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Can an 'Agreement to Agree' Support Expectation Damages?

By Curtis B. Leitner and Joseph R. Scholz

The label of "agreement to agree" is often understood as the death knell of a contract claim. Often—but not always. Under New York law, a preliminary agreement that omits material terms can still impose an obligation to negotiate in good faith toward a complete agreement.

Preliminary agreements are common in letters of intent or term sheets that proceed complex transactions, like mergers, where parties want to ensure that their time and resources are not wasted on an uninterested counter-party.

New York courts usually hold that damages from the breach of a preliminary agreement are limited to out-of-pocket costs—and that expectation or benefit of the bargain damages are not recoverable. After all, a preliminary agreement to negotiate in good faith is merely an "agreement to agree." It is not a "bargain" from which the non-breaching party could expect, or a court could measure, benefit of the bargain damages.

A recent decision by the New York County Supreme Court, *Cresco Labs New York v. Fiorello Pharmaceuticals*, 178 N.Y.S.3d 425 (N.Y. Sup. Ct. 2022), upends this damages limitation. *Cresco* ruled that, at least on the specific facts of that case, expectation damages were warranted for breach of a preliminary agreement. The court's analysis could expose contracting parties to substantial additional liability from preliminary agreements. This article situates *Cresco* within the relevant New York case law and explains why contracting parties and counsel should take notice.

Type One and Type Two Agreements

In *Teachers Insurance & Annuity Association of America v. Tribune,* 670 F. Supp. 491 (S.D.N.Y. 1987), then-U.S. District Judge Pierre Leval of the Southern District of New York coined the distinction between "type one" and "type two" preliminary agreements. Type one agreements are preliminary in form only. The parties agree to all material terms and express an intent to be bound by an informal document, but they also agree to create a more formal elaboration of their agreement. In that case, the informal agreement is already binding, and remains so until it is superseded by a more formal contract.

Type two agreements are preliminary in form and substance. The parties agree to some major terms, but they also acknowledge that material terms remain to be negotiated. The parties further agree to negotiate in good faith to reach an agreement on outstanding terms within an agreed-upon framework. In Judge Leval's words, the parties "bind themselves to a concededly incomplete agreement in the sense that they accept a mutual commitment to negotiate together in good faith in an effort to reach final agreement within the scope that has been settled in the preliminary agreement." The parties can back out, of course. But a court may scrutinize their conduct (and motivation) for bad faith—for example, foot-dragging or insisting on terms that contradict the preliminary agreement.

Type two agreements can be commercially valuable. Parties invest substantial time and cost negotiating a complex deal—relationship-specific investments, foregone opportunities, tracking down information or procuring liquidity. As Judge Richard Posner explains, the "parties may want assurance that their investments in time and money and effort will not be wiped out by the other party's foot-dragging or change of heart or taking advantage of a vulnerable position created by the negotiation." See *Venture Associates v. Zenith Data Systems*, 96 F.3d 275, 278 (7th Cir. 1996).

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Damages From a Type Two Agreement

New York courts typically limit damages for breach of a type two agreement to reliance damages (such as out-of-pocket costs). Hence, the New York Practice Series treatise on contracts states: "Although expectancy damages such as lost profits are not available to redress a failure to negotiate in good faith, a party can recover as reliance damages its out-of-pocket costs in pursuing the agreement."

Expectation damages put the nonbreaching party in the position it would have been if the breaching party had performed. Expectation damages are generally not recoverable for breach of a type two agreement because such an agreement is not an agreement to perform. It is an agreement to negotiate in good faith, which might or might not result in agreement to perform.

A plaintiff seeking expectation damages for a breach of a type two agreement would have to prove damages flowing from a hypothetical agreement that was never reached (but would have been reached if both parties negotiated in a good faith). Because the terms of the agreement are unknown—and the breaching party will inevitably claim are unknowable—this may present an insurmountable burden.

The leading New York case on damages recoverable for the breach of a type two agreement is *Goodstein Construction v. City of New York*, 80 N.Y.2d 366 (1992). The plaintiff, a real estate developer, agreed to "to exclusively negotiate the terms and con-

ditions of a land disposition agreement" (LDA) with New York City. The preliminary agreement specified a price, but it stated that the LDA would be contingent on the approval of regulatory bodies, and that the city could "terminate negotiations at any time." The city backed out and the developer sued the city for failing to negotiate in good faith. The developer sought $1 million in out-of-pocket costs and $800 million in lost profits.

The court of appeals limited the developer's damages to out-of-pocket costs:

To allow the profits that plaintiff might have made under the prospective LDA as the damages for breach of the exclusive negotiating agreements would be basing damages not on the exclusive negotiating agreements but on the prospective terms of a nonexistent contract which the city was fully at liberty to reject. It would, in effect, be transforming an agreement to negotiate for a contract into the contract itself.

