New York Law Journal

A NEW YORK LAW JOURNAL SPECIAL SECTION

Litigation

An ALM Publication

WWW.NYLJ.COM

MONDAY, SEPTEMBER 13, 2010

Navigating the **Shadowy Borderland** Between Contract and Tort

Cases provide some rules, but results are not always predictable.

NYLJ

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AS EARLY AS 1882, the New York Court of Appeals lamented that:

> We have been unable to find any accurate and perfect definition of a tort. Between actions plainly ex contractu and those as clearly ex delicto there exists what has been termed a borderland, where the lines of distinction are shadowy and obscure, and the tort and the contract so approach each other, and become so nearly coincident as to make their practical separation somewhat difficult.[1]

The borderland between tort and contract continues to perplex litigants, as several recent cases illustrate. Tort theories often are thought to give the plaintiff an edge, by making punitive damages available or simply by avoiding contract language that limits liability or remedies. Consequently, a frequent subject of motion practice is whether a plaintiff's tort claims are adequately pleaded as torts or are merely dressed up contract claims.

The general rule is that, to plead a tort, the plaintiff must allege "the breach of a legal duty independent of the contract." Unfortunately, just what constitutes a "legal duty independent of the contract" is not always clear. Even where the complaint alleges each element of a tort cause of action, it is usually necessary for the court to consider how the tort claims relate to the alleged breach of contract.

Simple pleading embellishments are insufficient. For example, allegations of scienter will not rescue a potentially duplicative tort claim: both negligent and intentional breaches of contract are breaches of contract, and nothing more. Nor is it enough to assert that a tort duty of care required the defendant to follow a contract; though the suggestion that a "reasonable person" would not have breached the contract sounds superficially plausible, it boils down to a claim that a breach of contract is negligent per se.

Identifying Non-Contractual Duties

The analysis is more complex where the plaintiff alleges, not that the defendant was negligent because it breached the contract, but that the defendant breached the contract because it was negligent.

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A generic allegation of lack of "due care" is insufficient to convert a contract claim into one sounding in tort. But the breach of a specific non-contractual duty of care can establish tort liability.

One example is where the defendant is subject to a professional duty of care. The presence of a contract will not nullify claims for professional malpractice, which implicate duties imposed "as a matter of policy apart from contractual obligations."[2]

The viability of a tort claim based on malpractice, however, depends on the defendant actually being a professional. Claims involving insurance brokers, computer consultants and investment banks have all been held duplicative of contract claims,[3] whereas investment advisors, for example, may be subject to professional duties under certain circumstances.[4] Thus, the outcome may hinge on a characterization of the capacity in which the defendant acted.

Also note that while a malpractice theory may expand the scope of damages, it can also shorten the statute of limitations. CPLR 214(6) provides that a claim for malpractice "whether the underlying theory is based in contract or tort" is subject to the three-year limitations period, rather than the six-year period generally applicable to contract claims.

Plaintiffs seeking to take advantage of the longer statutory period have some room to plead "breach of a contract to obtain a particular bargained-for result,"[5] such as a doctor's promise to cure a disease. But such contracts are rare, and the exception is interpreted narrowly; where the promised result is consistent with ordinary professional obligations, the claim will be swept into the realm of malpractice for limitations purposes.[6]

Another possible route to tort liability is to allege that the particular contract implicated a significant public interest. This approach often will overlap with malpractice, but may have independent use where the defendant does not belong to a well-defined profession. The cases on this topic tend to be fact-specific. The management of fire alarms has been held to trigger duties enforceable in tort, while more recently the operation of power plants has been held to be purely contractual.[7] Business services, including accounting and investment banking, are consistently held not to qualify as public interests.[8]

One other possible source of a non-contractual duty arises where a contract triggers a fiduciary or agency relationship. Those relationships can carry duties implied by tort law that go beyond the express contracts that created them, but parties can also waive implied duties by contract.[9]

What Is a Non-Contractual Statement?

Allegations of fraud in the performance of contractual duties are a great source of perplexity.

Generally, to allege fraud against a contracting party, a plaintiff must allege either (1) a separate legal duty, such as a fiduciary duty, (2) a false statement "collateral or extraneous to the contract," or (3) special damages from the fraud that are not recoverable in contract.[10]

Tort theories often are thought to give the plaintiff an **edge**, by making **punitive damages** available or simply by avoiding **contract language** that **limits** liability or remedies. Consequently, a frequent subject of motion practice is whether a plaintiff's tort claims are **adequately pleaded as torts** or are only dressed up contract claims.

False statements that are intended to conceal of a breach of contract, or to avoid performance, are not actionable as fraud.[11] Cases involving false statements made in the course of performance, that is, where a contract requires a true statement and the defendant breaches by making a false statement, have come out both ways.

The quandary is illustrated by the case of contractual reporting requirements. For instance, suppose that a license of intellectual property requires the licensee to report on its use of the property (for example, by making products that use patented technology). The plaintiff alleges that the defendant falsified its reports.

