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"I Coulda Been a Contender": Lost Profits After a Contract Breach

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Midcourse Corrections

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Greenwich S.F. v Wong

The decision in *Greenwich S.F. v Wong* (reported on p 35) truly requires a midcourse correction by attorneys, both litigators and transactionalists. An understanding long held by many—that aggrieved purchasers of real estate could recover benefit-of-the-bargain damages but not also lost profits—has abruptly been undercut, and in a way that henceforth will require careful planning by counsel in order to qualify under the new standards set by the First District Court of Appeal.

If your client had contracted to purchase a property for less than its market value, with plans to renovate it and resell it for a further profit thereafter, how much should he recover in damages when his seller changes her mind and refuses to sell? Suppose, to use some of the numbers that were thrown around (somewhat loosely) in *Greenwich*, the second contract price was $760,000 but the buyer believed it was worth at least $878,000 ($118,000 more than the price) and also believed that after reconstructing it, he could sell for over $3 million, thus clearing a second profit of $600,000 on the remodel. After the seller's breach, can he recover the $600,000 as well as the $118,000, or only the $118,000? (This question is different for the buyer who intended to flip the property immediately for a profit, since the original benefit-of-the-bargain calculation for him should cover both aspects, so I am not further considering that kind of deal.)

The first number—$118,000—is what CC §3306 clearly provides for, stating that a purchaser's damages include "the difference between the price agreed to be paid and the value of the estate agreed to be conveyed at the time of the breach." This is standard benefit-of-the-bargain damages, requiring a plaintiff to produce evidence that the property was worth more than the price he was paying—a requirement that is not impossible to meet because it involves value "at the time of breach" rather than value at the earlier date of contracting (when one intuitively expects the value and price to be the same, unless the buyer was withholding from the seller some superior knowledge that he had, *e.g.*, that the city was about to condemn the property or that a new high-rise was to go up next door). In *Greenwich*, however, the jury found that the difference between the market value and the contract price at breach date was 0, thus depriving that plaintiff of any claim to such general damages. (This result looks somewhat odd in light of the fact that the seller's breach consisted of her refusal to sell at the original $760,000 price and her demand for an increased price of $1.1 million, but perhaps the comparable sales showed that the seller was just a dreamer.)

Consequential Damages and Lost Profits

Under CC §3306 as it existed until 1983, the nonexistence of any benefit-of-the-bargain damages would have basically terminated the purchaser's case. But the amendment to this section in that year not only eliminated the old requirement of bad faith as a precondition for benefit-of-the-bargain damages, it also added “consequential damages, according to proof” as recoverable. Justice Kline gives readers a thorough review of all this by way of reaching the conclusion that lost profits may now be recovered by a buyer as special damages (a conclusion that he acknowledges had not been widely held by commentators). That new conclusion has many ramifications, over and above the addition of a new weapon to the arsenal of threats that can be made to reluctant sellers about how much they can be sued for if their remorse does get the better of them (or cautions that their own counsel should now give to them). This new remedy also harbors many traps for unwary attorneys.

Lost profits are special, rather than general, damages, so they do not come that easily. The court’s opinion contains two sets of conditions, which I will quote (and number). The court says: “Not only must such damages [1] be pled with particularity, but they must also [2] be proven to be certain both as to their [2a] occurrence and their [2b] extent, albeit not with mathematical precision.” Its next sentence asserts: “[T]hey may include lost profits, where such profits are [3] the natural and direct consequence of the breach, where [4] the amount of the lost profits can be established with reasonable certainty, and where [5] the seller knew of the buyer’s intent to use the property for profit.” 190 CA4th at 754. The requirements are cumulative, and all must be met if lost profits are to be recovered. (Since conditions #2 and #4 clearly overlap, they will generally be discussed together.)

In Negotiating the Deal

Taking up these conditions in a more practical order, as they might affect parties and counsel, an attorney for a buyer engaged in drafting the initial offer to purchase now ought to be sure to include whatever is necessary to satisfy condition #5—making the seller aware of the client’s profit plans. A seller who can show that she was unaware of the buyer’s dream to make a million-dollar profit need have no further worries about that dream, even though all of the other preconditions have been met. She may be liable for benefit-of-the-bargain damages, but not lost profits.

The seller who has been so advised lacks this protection. She cannot close her ears at the negotiating or drafting stage, so she must propose protective or exculpatory language, probably somewhere in the vicinity of the integration and “no other representations” clauses. Good language ought to be a complete defense, unless the buyer can think of some even more devious way to get it back in.

