A New Path To Proving Lost Future Profits In NY Court

By **Reid Skibell and Nathan Ades** (April 27, 2022)

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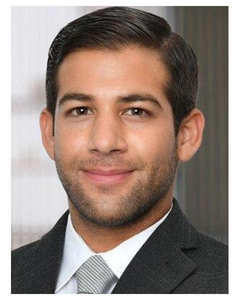

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One of the complexities faced in litigation involving early-stage companies is proving entitlement to lost profits as damages. In any lawsuit, the plaintiff's entitlement to compensatory damages will depend on proving what would have taken place in the hypothetical world where the alleged misconduct did not take place, as compared to the real world.

By its very nature, that exercise involves a degree of uncertainty and estimation, which is typically addressed through a combination of evidence and expert testimony. But demonstrating what the hypothetical world would have looked like is particularly difficult when the plaintiff's business lacks a historical track record or, worse yet, is merely at the concept stage.

In New York, plaintiffs generally face a demanding standard for demonstrating an entitlement to lost future profits in breach of contract actions involving early-stage ventures. In the 1986 Kenford Co. v. County of Erie decision, a New York Court of Appeals stated that the plaintiff must introduce evidence showing that lost future profits are "reasonably certain and directly traceable to the breach" to show lost profits are reasonably ascertainable.[1]

A recent decision, Indeck Energy Services Inc. v. Merced Capital LP, demonstrates how an opposing parties' internal documents can provide an alternative path to proving lost profits with reasonable certainty under New York law.

The Traditional Kenford Standard

When it comes to proving lost future profits, the seminal decision is Kenford.[2] The court in that matter considered a situation where the parties entered into a contract for the construction and operation of a domed baseball stadium near Buffalo, New York.

Part of the risk of the venture was that while the parties had detailed plans to develop the land and profit from the baseball franchise, neither of them had any prior experience in those areas; the plaintiff was a local businessman and defendant was the county.[3] After negotiations about terms broke down and construction was abandoned, the businessman sued for breach of the contract.

While in a typical breach of contract situation a plaintiff would have to prove they are entitled to lost profits with reasonable certainty, in Kenford, the court recognized the need for a different standard. Because the dispute centered around a startup business with no track record or historical comparables, the Kenford court reasoned a "stricter standard" was required to prove that future profits could have realistically been actualized.[4]

While the plaintiff introduced a plethora of evidence, including "advanced and sophisticated models," that was not enough under the circumstances.[5] This was because the plaintiff lacked relevant experience and could not point to a comparable business. On these facts, the Kenford court found that any estimate of lost profits, no matter how detailed or supported, would be unduly speculative. To put it another way, any estimate of lost profits would be inherently unreliable because there "did not exist a reasonable basis of experience" by which the court could measure the business's profitability.[6]

In following years, courts have attempted to flesh out the strict standard for new businesses that was established in Kenford. However, no consensus has emerged on how to apply it, and many of the decisions are fact specific. Some courts have required plaintiffs to meet multipronged tests that take into account "general market risks" that could affect future profits, such as technological advancements, regulatory changes, or market movement.[7]

In others, courts have reasoned that plaintiffs must demonstrate the profitability of comparable ventures that can effectively stand-in for the lost business opportunity.[8] Regardless of the precise application of Kenford's standard, however, underpinning each case is a consistently difficult evidentiary burden for the injured early-stage business to prove entitlement to lost future profits, which includes measurable, comparable, or historical data.

Thus, when it comes to emerging businesses proving an entitlement to future profits in New York, success has generally depended on an ability to show how a comparable business performed and with data demonstrating the market dynamics — i.e., market size, costs, existence and competitors — were analogous.

The Alternative Approach Adopted in Indeck

The December 2021 Indeck Energy v. Merced decision in the First Department of the New York Supreme Court's Appellate Division shows another, far less demanding path to proving lost future profits with reasonable certainty.[9] Moreover, Indeck suggests that business ventures that are unique and lack a real-world proxy — such as a domed baseball stadium in Buffalo — may still be able to demonstrate lost profits with reasonable certainty.

The disputing parties in Indeck were players in the energy industry.[10] In the transaction at hand, the parties entered into a confidentiality agreement concerning the creation of natural gas "peaker" power plants in an area known as the Electric Reliability Council of Texas, or ERCOT.[11]

The business was risky, and profits were deemed volatile because the peaker plants both would only come into use when energy use surged beyond normal capacities; thus hypothetically they could charge particularly high rates for power.[12] Subsequently, in violation of a confidentiality agreement, two employees left Indeck and attempted to partner with the defendant-Merced to develop the peaker plant business.[13] Indeck sought damages for loss of future profits, among other remedies.[14]

On its face, the circumstances in Indeck were comparable to those in Kenford. There was no directly comparable natural gas peaker plant project that the plaintiff could use as a proxy to prove the viability and profitability of its untested ERCOT venture. It also faced a difficult task in proving profitability in an irregularly fluctuating market for peaker power demand. The profitability of the peaker plant, therefore, depended on numerous factors that were inherently difficult to project; a wide range of inputs would dramatically affect any estimation of lost future profits.