The false reports are misrepresentations, intended to cause reliance, and so at first glance might seem to include the elements of an ordinary fraud claim. Moreover, there is a plausible argument that deliberately sending a false report is worse than simply failing to submit any. On the other hand, the duty to report at all is a product of the contract. Without the license, the reports would be meaningless, and reliance would be inconceivable.

Reflecting that tension, cases addressing this fact pattern have reached different results. In *Margel v. E.G.L. Gem Lab*, the Southern District held that because the defendants did not owe "any duty to report… apart from the duty under the contract," allegations that they under-reported their issuance of gem grading certificates did not state a claim for fraud.[12]

The Eastern District came to the same conclusion in *Atlantis Information Technology v. CA Inc.*, where it held that a plaintiff alleging falsification of royalty reports was "unable to demonstrate that its fraud claim is based on a legal duty separate and apart from the Defendant's contractual obligations."[13] Likewise, in *Cooper v. Sony Records*, the Southern District held that an alleged "scheme to under-report royalties" did not "relate to facts that were collateral and extraneous to" the contract.[14]

By contrast, in a dispute between the Beatles and their record company, the First Department held that "false statements and accountings" pursuant to a copyright license could state a claim for fraud, as well as breach of contract.[15] And in *Com-Tech Associates v. Computer Associates International*, the Eastern District, addressing RICO claims that the defendants "willfully underreported the actual amount of receipts" under a license, first found that "the defendants possessed the requisite intent" and then concluded that the claims "clearly sound in 'fraud,' rather than merely 'breach of contract.'"[16]

Specific Results Are Often Fact-Driven

Though the principles set forth in these cases may appear inconsistent, on closer examination the results were driven more by the specific facts than the courts' differing views on the law.

The court in *Apple Records* viewed the existence of a fiduciary duty between the record label and the artists as critical to the validity of the fraud claim. On similar facts, *Cooper* found no such duty; *Atlantis* also considered and rejected allegations of a "special relationship." A duty of bailment

arising from the *Apple Records* defendant's possession of the plaintiffs' property was another important factor. In *Com-Tech*, by contrast, the court relied on allegations of an "overall scheme to defraud the plaintiff," as to which the royalty reports were only one part, though other courts have treated similar allegations as mere embroidery on a defective claim.

Like fraud in the performance of a contract, a misstatement of fact that was collateral to a contract, but formed the inducement for it, may serve as the basis for a fraud claim. Thus, in *IMG Fragrance Brands, LLC v. Houbigant Inc.*, the court found that allegations that the defendant misrepresented that its lenders had consented to its entry into a contract with a third party could have stated a claim for fraud had they been pleaded with particularity.[17]

Claims that the defendant entered into a contract with no intention to perform, so-called "promissory fraud," are governed by what the federal courts have called "a very long and very puzzling line of New York cases. On at least four occasions, New York's Court of Appeals has expressly held that 'a contractual promise made with the undisclosed intention not to perform it constitutes fraud.' At the same time, however, there are numerous Appellate Division cases that state precisely the opposite rule."[18]

Notably, federal courts in New York usually follow the Appellate Division rule, not that of the Court of Appeals, and do not recognize promissory fraud.[19] Some attempt to distinguish the Court of Appeals decisions on their facts, noting that they involved oral promises that were independent of the written contracts.[20]

Others infer the acquiescence of the Court of Appeals from the fact that it has declined to reverse any of the numerous Appellate Division decisions adopting the more pro-defendant rule.[21] And yet others acknowledge the split in authority but reason that the job of federal courts under *Erie* is to predict what a state trial court would do, even if that is arguably inconsistent with the Court of Appeals.[22]

Federal courts have also indicated limited receptiveness to claims based on misstatements of future intent, where the statements relate to actions other than those set forth in the contract. In one recent case, *Maxim Group v. Life Partners Holdings*, the Southern District dismissed a fraud counterclaim that was based on a straightforward allegation that the counterclaim-defendants "were fully aware that they had no intention of performing as stated in" a contract for financial advisory services.[23]

The court announced that "[i]t is well-settled in New York…that a contract claim cannot be converted into a fraud claim by the addition of an allegation that the promisor intended not to perform when he made the promise."

The defendants also argued in support of their counterclaim that the contract was induced by false promises to raise specific amounts of debt financing, promises that did not appear in the contract. The court rejected that argument too, but for lack of evidence, and appeared to leave open the possibility that it could be a valid basis for fraud.