In Conducting the Litigation

If the matter does not come to counsel until a contract has already been drafted and a breach already occurred, then any opinion to either party about the extent of recovery or exposure will depend on the plaintiff attorney’s success in unearthing meaningful evidence on this condition #5. If no such evidence of communication exists, the case probably shrinks to a pure benefit-of-the-bargain issue, which may hardly count for much in a stable market where the contract price and market value were probably similar. From the defense position, seller’s counsel can probably only advise her client not to talk too much.

If a complaint is being filed, condition #1—pleading the lost profits with particularity—clearly kicks in. Amendments following demurrers can probably be easily made when necessary to cure initial omissions, but no plaintiff looks forward to dealing with the problem of needing to amend to conform to the proof because of the variance between the pleading and the proof, which in turn is due to the fact that not enough attention had been paid to the matter in the original pleadings. This is one of those issues that has to be thought about at the start, not at the eve of trial.

The proximate cause requirement of condition #3—lost profits as a natural and direct consequence of the breach—is the vaguest and hardest requirement to analyze and meet. (It may be identical with condition #2a—proving their occurrence with reasonable certainty.) The *Greenwich* project fell through because the seller did not perform, but would it have generated the imagined profit anyway? Ventures are never planned with failure in mind, but that is no guaranty that success always follows. Plaintiff's counsel must somehow be able to persuade a jury that all the rest of the development would have gone according to plan if only the seller had honored her original commitment to sell. In fact, the persuasion task is even more daunting, because—as in *Greenwich*—the jury might be persuaded, but not the appellate court; it does not do much good to convince one body but not the other.

The When of Lost Profits

The court's recitation of the facts in *Greenwich* makes it appear that the contract was first executed in 2003 but delayed; that the breach occurred in 2005; and that the project was intended to be completed around 2005, and to result in a building worth $3.2 million (generating a $600,000 profit over cost), when the case was tried and the evidence introduced in 2008. But much happened in the real estate market between those years. Many buildings that were started and actually finished on speculation during that period generated losses rather than gains. Were the profits that were never made to be calculated with hindsight or with foresight? Should plaintiff's attorney have used the estimated (lost) profit as calculated at the time of the contract making (2003), or at the time of contract breaking (2005), or at the time of trial (2008)? The breach date would keep the lost profit formula in synch with the statutory benefit-of-the-bargain calculation (and would have probably resulted in the highest number), but it may be too unrealistic to award damages for not being able to construct a building that would have been a money loser had it actually come to market (as a 2008 calculation might establish). Given that testimony on this issue will inevitably be hypothetical, an expert could readily provide opinions (if litigation expenses are no problem) on all those items, but the jury will still have to be told which one to follow. Justice Kline's opinion offers no guidance on these questions.

The chief reason the plaintiff in *Greenwich* lost on this issue was condition #4 (proving lost profits with reasonable certainty), in particular the condition #2b version of that requirement—good proof of the extent of the profits—which made it much easier for the court not to have to deal too seriously with the proximate cause requirement of condition #5. The plaintiff's and expert's numbers were all over the place and not seriously thought through. The fact that even the favorable verdict could not redeem the poor presentation of evidence means to the rest of us that lost profits contentions and calculations have to be thoroughly worked out in advance (indeed, as far back as the discovery stage, when the adversary is asking about contentions).

Lost Profits in Other Situations

Lost profits in real estate deals are not confined to aggrieved buyers. Sellers have always been held entitled to recover, under CC §3307, the same "consequential damages according to proof," which provision will probably be read the same way as §3306 has been. Perhaps seller's counsel should give her client the same advice—informing her buyer of her plans of glory in reinvesting the money she will take from the sale—so that she too can recover her lost profit after the buyer breaches.

The seller's analysis is more complicated if a liquidated damages clause is also being negotiated—especially if it includes the 3-percent cap of CC §1675—because such a provision would probably be deemed to cover lost profits as well as benefit-of-the-bargain losses, unless it contains a special carve-out of that feature.

In another direction, since both buyers and sellers are capable of being defrauded by their counterparties and suing on that score, rather than for breach of contract, lost profits may pop up there as well. Civil Code §3343 may reject the basic benefit-of-the-bargain damage measure of §§3306 and 3307, but it is quite explicit in allowing defrauded parties to seek lost profits. The fraudulently induced seller may claim "an amount which will compensate him for profits or other gains which might reasonably have been earned by use of the property had he retained it" (CC §3343(a)(3)), while the defrauded buyer can seek "an amount which will compensate him for any loss of profits or other gains which were reasonably anticipated and would have been earned by him from the use or sale of the property had it possessed the characteristics fraudulently attributed to it" (CC §3343(a)(4)).

