a Pan-Am subsidiary. McKinley lent Jetborne $250,000 that Jetborne paid to Pan-Am as a deposit and forfeited when it was unable to complete the transaction. After McKinley caused the deal to crater by failing to obtain financing and otherwise breaching its obligations, McKinley sued Jetborne for payment of the loan. Jetborne counterclaimed for its lost profits, asserting that McKinley failed to use its best efforts to obtain financing. Although Jetborne’s lost profits claim was rejected for lack of sufficient certainty, the court held Jetborne did not have to repay the $250,000 debt Jetborne incurred in reliance on McKinley’s expected performance.

Consequential Damages
Consequential damages differ from general damages because they do not result directly from the breach.[29] Due to their attenuated nature, consequential damages must be "capable of proof with reasonable certainty."[40] While the distinction between general and consequential damages is superficially clear, the "application to specific contracts and controversies can be more elusive."[31] To classify a particular damages claim, a court looks to "the reasonable contemplation of the parties, the nature, purpose and particular circumstances of the contract known by the parties . . . as well as what liability the defendant fairly may be supposed to have assumed consciously, or to have warranted the plaintiff reasonably to suppose that it assumed, when the contract was made."[32]

Whether lost profits are general damages or consequential damages depends on the circumstances. In Biotronik A.G. v. Conor Medsystems Ireland, Ltd., a distributor of medical devices sought lost profits from a coronary stent manufacturer that had breached an exclusive distribution agreement. New York's Court of Appeals held the plaintiff's lost profits were general damages. The court identified the key question as being whether the lost profits "flowed directly from the contract itself or were, instead, the result of a separate agreement with a nonparty." Because Biotronik and Conor's distribution contract "used plaintiff's resale price as a benchmark for the transfer price," the court concluded the lost profits "flow directly from the pricing formula" and were therefore direct damages.[35] By contrast, the Southern District of New York held in Compania Embotelladora Del Pacifico, S.A. v. Pepsi Cola Co. that lost profits for breach of a beverage bottler agreement were consequential damages because they flowed from "collateral business arrangements."[36]

Consequential damages may also include "damages that resulted from the loss of an income-producing asset, the fair market value of which may be based, in whole or in part, on a buyer's projections of what income he could derive from the asset in the future."[37]

Whether a plaintiff should seek lost profits or market value depends on the case. The plaintiff in Schonfeld wisely sought both in the alternative. It is sometimes easier to calculate fair market value with reasonable certainty than to calculate lost profits. The fair market value of a contract is "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts." Lost profits "must be capable of measurement based upon known reliable factors without undue speculation."[40] This is a difficult hurdle, especially when the lost profits are based on projections of future profit.[41]

**Punitive Damages**

Punitive damages are designed to punish and deter the defendant and are not generally recoverable for breach of contract.[42] Punitive damages are intended to vindicate public rights, whereas breach of contract damages are intended to redress private wrongs.[43] Punitive damages are available only "in those limited circumstances where it is necessary to deter defendant and others like it from engaging in conduct that may be characterized as 'gross' and 'morally reprehensible,' and of 'such wanton dishonesty as to imply a criminal indifference to civil obligations.'"[44] The non-breaching party must show the breaching party engaged in conduct that was actionable as an independent tort, of an egregious nature, directed at the plaintiff, and "part of a pattern directed at the public generally."[49] Tort claims that may qualify include claims that a party fraudulently induced the plaintiff to enter into a contract, or that the party engaged in conduct outside the bounds of the contract but intended to defeat it.[46]

In Rocanova v. Equitable Life Assurance Society of the United States, the plaintiff brought an action against an insurer alleging unfair settlement practices in connection with a disability income policy, and sought punitive damages based on allegations that, among other things, the insurance company had engaged in a pattern of publicly-directed bad-faith conduct in evading insurance claims.[47] The Court of Appeals rejected the punitive damages claim. The Court held that, even accepting the plaintiff's allegation of bad-faith conduct as true, he had failed to state a claim of egregious tortious conduct directed at himself, because the insurance company's alleged settlement practices did not constitute "a fraud evincing a 'high degree of moral turpitude' and demonstrating 'such wanton dishonesty as to imply a criminal indifference to civil obligations.'"[48]

