

IS IT A CONTRACT BREACH? IS IT A FRAUD?



The Answer May Depend on Which Court You're in

by Mark S. Olinsky and Matthew L. Lippert

Disappointed commercial counterparties often assert fraud claims alongside their contract-based causes of action, perhaps to exert pressure or perhaps because they genuinely believe themselves to have been defrauded. Whatever the motivations,

understanding whether the fraud and contract claims may be asserted together is of crucial importance in assessing a new case, not least because “[a]ttaching a tort claim to a breach of contract action dramatically alters the rules governing damages.”¹ The answer to that question may depend on whether the claim is heard in state or federal court, even when both

would purport to apply New Jersey law.

New Jersey's federal and state courts do not have a unified approach to the question of whether or how contract claims and fraud claims can coexist.² For years, the federal courts in New Jersey have interpreted New Jersey law as separating fraud claims from contract claims by relying on a distinction between 'intrinsic' and 'extrinsic' fraud. That is, statements within (or intrinsic to) a contract can form the basis for a breach of contract claim, while only statements outside (or extrinsic to) the contract can form the basis for a fraud claim. The same distinction is sometimes described as separating 'fraud in the inducement' from 'fraud in the performance.'³

This rule has intuitive appeal, because it subjects matters inside the contract to contract rules and remedies, and subjects matters outside the contract to non-contract rules and remedies. Thus, in *Bracco*, where the plaintiff claimed the defendant, its contract counterparty, engaged in a "scheme to cheat" it by submitting requests for, or improperly retaining, reimbursements from the plaintiff to which it was not entitled, the court held that the claimed fraud was fraud in the performance, and was, therefore, not actionable.⁴

The federal rule also fits together well with two related concepts—the economic loss rule and the exception to the parol evidence rule for fraud claims. First, the economic loss rule "prohibits plaintiffs from recovering in tort economic losses to which their entitlement only flows from a contract."⁵ The parol evidence rule generally prohibits the use as evidence of oral statements "to alter or vary an integrated written instrument," but still permits using oral statements as proof of fraud, either to render the written instrument "void or voidable," or "to prosecute a separate action predicated upon the fraud."⁶

A rule that treats intrinsic misrepresentations as breaches of contract can

coexist comfortably alongside these doctrines. A different rule, on the other hand, would require courts in commercial disputes to answer multiple, independent questions, such as: 1) does a particular fraud claim duplicate a breach of contract claim, 2) is the claimed fraud barred by the economic loss rule, and 3) can the claimed misrepresentation be supported with evidence of extra-contractual statements? If different principles governed each of those inquiries, courts would have to harmonize the three separate, potentially dissonant answers to those questions.

Despite the conceptual appeal of the federal rule, the state courts as a whole have not embraced it. There are, to be sure, older New Jersey authorities setting out a stark division between fraud claims and contract claims, sometimes doing so in emphatic terms: "[Defendant] has confused the remedy for fraud and deceit with the remedy of action on the contract for breach of warranty. They are mutually exclusive."⁷ More recent New Jersey authority also generally supports the separation of tort and contract claims. "Under New Jersey law, a tort remedy does not arise from a contractual relationship unless the breaching party owes an independent duty imposed by law."⁸ However, as *Saltiel* itself notes, "the boundary line between tort and contract actions is not capable of clear demarcation."⁹ Indeed, because fraud is an intentional tort, it might be said that there is always an independent duty, because "every person is under a duty not to commit intentional torts."¹⁰ Hence, while some state court decisions apply the federal framework, others are hesitant to endorse it.¹¹

Much of the confusion stems from the fact that the New Jersey Supreme Court has addressed the tort/contract boundary in the context of negligence or product liability—but not fraud—and in the context of contracts for the purchase of goods covered by the Uni-

form Commercial Code (UCC). The New Jersey Supreme Court adopted the economic loss rule in *Spring Motors Distributors v. Ford Motor Co.*,¹² when it held that "a commercial buyer seeking damages for economic loss resulting from the purchase of defective goods may recover...for breach of warranty under the UCC, but not in strict liability or negligence."

Spring Motors required the Court to "reconsider the policies underlying the doctrine of strict liability and those underlying the UCC."¹³ Within that context, the Court explained that "tort principles, such as negligence, are better suited for resolving claims involving unanticipated physical injury, particularly those arising out of an accident," while contract principles "are generally more appropriate for determining claims for consequential damage that the parties have, or could have, addressed in their agreement."¹⁴

The New Jersey Supreme Court then elaborated on the economic loss rule in *Alloway v. General Marine Industries, L.P.*,¹⁵ again in the context of a sale of goods covered by the UCC and claims of negligence and breach of warranty. In *Alloway*, the plaintiff purchased what it claimed was a defective boat, which sank, and asserted claims "in negligence and strict liability for economic loss[.]"¹⁶ In addition to discussing *Spring Motors'* observations about the roles of tort and contract principles, *Alloway* canvassed the law of other jurisdictions and agreed with the majority that the UCC represents a statutory allocation of risk between purchasers and sellers that should govern claims for economic losses. However, *Alloway* also noted that "victims of fraud or unconscionable conduct possess substantial rights to recover for common-law fraud or for violations of various state and federal statutes."¹⁷ Against the background of "judicial decisions and statutory enactments, including the UCC," that "pro-

protect consumers from overreaching,” the *Alloway* Court considered “a tort cause of action for economic loss” to be “superfluous and counterproductive.”¹⁸

