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First Dept. Forms Bright-Line Rule To Cap Damages From Breach of 'Agreement to Agree'

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My March 2023 column flagged an important decision by the New York County Supreme Court that bucked the general principle that damages from the breach of a preliminary "agreement to agree" are limited to out-of-pocket costs.

That case, *Cresco Labs New York v. Fiorello Pharms.*, 178 N.Y.S.3d 425 (N.Y. Sup. Ct. 2022), involved the breach of an agreement to negotiate in good faith toward a cannabis license deal. The agreement had a confidentiality clause and a "no shop" provision that required the parties to negotiate exclusively with each other for the 30-day term. The court found that one party breached the preliminary agreement within "a nanosecond" by soliciting other bidders and slow-walking the negotiations to run out the 30-day exclusivity period.

Under New York law, damages for breach of preliminary agreement are typically limited to out-of-pocket costs, such as due diligence fees. Expectation damages based on the failure to consummate the contemplated deal, such as lost profits, are not permitted.

As the New York Court of Appeals explained in the seminal case, *Goodstein Const. v. City of New York*, 80 N.Y.2d 366, 373 (1992), an award of expectation damages based on an "agreement to agree" would be based on "the prospective terms of a nonexistent contract which the [the breaching party] was fully at liberty to reject," and "would, in effect, be transforming an agreement to negotiate for a contract into the contract itself."

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In *Cresco*, however, the trial court held that the plaintiff was entitled to a very large award (potentially more than $80 million) of expectation damages from a preliminary agreement: the increased cost of "covering," or engaging in a replacement license deal.

While *Cresco* was on appeal, my previous column suggested that the decision could open the door to unexpected claims for expectation damages from breaches of preliminary agreements.

In June 2023, the First Department slammed the door shut. The court reversed and pronounced a bright-line rule: the remedy for the breach of a preliminary "agreement to agree" cannot exceed out-of-pocket costs.

This article revisits the unique facts of *Cresco*, explains the First Department's decision and suggests lessons for drafting (and litigating) parties.

'Cresco' Refresher

Cresco ran multi-state medical cannabis business and wanted a license to operate in New

York, one of the most important markets. Fiorello, a non-operational cannabis dispensary business, held one of two New York licenses that were available for sale. Both Cresco and Fiorello needed a quick deal. Unless Fiorello secured funding to commence operations in short order, it would lose its New York license. Cresco required a New York cannabis license to execute an upcoming go-public transaction in Canada.

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 non-binding price of $26 million. Since the LOI was an "agreement to agree," 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.

The LOI was plainly intended to be binding in certain respects. It explicitly stated it was "intended to be binding on the Parties until supplanted by a definitive agreement." The LOI also included exclusivity and confidentiality terms. The parties agreed to negotiate in good faith to reach a definitive agreement within 30 days; to not discuss a cannabis license deal with any third parties during that period; and to keep the LOI and the potential transaction confidential.

The court found that, "Fiorello did not honor the LOI even for a nanosecond." Fiorello immediately breached the confidentiality and exclusivity provisions, obtained a higher offer from another suitor and slow-walked its communications with Cresco to run out the clock on the LOI.

Ultimately, both Cresco and Fiorello completed transactions similar to the deal in the LOI, but with different parties and at very different prices. Fiorello sold its license 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 non-operational.

Both deals were eventually approved by the New York Department of Health.

Trial Court Permits Cover Damages

Fiorello argued that Cresco's damages from Fiorello's breach of the confidentiality and exclusivity provisions were capped at Cresco's out-of-pocket costs—*i.e.*, the legal fees and due diligence costs incurred pursuing the deal with Fiorello.

In a lengthy opinion, the trial court rejected Fiorello's argument and held there is no bright-line rule against an award of expectation damages for breach of a preliminary agreement. Expectation damages are available, the court explained, if they are "contemplated as likely to result from the nature of the agreement."

The court found that Cresco could not recover 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 exclusivity 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."

Based on this analysis, the court ruled that Fiorello was liable for substantial damages: the difference between the $42.6 million price at which Fiorello sold its license to another party, and the $129 million that Cresco paid to cover by purchasing the only other available New York cannabis license.

The court took pains to establish that, on the unique facts of the case, these damages were not speculative. The court inferred that Fiorello would have sold to Cresco for $42.6 million because Fiorello actually sold its license at that price to

another party. Likewise, the court inferred that Cresco would have paid $42.6 million for Fiorello's license because Cresco actually paid a much higher price for the license.

Barring Cresco from recovering expectation damages, the court reasoned, would "attach no commercial value as to the 'no-shop' [i.e., exclusivity] and confidentiality provisions and ignore the legitimate expectations of the parties reflected in this carefully and highly negotiated LOI."

First Department Reverses

On appeal, the First Department reversed and directed the trial court to limit Cresco's damages to out-of-pocket costs. The court clarified that the prohibition against expectation damages from breach of a preliminary agreement is a bright-line rule—not an issue assessed on a case-by-case basis.

Specifically, the court held that "*Goodstein* applies where an agreement to agree includes exclusivity and confidentiality provisions." In the context of a preliminary acquisition agreement, damages cannot be awarded based on "the theory that [plaintiff] would have acquired" the counterparty, "as the "[counterparty] was not bound to go forward with the transaction."

On appeal, Fiorello argued that three features of the LOI proved that Cresco contemplated cover damages—that is, Cresco understood that, if it breached, it would be liable for the increased costs incurred by Fiorello in an alternative license deal. Specifically, (1) the exclusivity provision was effective for the 30-day duration of the LOI and was not terminable at will; (2) the exclusivity provision was mutual; and (3) the LOI specifically stated that it was "intended to be binding."

The First Department held that "it does not follow that the parties reasonably contemplated cover damages as the remedy for breaching" the LOI. The absence of a definitive agreement was dispositive: "That the parties entered only a preliminary agreement with no obligation to close a transaction and no specific damage provision for breach conclusively shows that defendant did not wish to assume the risk of covering whatever replacement transaction plaintiffs might pursue."

Implications

Cresco establishes a default damages rule for contracting parties. If the parties do not reach a definitive agreement, but agree only to continued good faith negotiations toward a definitive agreement, damages from a breach will be limited to out-pocket costs.

It does not matter if the parties add bells and whistles to the preliminary agreement—confidentiality, exclusivity, promises of best efforts, statements about intent to be bound and the like—the breaching party will only be liable for reliance damages.

This rule facilitates "efficient breaches," where it makes economic sense for a party to breach a contract, make its counterparty whole and consummate a better-priced transaction with a different party.

Importantly, parties are free to contract around the default rule. The First Department held that Cresco and Fiorello did not "reasonably contemplate" cover damages from a replacement transaction because their preliminary agreement had "no specific damages provision."

Contracting parties can add teeth to preliminary agreements by negotiating provision that specifies the damages resulting from a breach. Otherwise, beware: parties can shirk a preliminary agreement for the limited price of a counter-party's out-of-pocket costs.

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