

Perspective

A publication of the Young Lawyers Section
of the New York State Bar Association

Pleading Fraud and Breach of Contract in the Insurer-Insured Context

By Russell Bloch

New York has traditionally been a favorable venue for insurance companies.¹ If an insurer takes advantage of a claimant by engaging in fraudulent practices, the claimant who intends to hold its carrier accountable faces an uphill legal battle. This is because New York law does not liberally permit plaintiffs to plead both breach of contract and fraud claims that arise from the same series of events.² Courts in New York require plaintiffs to allege a distinct set of facts for each cause of action when the fraud is related to the contract claim, the so called “separate fact requirement.” This legal reality can be particularly hard to swallow for disability claimants who are denied coverage by their carriers. Insurance companies, not always able to distinguish phony from genuine claims, are suspicious of all claims and often resort to predatory denial processes. Claimants tend to feel the denial was in bad faith, feel defrauded, and often seek punitive damages in addition to what they claim under the policy.³ In New York, punitive damages are available only as a remedy in tort, not contract. As the “separate fact requirement” makes it difficult to sue for a tort that is related to a contract claim, it is therefore difficult for plaintiffs to seek punitive damages—which are only available when alleg-

ing a tort—when they are defrauded by an insurance company.⁴

This legal struggle has never been more relevant than it is today, with reports of insurance company mistreatment—as well as consumer fraud—higher than ever. This article discusses the troubled insurer-insured relationship, focusing on the legal hurdles facing a claimant who sues an insurance carrier for a tort in addition to a breach of contract.

I. A Troubled Relationship

Reports of insurance carrier underpayment, claim denial and delay have been increasing for several years.⁵ Insurance companies in this economy flex their institutional muscles to fight claims while weakening an insured’s claim, and it is often in their economic interest to do so.⁶ Some reported tactics include obtrusive and misleading

video surveillance,⁷ over-reliance on independent medical examiners and consultants,⁸ and employing out-of-date U.S. Department of Labor listings to find a claimant’s job activity at sedentary level, thereby declaring he is not disabled and can go back to his job.⁹ Insurers also tend to exploit their structural advantage in the claims process. Insurers are required to respond to claims within a certain time period, and if they fail to do so, their self-imposed penalties require payout of the policy. It is not unheard of for insurers who miss such a deadline to back-date a denial letter to a claimant so that it falls within the response window. As is discussed below, this may or may not be fraud in New York.

Deceitful practices are, of course, not limited to insurance companies. Fraud on behalf of claimants has

(Continued on page 10)

Inside

| | | | |
|--|---|--|----|
| A Message from the Section Chair | 2 | Scenes from the Young Lawyers Section Trial Academy | 14 |
| India Recognizes Limited Liability Partnerships— <i>Any Attraction for U.S. Investors?</i> <i>(Vikas Varma)</i> | 3 | NYSBA Annual Meeting Young Lawyers Section Bridging the Gap Program: New Cases and Legislation for the Next Generation | 16 |
| Scenes from the Young Lawyers Section Fall Meeting | 8 | | |



Pleading Fraud and Breach of Contract in the Insurer-Insured Context

(Continued from page 1)

spiked in the past year. Fraud fighting bureaus have seen a significant increase in all fifteen types of fraud schemes, including home arson cases, drivers ditching unwanted vehicles, and questionable slip and fall cases.¹⁰ Some studies suggest that more than one-third of people hurt in auto accidents exaggerate their injuries, adding approximately \$13 billion to America's annual insurance bill.¹¹ Other studies find nearly one-third of doctors exaggerate the severity of a patient's illness.¹² While this article focuses on fraud on the insurer side and the legal hurdles facing a plaintiff with a genuine claim, it is important to note the bad faith which travels on this two-way street.

II. Pleading Fraud and Breach of Contract in New York

A claimant who sues her insurer for fraud and breach of an insurance contract has three major hurdles to cross when fighting a Motion to Dismiss. The first is Rule 9(b) of the Federal Rules of Civil Procedure (FRCP), which sets a heightened pleading standard when alleging fraud: "In alleging fraud or mistake, a party must state with particularity the circumstances constituting fraud or mistake."¹³ Particularized allegations have an origin in public policy and are meant to prevent litigants from dragging defendants' names through mud based on broad, unfounded allegations.