Under §3343, the special preconditions for recovery for either a defrauded buyer or defrauded seller are:

- Acquisition for the purpose of using or reselling at a profit (which does not fit well with a claim by a defrauded seller);
- Reasonable reliance on the fraud; and
- Proximate cause.

This list has some similarity to the *Greenwich* preconditions for lost profits in a breach of contract case, although the requirement of forewarning the other side is notably absent.

In general, evaluation should be different for fraud and breach of contract cases; which measure of damages will be used may play a role in making the choice between the two causes of action. Not all situations afford an aggrieved party the option of electing between fraud and breach of contract, but counsel should be careful to comply with the appropriate standard(s) in taking or working up the case, especially now for those lost profits. Life is now clearly more complicated than it was before.

Although lost profits may be awarded as consequential damages under CC §3306 for breach of real estate sales contract in an appropriate case, they were not warranted here because prospective purchasers failed to prove projected lost profits with requisite reasonable certainty.

Greenwich S.F., LLC v Wong (2010) 190 CA4th 739, ___ CR3d ___

In 2002, Husband and Wife purchased a San Francisco property in joint tenancy. Husband orally agreed that Contractor would build a two-unit building and receive compensation for work done plus 20 percent of the resale profit. After Husband died suddenly, Wife sought a buyer for the property for $760,000. Contractor put together a group of would-be purchasers (Greenwich S.F.), who signed a purchase contract in July 2003. Greenwich S.F. changed the project to a single-family residence, began preparing for renovations, and paid $60,000 into escrow. After delaying the conveyance of the property, Wife breached that contract and demanded $1.2 million for the property. Greenwich S.F. sued Wife.

At trial, Greenwich S.F. provided substantial evidence of $90,000 spent to renovate the property, including costs for design work, minimum annual tax payment, planning department fees, and a mandatory soils report. It was anticipated that construction would be completed in 2 years. An expert testified about property values but did not provide viable testimony about anticipated construction costs. A jury awarded Greenwich S.F. $600,000 in lost profits, $90,000 in renovation costs, and $60,000 for the payment into escrow. Wife appealed but did not file a new trial motion.

After reviewing the legislative history of CC §3306, California case law, scholarly treatises, and law of other states, the court of appeal concluded that in an appropriate case, lost profits may be awarded as an element of consequential damages under CC §3306 for breach of real estate sales contract—but this was not an appropriate case.

Wife successfully appealed the consequential damages award as uncertain in amount and unduly speculative as a matter of law. Thus, it was not necessary for Wife to move for a new trial before appealing the consequential damages award because Wife challenged whether sufficient evidence supported a lost profits award in any amount, not whether damages were excessive—which would have required a new trial motion. Further, the sufficiency of evidence issue did not depend on the resolution of factual issues or witness credibility, which would be better resolved at the trial court level. Nevertheless, Wife was barred from appealing the $90,000 renovation damages award because she was challenging that award as excessive. The court upheld the $60,000 award for escrow expenses.

The court held that the alleged, projected $600,000 lost profits were uncertain in amount and unduly speculative. The evidence at trial did not support a lost profits award based "on an unconstructed residence that possibly would have been sold to an unidentified and hypothetical purchaser more than two years after the breach of contract." 190 CA4th at 764. Greenwich S.F. had not yet obtained a construction loan; since no viable evidence was presented about the costs of construction, which is an incremental part of the lost profit calculation, the lost profit calculation was based on speculative evidence as well. The court found that (120 CA4th at 766):

> The lost profits claim was based on the assumption that Greenwich S.F. would have constructed the residence according to the plans and specifications without changes and that the venture would have been profitable. These assumptions were inherently uncertain, contingent, unforeseeable and speculative.In light of this holding, the court declined to determine whether Wife had been apprised at the time of the contract that Greenwich S.F. planned on developing the property for resale and profit. Since the court of appeal reversed the bulk of the damage award, the trial court should reconsider the award of attorney fees. Parties should bear their own costs and fees on appeal.

COMMENT: *See Roger Bernhardt's "Midcourse Corrections" column, on p 21 of this issue, for further comments on* Greenwich S.F. v Wong.*—Eds.*