Thus, like in Kenford, there was no indication that the projections presented by the plaintiff could be verified or substantiated by comparisons to similar businesses. Indeed, the defendant argued that lost profits could not be proven with reasonable certainty on five separate occasions; each time it lost.[15] Indeck was awarded nearly $16 million in lost profits, which was subsequently upheld on appeal.[16]

To demonstrate lost profits, the Indeck introduced a standard discounted cash flow model to demonstrate the profitability of the lost peaker plant business opportunity, which was based on the defendant's inputs. These inputs were taken from projections that Merced had utilized in evaluating the potential for the power plants, which Indeck's expert "sanity checked based on his professional experience."[17]

While Merced did utilize these projections in conducting its business, they were still projections and subject to the same problems of any profitability estimate of an early-stage company that is untethered from a historical track record or real-world proxy. Accordingly, while they were not prepared specifically for litigation, the evidence was precisely of the type rejected by the Kenford court as fatally flawed. Nevertheless, the trial court found the evidence to be reliable.

It reasoned that "Indeck's expert's DCF analysis is based on Merced's internal documents and projections made in the ordinary course of business — as opposed to those used to pitch investors — which are inputs of the highest caliber."[18] Underscoring the point that defendant's reliance on the projections made them de facto reliable, the court noted:

> Merced's contention that a DCF model is inherently speculative in this context is rejected because such a model is regularly relied on by market participants in the ordinary course of business when investing in peaker energy plants. If the projections are a good enough basis for sophisticated parties to invest significant amounts of real money, they are good enough for assessment of damages too. Indeck's DCF model is thus a reliable indicator of [one of the peaker plant project's] value.[19]

In reaching this conclusion, the trial court seemingly disregarded Kenford and its progeny; there is not even a nod to that line of cases. Instead, the court relied on a Delaware Court of Chancery decision involving an appraisal action and a two-decades-old holding from the U.S. Court of Appeals for the Second Circuit, Sir Speedy Inc. v. L & P Graphics Inc., which had never been cited by a New York state court.[20]

The latter case, which involved sales of the defendant's franchises, was also factually distinguishable.[21] In Sir Speedy, the plaintiff presented evidence showing that in one region real-world franchises had outperformed the defendant's projections, which, according to the Second Circuit, corroborated the veracity of those projections.[22]

By contrast, the Indeck court found the actual performance of the peaker plants in the years following the contractual breach to be immaterial: "To be sure, it is undisputed that in the years since the assumptions were made, the world unfolded differently. That is unremarkable."[23]

Importantly, after Indeck used Merced's own projections to prove damages, the latter was forced to disprove the reliability of its own projections at the time they were made. This had a significant practical impact; it flipped the script. Instead of the plaintiff having to present evidence demonstrating lost profits to a strict standard, the defendant was placed in the nearly impossible situation of having to attack the reliability of its own projections. Unsurprisingly, the trial court found Merced's attempt to do that was "not probative or credible."[24]

Conclusion

The First Department's decision upholding the decision in Indeck paves the way for the decision to be more widely cited. And the logic of the decision has wide applicability. While the business projections that proved so pivotal in Indeck were created by the defendant, the trial court's reasoning suggests that any business projections can be utilized to prove lost future profits with reasonable certainty if the projections were relied upon by the defendant in the regular course of business.

It is the defendant's use of the projections that is the lodestar of reliability. The holding in Indeck thus represents a nuanced shift in New York jurisprudence on lost profits that could make it far easier for plaintiffs to succeed on claims for lost profits.

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[1] Kenford Co. v. Erie , 67 N.Y.2d 257, 261 (1986).

[2] See Kenford Co. v. Erie, 67 N.Y.2d 257 (1986).

[3] Kenford Co. v. Erie, 108 A.D.2d 132, 134 (4th Dep't 1985),aff'd, 493 N.E.2d 234 (1986).

[4] Id. at 261.

[5] Id. at 261-262.

[6] Id. at 261.

[7] See, e.g., Schonfeld v. Hilliard , 218 F.3d 164, 174 (2d Cir. 2000).

[8] See, e.g., Wathne Imps., Ltd. v. PRL USA, Inc ., 953 N.Y.S.2d 7, 13 (1st Dep't 2012); Bersin Props., LLC v. Nomura Credit & Cap., Inc ., 159 N.Y.S.3d 828, at *13 (N.Y. Sup. Ct. Feb. 7, 2022).

[9] Indeck Energy Servs., Inc. v. Merced Cap., L.P. , No. 652171/2014, 2020 WL 6081952 (N.Y. Sup. Ct. Oct. 15, 2020).

[10] Id. at *2.

[11] Id.

[12] Id.

[13] Id.

[14] Id. at *3.

[15] Id. at*6.

[16] Id. at *12.

[17] Id. at *8.

[18] Id. at *5.

[19] Indeck Energy Servs., Inc. v. Merced Cap., L.P., 159 N.Y.S.3d 405, 408 (Dec. 8, 2021) ("The trial court properly accepted plaintiff's expert's models, assumptions and conclusions as sound based upon the evidence and an assessment of credibility.").

[20] ACP Master, Ltd. v Sprint Corp ., 2017 WL 3421142, at *31 (Del. Ch. July 21, 2017); Sir Speedy, Inc. v. L & P Graphics, Inc ., 957 F.2d 1033, 1038 (2d Cir. 1992).

[21] ACP Master,2017 WL 3421142, at *31.

[22] Sir Speedy, 957 F. at 1040.

[23] Indeck, 2020 WL 6081952 at *9.