Second, a plaintiff must plead the common law fraud elements by clear and convincing evidence. The required elements are: (i) a misrepresentation or omission of material fact; (ii) that the defendant knew to be false; (iii) that the defendant made with the intention of inducing reliance; (iv) upon which the plaintiff reasonably relied; and (v) that caused injury to the plaintiff.¹⁴

The third hurdle facing these plaintiffs is the requirement that the fraud and breach of contract together

must allege separate facts for each cause of action. Case law demonstrates that "[a] claim for fraud will be found duplicative and dismissed where the fraud cannot sufficiently be distinguished from the breach of contract claim."¹⁵ Though New York struggled to clarify this confusing requirement, it is now clear that a plaintiff may satisfy this requirement in one of three ways: (a) by establishing a legal duty separate from the duty to perform under the contract, (b) by showing a fraudulent misrepresentation collateral or extraneous to the contract, or (c) by showing special damages that have been caused by the misrepresentation and are unrecoverable as contract damages.¹⁶ As discussed below, it is difficult for insurance claimants who want to plead both breach of contract and fraud to comply with any of these prerequisites.

(a) Establishing a Separate Legal Duty

This "separate fact" requirement has proven to be an extremely difficult threshold for these claimants to cross. First, unlike other states, an insurer in New York does not owe its client any special duty.¹⁷ Courts will only find a special duty, and therefore the foundation for an independent tort, if (1) the parties stand in a confidential or fiduciary relationship with each other,¹⁸ or (2) one party possesses superior knowledge, not available to the other, and knows the other is acting on the basis of mistaken knowledge.¹⁹ Even though courts acknowledge the disparate bargaining positions inherent in an insurance contract,²⁰ an insurer in New York owes no more of a duty to an insured than an ordinary business party would to a commercial contract.²¹

(b) Collateral or Extraneous Exception

In New York, a mere allegation by the Plaintiff that the defendant

entered into the contract without the intent to perform it is insufficient to support a fraud claim.²² However, a false promise can support a claim for fraud where that promise was "collateral or extraneous" to the terms of the contract. These so-called "fraud in the inducement" cases surface where one party induces the other to enter a contract by misrepresenting present facts, like its financial policy,²³ as opposed to future promises to perform. Courts permit these fraud claims because the inducement is considered "collateral" to the contract it precedes.

Fraud in the inducement is widely considered *the* exception to the bar of asserting fraud and breach of contract together. This would not, though, include the back-dating example presented in section I, where a carrier, having missed its window to respond to a claimant, back-dates a letter so that it falls within that response period. It is unlikely a claimant could convince a court that it was induced to enter a contract because it thought the insurer would respond within, say, 30 days to its claim. Moreover, a carrier's promise at the time of contracting to respond within 30 days, even if insincere, relates to the performance of some future act, as opposed to present fact, and would fail the inducement exception. Since New York does not recognize a cause of action based upon a defendant's failure to reveal a breach, the question becomes whether the failure to reveal a breach can be distinguished from an affirmative effort to conceal a breach to the other party.

It would likely offend the public interest to exclude carriers who engage in practices such as back-dating from tort exposure. In fact, there is scattered support in the case law permitting a fraud claim where one party affirmatively misrepresents or conceals something material during performance of the contract. In *Freedman v. Pearlman*, the parties entered into a

working relationship and made several oral promises regarding profit sharing.²⁴ Under these contracts, Freedman was supposed to receive a percentage of defendant Pearlman's existing stock options. Throughout performance of the contract, Pearlman claimed that he did not receive any stock options in a joint venture, but this was untrue. Freedman, upon discovering the truth, sued Pearlman for various causes of action, including fraud and breach of contract. The Court sustained the fraud claims, finding them not duplicative of the breach of contract claim. With respect to the fraud claim, the court found it almost dispositive that the defendant "deliberately concealed the amount of income received from Bally's so that the one-third share Freedman was allegedly entitled to by contract was undercounted."²⁵ Similarly, in *Eagle Comtronics v. Pico Products*, the defendant allegedly "misrepresented or concealed existing facts" regarding patent licenses, and the court found the plaintiff's fraud claim "discrete" from the contract claim.²⁶

In *Jordan Investment Co. v. Hunter Green*, the defendants, various investment firms, agreed to invest the plaintiff's money into non-leveraged assets.²⁷ Since the plaintiff was a charitable trust, it was important that its funds were invested in non-leveraged assets in order to preserve its tax-exempt status. Although the defendants assured them that this would be the case and that they would notify the plaintiff before making any investment decisions, the defendants invested the trust's money on a leveraged basis and intentionally concealed this fact from the plaintiff. In denying the defendants' motion to dismiss, the Court emphasized how the defendants went out of their way to conceal from the plaintiff that its funds were being invested in leveraged assets. The Court declared that "misrepresentations made after a contract is entered into which relate to a present fact that would exist if the contract were performed, are collateral or extraneous to the contract...and are action-

able in fraud."²⁸ *Jordan* is significant in that the District Court extended the "collateral or extraneous" exception, which previously had only been applied to fraudulent inducement cases, to post-formation misrepresentations. These decisions suggest that affirmative misrepresentation that relate to post-formation contract performance might be actionable as an independent tort in New York.