The court explained that, because negotiations were terminable by the city and subject to layers of regulatory approval, the city could not have reasonably contemplated exposure to damages based on a hypothetical LDA. Additionally, expectation damages made little economic sense, as the city would face "liability of catastrophic proportions when the other party was assuming no risk whatsoever."

Cresco—Setting the Stage

Cresco held that, *Goldstein* notwithstanding, a type two agreement can support an award of expectation damages. The decision was very fact-specific; so it is necessary to describe the facts in some detail.

Cresco ran a medical cannabis business and wanted a license to operate in New York, one of the most important markets. The New York license was critical to Cresco's plan to go public in Canada in the near future. Fiorello held one of two New York licenses that were available for sale, but it was not yet operating a dispensary. Unless Fiorello began operations in short order, it would lose its New York license. Thus, both Cresco and Fiorello needed a quick deal.

In February 2018, the parties entered into a binding letter of intent (LOI) to negotiate a definitive agreement within 30 days. The LOI specified a sale price ($26 million), but it left important terms open—for example, the terms of a management agreement whereby Cresco would manage and fund Fiorello's operations until closing, to ensure that Fiorello's license remained in good standing. Importantly, the LOI contained a confidentiality clause and a "no shop" provision, which barred the parties from discussing a cannabis license deal with third parties for 30 days.

The court found that "Fiorello did not honor the LOI even for a nanosecond." Fiorello immediately breached the confidentiality and "no shop" provisions, obtained a higher offer from another suitor, and slow-walked its communications with Fiorello to run out the clock on the LOI. Ultimately, both Cresco and Fiorello completed transactions similar to the deal in the LOI with different parties.

The prices, however, were very different from the LOI. Fiorello was acquired for $42.6 million (and shares of the acquirer of an unspecified value). Cresco acquired the company with the only other available New York cannabis license for $129 million in cash and equity. Like Fiorello, the license holder was nonoperational. Both deals were approved by the New York Department of Health.

Cresco—Beyond Reliance Damages

Citing *Goodstein*, Fiorello argued that Cresco's damages were to limited to out-of-pocket costs. The court rejected that argument and held that *Goodstein* does not rule out expectation damages from a type two agreement. Instead, *Goodstein* limits damages to those "contemplated as likely to result from the nature of the agreement." The court explained that *Goodstein* barred Cresco from recovering expectation damages predicated on the $26 million LOI price. Fiorello had agreed to negotiate in good faith to reach an agreement at that price—not to sell at that price.

Nonetheless, the court held that Cresco could recover expectation damages in the form of its cost of cover—that is, the incremental cost of purchasing a substitute New York cannabis license. Based on the "no shop" and confidentiality provisions, and each party's urgent need to consummate a license deal, Cresco's costs of cover "naturally flowed" from Fiorello's breach. Specifically, the court held that Cresco could recover the "delta between the cost of the alternative transaction that Cresco consummated and the cost that Cresco would have incurred in doing the transaction with Fiorello—the amount that Fiorello was prepared to, and did, sell for, as this is exactly what was contemplated as likely to result from the nature of the agreement." Under this analysis, Fiorello was liable for substantial damages: the difference between the $42.6 million price at which Fiorello sold its license, and the $129 million that

Cresco Paid to Cover by Purchasing a Replacement License

The unusual factual scenario in *Cresco*—including both parties consummating a transaction similar to that in the LOI with third parties—allowed the court to draw a confident inference about what Cresco and Fiorello's definitive license agreement would have been. The court inferred that Fiorello would have sold to Cresco for $42.6 million because Fiorello actually sold its license at that price, and that Cresco would have paid $42.6 million because it actually paid a much higher price. The fact remains, however, that Cresco's damages are premised on hypothetical agreement that Fiorello was not obligated to enter.

Nevertheless, the court distinguished *Goodstein* on the grounds that Cresco involved a "no shop" provision. Barring Cresco from recovering expectation damages, the court reasoned, would "attach no commercial value as to the 'no-shop' and confidentiality provisions and to ignore the legitimate expectations of the parties reflected in this carefully and highly negotiated LOI."

Conclusion

The *Cresco* decision is currently on appeal. In the meantime, plaintiffs will seize on its analysis to seek expectation damages from type two agreements with exclusivity and confidentiality provisions. Parties to those agreements should not take for granted that damages will be limited to out-of-pocket costs, and tailor their contract language accordingly.

Curtis B. Leitner *is a business litigation partner in McCarter & English's New York office. He represents companies and individuals in complex civil disputes, as well as white collar criminal and regulatory enforcement matters. He can be reached at cleitner@mccarter.com.*

Joseph R. Scholz *is a business litigation partner in the firm's New York office. He an experienced trial lawyer who has successfully litigated disputes in federal and state courts and arbitrations for over 25 years. He can be reached at jscholz@mccarter.com.*