A rare breach of contract case in which punitive damages were held available was Skibinsky v. State Farm Fire & Casualty Co.[49] There, the plaintiff alleged the defendant had engaged in a pattern of deceptive conduct by selling lesser policies than those requested by members of the public, while representing the desired coverage had been provided. Because of the widespread nature of the alleged intentional misrepresentations, the Appellate Division concluded that the allegations could constitute a "fraud upon the public" that justified the award of punitive damages.[50]

**Contractual Limitation of Damages**
New York has adopted a freedom of contract approach to clauses that limit parties’ damages: they are generally enforceable, subject to certain limited exceptions. The exceptions include fraud or gross negligence by the party relying on the limitation or the existence of a special relationship between the parties, such as employer and employee. Moreover, absent language to the contrary, a limitation clause does not apply to misrepresentations made to induce a party to enter the agreement. There are also statutory prohibitions on damages limitations for certain types of contracts, such as those involving work done to real property.

The identity of the parties is important. Courts are more likely to enforce liability limitations agreed by sophisticated parties represented by counsel. The courts can refuse to enforce a limitation that resulted from unconscionable conduct or inequality in bargaining power so drastic that the party which seeks to invalidate the clause had no choice but to accept it. But the courts will not void a limitation clause merely because a party has acted in its own economic self-interest.

Consequential Damage Waivers

Courts will generally enforce contract provisions that exclude consequential damages so long as they are not unconscionable. To demonstrate unconscionability, a party needs to show that the contract was “both procedurally and substantively unconscionable when made”—i.e., one of the parties lacked a meaningful choice, and the contract terms were unreasonably favorable to the other party. Under the Uniform Commercial Code, absent unconscionability, clauses that exclude consequential damages will be enforced even if the limited remedy that remains available to the non-breaching party (e.g., direct damages, or repair and replacement in a sale of goods contract) fails in its essential purpose.

Liquidated Damages

A liquidated damages clause prescribes a fixed payment in the event of a breach. Liquidated damages clauses range from straightforward per diem amounts often found in construction contracts to complex economic formulae contained in swap agreements. Liquidated damages clauses “permit parties to look to the future, anticipate that there may be a breach and make a settlement in advance.” New York will enforce a liquidated damages clause so long as the stipulated damages do not constitute a penalty. The reviewing court will consider whether the specified liquidated damages are “at an amount which is reasonable in the light of the anticipated or actual harm caused by the breach, the difficulties of proof of loss, and the inconvenience or nonfeasibility of otherwise obtaining an adequate remedy.” It is unwise to include any language in a liquidated damages clause that suggests it is a penalty. Courts are more likely to enforce a liquidated damages clause if the contract involves a new business venture or product with little history where damages are difficult to ascertain at the time of contracting. New York’s Court of Appeals has noted a growing judicial trend toward enforcement of liquidated damages provisions in contracts between sophisticated parties.

An enforceable liquidated damages clause precludes the recovery of any other damages even if such damages are not covered by the liquidated damages clause. Where a contract expressly provides a party can recover both liquidated and actual damages, the liquidated damages provision will be unenforceable. For example, in U.S. Fidelity and Guaranty Co. v. Braspetro Oil Services Co., the Second Circuit invalidated a liquidated damages provision that required sureties to pay obligees following the demise of a construction consortium contract, because under the contract the obligees were also expressly permitted to recover actual damages. The court held “[u]nder no circumstances… will liquidated damages be allowed where the contractual language and attendant circumstances show that the contract provides for the full recovery of actual damages, because liquidated and actual damages are mutually exclusive remedies under New York law.”