By contrast, in *DirecTV Latin America, LLC v. Park 610, LLC*, the court found that alleged misrepresentations about the ownership structure of a joint venture party were collateral to the contract and therefore could support a claim for fraud.[24] According to the complaint, one defendant represented that the sole purpose for the structure was to facilitate transfers among family members, when in fact the defendants intended to engage in illegal kickbacks with some of the plaintiff's employees. In upholding the fraud claim, the court noted that "[i]f a promise was actually made with a preconceived and undisclosed intention of not performing it," it can serve as the basis for claims of fraud and rescission.[25]

Conclusion

Though some rules can be extracted from these cases, results are often not entirely predictable. Indeed, it appears that the borderland between contract and tort will remain shadowy for some time to come, and so litigants will be well served by keeping the following tips in mind.

First, even more than in other areas of law, overreliance on broad principles can be hazardous: those principles often are subject to exceptions and depend on slippery characterizations of legal duties.

Second, it is important (for the plaintiff) to frame the case so as to show that particular duties were separate from contractual obligations and caused separate damages.

Third, it is important (for the defendant) to always view with some skepticism complaints alleging both contract and tort claims; an early motion to dismiss is often a viable option and a good use of resources.

And finally, above all, we suggest that counsel for both plaintiffs and defendants not overlook the importance of framing the issue. With the discretion that courts retain in deciding whether a fraud claim duplicates one for breach of contract, describing the case in terms that feel more like tort or more like contract can make all the difference.

1. *Rich v. NY Central & Hudson RR Co.*, 87 N.Y. 382 (1882).
2. *Bridge Street Homeowners Ass'n v. Brick Condo. Devs., LLC*, 18 Misc. 3d 1128(A) (Sup. Ct. Kings Co. 2008) (malpractice against architect/engineer).
3. *Manes Org. Inc. v. Meadowbrook Richman Inc.*, 2 A.D.3d 292, 293 (1st Dept. 2003); *RKB Enters. Inc. v. Ernst & Young*, 182 A.D.2d 971, 971-72 (3d Dept. 1992).
4. *Sacher v. Beacon Assocs. Mgmt. Corp.*, 270 Misc. 3d 1221(A) (Sup. Ct. Nassau Co. April 26, 2010).
5. *St. Alexander's Church v. McKenna*, 294 A.D.2d 695, 696 (3d Dept. 2002).
6. See *In re R.M. Kliment & Frances Halsband*, 3 N.Y.3d 538, 542-43 (2004) (breach of architect's promise to comply with building code sounded in malpractice, not contract).
7. Compare *Sommer v. Fed. Signal Corp.*, 79 N.Y.2d 540, 553 (1992) with *Trafalgar Power Inc. v. Aetna Life Ins. Co.*, 396 B.R. 584, 591 (N.D.N.Y. 2008).
8. *TD Waterhouse Investor Servs. Inc. v. Integrated Fund Servs. Inc.*, No. 01 Civ. 8986(HB), 2003 WL 42013, at *12-*13 (S.D.N.Y. Jan. 6, 2003); *Deutsche Bank Secs. Inc. v. Rhodes*, 578 F. Supp. 2d 652, 670 (S.D.N.Y. 2008).
9. See Restatement (Second) Agency §376 cmt. a.
10. *Bridgestone/Firestone Inc. v. Recovery Credit Servs. Inc.*, 98 F.3d 13, 20 (2d Cir. 1996).
11. *McDowell Research Corp. v. Tactical Support Equip. Inc.*, No. 08-CV-6499, 2009 WL 2901594, at *6 (W.D.N.Y. Sept. 4, 2009).
12. No. 04-cv-1514(PAC)(HBP), 2010 WL 445192, at *6 (S.D.N.Y. Feb. 8, 2010).
13. 485 F. Supp. 2d 224, 232 (E.D.N.Y. 2007).
14. No. 00-cv-233(RMB), 2001 WL 1223492, at *6 (S.D.N.Y. Oct. 15, 2001)
15. *Apple Records Inc. v. Capitol Records Inc.*, 137 A.D.2d 50, 56 (1st Dept. 1988).
16. 753 F. Supp. 1078, 1090 (E.D.N.Y. 1990).
17. 679 F. Supp. 2d 395, 409 (S.D.N.Y. 2009).
18. *Cougar Audio Inc. v. Reich*, 2000 WL 420546, at *6 (S.D.N.Y. 2000).
19. See id. at *6 n.4 (collecting cases).
20. See *Reddy v. Mangino*, No. CV 2008-4805(ILG)(MDG), 2010 WL 2771836, at *2 (E.D.N.Y. July 13, 2010).
21. See *Rolls-Royce Motor Cars Inc. v. Schudroff*, 929 F. Supp. 117, 123 (S.D.N.Y. 1996).
22. See *Best Western Int'l Inc. v. CSI Int'l Corp.*, No. 94-cv-0360, 1994 WL 465905, at *5 (S.D.N.Y. Aug. 23, 1994).
23. 690 F. Supp. 2d 293, 308-09 (S.D.N.Y. 2010).
24. 691 F. Supp. 2d 405, 437 (S.D.N.Y. 2010).
25. Quoting *Sabo v. Delman*, 3 N.Y.2d 155, 160 (1957).w