

# The Business Suit

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## Distinguishing Valid Fraud Claims From Trumped Up Breach of Contract Actions

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The scenario is an all too familiar one for business principals and their counsel alike. A deal that at its inception holds great promise soon falters and then crumbles, leaving in its wake former business partners now divided by dashed hopes and hard feelings. Because the parties' respective rights and obligations typically are governed by a contract, breach of contract claims are reflexive responses to such failed ventures. However, feelings of bitterness, disappointment and betrayal can and frequently do give rise to fraud claims. The aggrieved party asserting the fraud claim under New York law must successfully negotiate the bedrock principle that a contractual dispute is not magically transformed into a fraud claim merely by alleging that the defendant never intended to fulfill its obligations under the controlling contract. See, e.g., *PI, Inc. v. Quality Products, Inc.*, 907 F. Supp. 752, 761 (S.D.N.Y. 1995). Indeed, the courts are justifiably skeptical of fraud claims asserted in these circumstances. In *Turnball v. Kling*, 1999 WL 672561 (S.D.N.Y. August 26, 1999), Judge Shira Scheindlin of the Southern District of New York provides a roadmap of sorts for determining whether a court is likely to deem a fraud claim asserted in this context as being entitled to full consideration or subject to immediate dismissal as nothing more than a plain vanilla contract dispute masquerading as a fraud claim.

### Factual Background

In *Turnball*, the defendant was the president and majority shareholder of Great Scott Inc. ("GSI"), a toy company. In early 1995, defendant offered plaintiff a senior vice president position at GSI. During negotiations, defendant made the following representations ("1995 Representations") to plaintiff:

- GSI and defendant "possessed sufficient capital to profitably operate GSI's business";
- defendant's father, a highly experienced toy industry executive, would be "closely and permanently involved in the day-to-day operations of GSI"; and,

- GSI was then in the process of acquiring two or three toy companies.

Relying on these representations, plaintiff left another toy company and joined GSI pursuant to an oral employment agreement. Shortly thereafter, defendant's father curtailed his involvement in GSI's operation. It also soon became apparent that GSI did not possess sufficient capital to operate its business and had made no progress toward acquiring another toy company.

During the summer of 1996, plaintiff's prior employer attempted to bring its former executive back into the fold with a very attractive offer. When plaintiff advised defendant that he intended to return to his former employer, defendant implored plaintiff not to leave. In doing so, defendant made the following representations ("1996 Representations"):

- GSI was about to "take off";
- GSI soon would obtain additional financing;
- acquisitions of other toy companies were imminent; and,
- plaintiff's earnings would soon be "phenomenal," including significant bonuses and stock options.

Relying upon defendant's representations, plaintiff rejected his former employer's advances and stayed on at GSI. And, once again, GSI did not "take off," additional financing never materialized and no acquisitions were effected.

By early 1997, things turned from bad to worse. In January 1997, GSI stopped reimbursing plaintiff for business expenses. The following month, GSI stopped paying plaintiff's salary. Several months later, plaintiff queried whether he should be looking for another job. In response, defendant urged plaintiff to "hang in there" and represented to plaintiff that "[i]t's all coming together, new financing is imminent" ("1997 Representation"). Relying on defendant's representation, plaintiff stayed on at GSI until he left the company in October 30, 1997. *Id.* at 3.

In August 1998, plaintiff commenced a breach of contract action against GSI and defendant. The parties negotiated a

\$50,000 settlement. During settlement discussions, defendant represented to plaintiff ("1998 Representation") that "financing for GSI was in place and [that] there would be an infusion of funds on January 1, 1999[.]" Defendant proposed that the settlement be paid out in installments over time. Relying upon the 1998 Representation, plaintiff agreed to the payment schedule proposal. The parties filed a stipulation of discontinuance. Thereafter, GSI made not a single installment payment due under the settlement agreement. In fact, in early 1999, GSI filed for bankruptcy protection. *Id.*

### The Claims

Plaintiff subsequently commenced litigation against defendant, asserting three claims for fraud. In Claim I, plaintiff alleged that defendant, through the 1995 Representations, fraudulently induced him to enter into the oral employment agreement. In Claim II, plaintiff alleged that through the 1996 and 1997 Representations, defendant fraudulently induced him to reject the offer of his former employer and remain on at GSI. In Claim III, plaintiff alleged that defendant fraudulently induced him to enter the settlement agreement based on the 1998 Representation. Defendant moved to dismiss the complaint. Among other arguments, defendant took the line of attack typically pursued in such scenarios—i.e., that "plaintiff cannot maintain an action for fraud because plaintiff's Complaint is nothing more than a contract claim against GSI disguised as a fraud claim against defendant." *Id.* at 4.