A party that seeks to avoid liquidated damages must prove the existence of one of the limited grounds for denying enforcement. For example, enforcement can be denied if the liquidated damages clause does not provide for the recovery of a sum certain or does not contain a damages formula susceptible to undisputed calculation. In such circumstances, the clause is unenforceable because it fails to achieve the aim of resolving the damages question in advance without significant dispute.

Holladay-Tyler Printing Corp. illustrates how courts will strive to enforce a liquidated damages clause even where the method of calculation can be open to dispute. That case involved a suit by an equipment lessor against a printer for breach of an equipment lease. The lease included a formula for the calculation of damages that referred to the “sale proceeds” from the lessor’s resale of the equipment. The Southern District of New York enforced the clause. The Court held that while the calculation of “sale proceeds” could be the subject of a genuine dispute between the parties, “the inherent restriction of that amount to the market price… sufficiently ensures that the clause will operate effectively as a valid liquidated damages clause must.”

Legal Fees
Unless the parties agree in their contract that the prevailing party in a breach dispute can recover legal fees, such fees are normally not recoverable. When the parties have agreed the winner in a dispute can recover its legal fees, the court may award "presumptively reasonable fees." The presumptively reasonable fee boils down to what a reasonable, paying client would be willing to pay, given that such a party wishes to spend the minimum necessary to litigate the case effectively. Practitioners should be aware that legal fees can be awarded if the parties agree to arbitrate under arbitration rules that provide for the recovery of legal fees. Many international arbitration rules contain such provisions.

Interest

Section 5001 of New York’s Civil Practice Law and Rules provides that a plaintiff can recover pre-judgment interest at 9%. Such interest runs from the earliest date of breach and can be substantial in a high-value case. The rate is so high in the current environment that it can provide an incentive for the defendant to settle. The statutory rate applies unless the parties have agreed to a different prejudgment interest rate in their contract. However, the parties must agree specifically that the agreed rate is for pre-judgment interest. A normal interest provision in a loan agreement does not replace the statutory rate. Indeed, a party which breaches a loan agreement can find itself faced with a judgment that requires it to pay 9% prejudgment interest on both the principal and the unpaid ordinary interest that was due under the loan agreement. New York courts have held that such recovery does not constitute double-dipping.

Determining breach of contract damages can be rife with uncertainty. Nonetheless, parties and their counsel would be wise to carefully evaluate the available damages—along with limitations—in the early stages of a dispute. This will enable them to avoid surprises and increase the likelihood of a satisfactory result, whether in litigation or negotiated settlement.

[4] See Emposimato v. CICF Acquisition Corp., 89 A.D.3d 418, 421, 932 N.Y.S.2d 33, 36 (2011) ("In the case of a breach of a contract to sell securities, expectation damages are calculated as "the difference between the agreed price of the shares and the fair market value at the time of the breach."); Schonfeld, 218 F.3d at 175–76 ("General damages are sometimes called ‘market’ damages because, when the promised performance is the delivery of goods, such damages are measured by the difference between the contract price and the market value of the goods at the time of the breach.").
[8] Id.
[9] Id. at 1330.
[10] Id. at 1332.
[13] M. Golodetz Exp. Corp. v. S/S Lake Anja, 751 F.2d 1103, 1112 (2d Cir. 1985) ("The venerable rule that requires a plaintiff to mitigate his damages has been explained by the principle that ‘damages which the plaintiff might have avoided with reasonable effort ... are ... not caused by the defendant’s wrong ... and, therefore, are not to be charged against him.’") (quoting 2 Williston on Contracts § 1353 at 274 (1962)).
Note that this is not the case for a landlord seeking to enforce a commercial lease, and it is generally true that the rules governing real property contracts are often different than the rules governing other contracts. Holy Properties Ltd., L.P. v. Kenneth Cole Prods., Inc., 87 N.Y.2d 130 (1995) (commercial landlord had no duty to mitigate damages). However, in residential leases (which are often treated differently than commercial ones), a landlord has a statutory duty to mitigate. RPL Sec. 227-e.

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