Alloway’s observations about which cases are “better suited” to resolution by tort or contract principles are difficult to reconcile with its express carve-out for common law fraud, and it is not clear whether a transaction concerning something other than the sale of goods (such as an agreement for services or the sale of real property) would be treated differently in the absence of the UCC’s language preserving fraud claims. There is, consequently, tension between the federal approach and the reasoning of *Alloway*, which assumed the existence of viable fraud claims. The federal approach may also be difficult to apply in practice on occasion.¹⁹ But the federal approach is an internally consistent conceptual scheme that fits together well with other rules that differentiate between tort and contract actions. As it seems to be the only framework that courts have articulated for deciding whether fraud and contract claims can coexist under New Jersey law, it is important for practitioners to understand.

In the context of fraud claims arising from commercial transactions, the state and federal courts of New Jersey, while in theory both applying New Jersey law, find themselves in the same practical situation that prevailed prior to *Erie Railroad Co. v. Tompkins*,²⁰ in which the existence (or non-existence) of federal jurisdiction could change the rule of substantive law that governed a dispute. While different practitioners (and different political constituencies) may have different preferred resolutions to this question, the authors agree with Judge Freda Wolfson’s observation that courts in New Jersey “would greatly benefit from the guidance of the New Jersey Supreme Court in this regard and it is hoped that the New Jersey Supreme

Court will take the opportunity to clarify this area of law when the issue is next presented to the Court.”²¹ ☞

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Endnotes

1. *Saltiel v. GSI Consultants, Inc.*, 170 N.J. 297, 309 (2002) (quoting Michael Dorff, Attaching Tort Claims to Contract Actions: An Economic Analysis of Contract, 28 *Seton Hall L. Rev.* 390, 406 (1997) (alteration in *Saltiel*).
2. *See 7-Eleven, Inc. v. Maia Inv. Co.*, 2015 U.S. Dist. LEXIS 50753, at *12-*13 (D.N.J. April 17, 2015) (acknowledging the uncertainty and collecting cases); *Spectraserv, Inc. v. Middlesex County Utils. Auth.*, 2013 N.J. Super. Unpub. LEXIS 2173, at *45-*47 (Law Div. July 25, 2013).
3. *See, e.g., Bracco Diagnostics, Inc. v. Bergen Brunswick Drug Co.*, 226 F. Supp. 2d 557 (D.N.J. 2002).
4. *Id.* at 559, 564-65.
5. *Id.* at 562 (quoting *Duquesne Light Co. v. Westinghouse Elec. Co.*, 66 F.3d 604, 618 (3d Cir. 1995)).
6. *Ocean Cape Hotel Corp. v. Masefield Corp.*, 63 N.J. Super. 369, 378 (App. Div. 1960).
7. *Deerhurst Estates v. Meadow Homes, Inc.*, 64 N.J. Super. 134, 144 (App. Div. 1960) (citing *Bankers Indemnity Insurance Co. v. Henry Henkel & Sons*, 118 N.J. Eq. 244, 247 (Ch. 1935)).
8. *Saltiel v. GSI Consultants, Inc.*, 170 N.J. 297, 316 (2002).
9. *Id.* at 309-10 (quoting *New Mea Construction Corp. v. Harper*, 203 N.J. Super. 486, 493 (1985)).

10. *Emerson Radio Corp. v. Orion Sales, Inc.*, 2000 U.S. Dist. LEXIS 487, at *23 (D.N.J. Jan. 10, 2000).
11. *Compare PIM Brands LLC v. Cabot Acquisition, LLC*, 2008 N.J. Super. Unpub. LEXIS 3077, at *36 (Law Div. Nov. 21, 2008) (granting summary judgment dismissing certain fraud claims because they “relate[d] to the performance of the Landlord’s Lease obligations” and could not be asserted when the plaintiffs had “not shown that defendants owed an independent duty outside the scope of the Lease agreement”) with *Coastal Group, Inc. v. Dryvit Systems, Inc.*, 274 N.J. Super. 171, 177-78 (App. Div. 1994) (permitting purchaser of composite panel exterior walls to assert fraud and contract claims arising from alleged problems with the purchased goods).
12. 98 N.J. 555, 561 (1985).
13. *Id.* at 575.
14. *Id.* at 579-80.
15. 149 N.J. 620 (1997).
16. *Id.* at 623.
17. *Id.* at 639-640.
18. *Id.* at 641.
19. *See GE Corp. v. BASF Corp.*, 2008 U.S. Dist. LEXIS 69308, at *57 (S.D.N.Y. Sept. 4, 2008) (applying New Jersey law and noting that “the distinction between fraud-in-the-inducement and fraud-in-the-performance blurs at the margins”).
20. 304 U.S. 64 (1938).
21. *Montclair State Univ. v. Oracle USA, Inc.*, 2012 U.S. Dist. LEXIS 119509, at *18 (D.N.J. Aug. 23, 2012).