### The Court's Analysis

Defendant was on firm ground in urging dismissal of the fraud claims. The New York Court of Appeal has noted:

It is a well established principle that a simple breach of contract is not to be considered a tort unless a legal duty independent of the contract itself has been violated. This legal duty must spring from circumstances extraneous to, and not constituting elements of, the contract, although it may be connected with and dependent upon the contract. *Clark-Fitzpatrick Inc. v. Long Island R.R. Co.*, 70 N.Y.2d 382, 389, 516 N.E.2d 190, 193, 521 N.Y.S.2d 653, 656 (1987). Such distinctions drawn in a vacuum are one thing. However, application of this tenet in the real world is an entirely different matter. Difficult questions abound. When is a legal duty "independent" of the underlying contract? When are circumstances sufficiently "extraneous" to the controlling agreement to justify a fraud claim? Where precisely is the line drawn between circumstances that are "connected with and dependent upon" the contract at issue but not "constituting elements" of that agreement? The answer, of course, is that there is no "answer." Instead, the outcome is intensely fact-sensitive. How the courts thread this needle is a concern for plaintiffs counsel attempting to inject a contract dispute with the added punch a fraud claim can provide. It also is of critical importance to defense counsel's efforts to dispose of nasty fraud claims quickly (i.e., via a motion to dismiss) and quietly (i.e., pre-discovery) so as to deflect the notoriety of such allegations

and divest plaintiff of significant potential leverage in resolving what in reality may be nothing more than a straightforward contract dispute.

Judge Scheindlin's approach to separating the wheat from the chaff in this context highlights the difficulties facing both camps. She observed that "[a]n action for fraud 'cannot exist when the fraud claim arises out of the same facts as a breach of contract claim with the sole additional allegation that the defendant never intended to fulfill its express contractual obligations.'" *Turnball*, 1999 WL 672561 at 4. On the other hand, the court noted, "it is also well settled that an 'action for fraud can be maintained on the basis of allegations that a party made a collateral or extraneous misrepresentation that served as an inducement to the contract.'" *Id.* Thus, although a plaintiff must do more than merely dress a contract claim in fraud's clothing, "a valid fraud claim may be premised on misrepresentations that were made before the formation of the contract and that induced the plaintiff to enter the contract." *Id.* Addressing the three purported fraud claims one by one, Judge Scheindlin determined that two passed muster while the third was fundamentally defective and subject to dismissal.

With respect to Claim I, the court reasoned that defendant's representations regarding GSI's available capital, the imminent acquisition of other toy companies and the role his father would play in GSI's management "are collateral and extraneous to the terms and obligations of the employment agreement." *Id.* at 5. Judge Scheindlin observed:

Put another way, Claim I does not allege that when defendant represented he would pay plaintiff \$84,000 per year pursuant to the employment agreement he did not intend to do so.... Accordingly, Claim I does not concern breach of the employment agreement; instead, it concerns defendant's false and collateral representations which induced plaintiff to enter into that agreement in the first place.

*Id.* As for Claim II, Judge Scheindlin concluded that it, too, passed muster. "Again," the court wrote, "defendant's representations that GSI was about to 'take off' and that plaintiffs earnings would soon include bonuses and stock positions are collateral and extraneous to the terms of the employment agreement. They are statements defendant made after plaintiff entered the employment agreement to convince him to remain party to that agreement." *Id.*

Claim III, however, did not fare as well. Judge Scheindlin concluded that this claim, in which plaintiff alleged he was fraudulently induced to enter into the settlement agreement, "is a classic example of a contract claim disguised as fraud." From the Judge's perspective, the 1998 Representation "was simply a promise that GSI would be in a position to pay plaintiff \$50,000" to settle the matter. Plaintiff's purported fraud claim, the court concluded, "is simply a claim that GSI breached the Settlement Agreement." In short, Judge Scheindlin concluded, "Claim III is nothing more than a breach of contract claim against GSI, and therefore it cannot properly form the basis for a fraud claim against the defendant." *Id.*

## Conclusion

*Turnball* illustrates just how finely the distinctions can be drawn between colorable and deficient fraud claims in this area. For sure, Judge Scheindlin's characterization of the 1998 Representation as "simply a promise" as opposed to an actionable misrepresentation is subject to challenge, particularly at such an early juncture in the litigation. Nevertheless, her decision reflects the eagerness of many courts to prevent a contract dispute from morphing into an unwieldy fraud case, even if that effort involves seizing on strained distinctions.

Defense counsel would be advised to seize upon those same distinctions arising out of a poorly drafted complaint as well as the courts' historically low threshold of tolerance for fraud claims in this context. Such distinctions, joined with judicial skepticism toward such fraud claims, can provide a valuable opportunity to quickly narrow the scope of a litigation between former business partners or, in certain circumstances, dispose of that dispute altogether in an efficient and relatively painless manner.