(c) Alleging Extra-Contractual Damages

If a plaintiff establishes a separate legal duty or shows a collateral or extraneous misrepresentation, he must still show—or at the pleading stage, allege—damages that are not recoverable under the contract. The genesis of this requirement concerns the history between tort and contract remedies. Based on the classical English case *Hadley vs. Baxendale*, a party who breaches his promise owes only those damages that "...may reasonably be supposed to have been in the contemplation of both parties, at the time they made the contract, as the probable result of the breach of it."²⁹ Damages recoverable for a breach of contract are meant to put the nonbreaching party in the same place it would be had the contract been performed. Tort damages, on the other hand, exist to both compensate victims for injuries (compensatory damages) and vindicate some public value like deterring similar acts (punitive damages). Indeed, the tort duty of care is meant to "protect society's interest in freedom from harm."³⁰

In a disability insurance context, a plaintiff's extra-contractual damages are most likely to be a combination of damages from pain, suffering, and emotional distress as well as punitive damages. Where an insurer acts fraudulently, punitive damages are meant to punish such behavior. The public has an interest in ensuring that carriers do not engage in that type of behavior, and studies show that punitive damage awards help deter that type of conduct.³¹

These important justifications notwithstanding, it is difficult to recover punitive damages in New York. A plaintiff seeking punitive damages must show that the defendant engaged in "gross conduct that involves high moral culpability or demonstrates wanton dishonesty."³² If the fraud claim arises from a related contract claim, such as the "back-dating" example, courts in New York require the plaintiff to show that defendant's conduct was "aimed at the public generally." This additional "public harm rule" is an exceedingly high burden that requires alleging "ultimate facts" that show a "fraudulent and deceitful scheme" in dealing with the general public, therefore making it very difficult for such a plaintiff to recover punitive damages.³³

This "public harm rule" could very well relieve an insurer of exposure to punitive damages, as a claimant would have great difficulty in proving the carrier committed the act towards the public generally. This result is unjust, though, because it is unlikely a carrier back-dated a letter out of any personal animus towards a particular claimant. A carrier has one true north, and it applies equally to all of their cases: to limit policy payouts. This true north, therefore, can be said to apply to the public generally. Yet fraudulent acts to limit a policy payout would probably fail the public harm rule, absent some evidence the insurer committed back-dating previously. Where a plaintiff demonstrates evidence of intentional back-dating, courts should treat such behavior as dispositive fraudulent conduct.

III. Conclusion

The legal obstacles facing a plaintiff who feels defrauded by an insurance company are daunting, but they are not insurmountable. If an insurer goes out of its way to conceal a breach committed under a contract, some courts will hold it accountable by permitting a plaintiff to plead a tort in addition to breach of contract. This is a fair option.

Holding responsible an insurer who commits fraud along with breaching a contract serves the public interest, punishes wrongdoing and deters future fraudulent acts. A plaintiff is usually also required to allege punitive damages when asserting a tort and breach of contract, a fair if strict requirement, as punitive damage is considered a drastic remedy. Courts, however, should take a second look at applying the “public harm rule” to cases, like the back-dating example, where its application tends to hurt an important group: the consuming public.

Endnotes

1. See, e.g., Jeffrey Stempel, *Stempel on N.Y. Embraces Consequential Damages in Bad Faith Claims*, 2008 EMERGING ISSUES 191, at *1 (Mar. 27, 2008) (“finding that New York law is frequently the choice of insurers in drafting dispute resolution and choice-of-law clauses in policies”).
2. See *Sofi Classic v. Hurowitz et al.*, 444 F. Supp. 2d 231 (S.D.N.Y. 2006) (finding that “[w]hen a plaintiff alleges both a breach of contract and a fraud claim arising from the same series of events, New York courts have been cautious in sustaining an independent fraud claim.”).
3. If a plaintiff survives the pleading and summary judgment phase of a trial, he has to convince a court that the insurer acted arbitrarily or capriciously in denying a claim for disability benefits. This requires proof that the administrative record did not contain substantial evidence to support the denial. Moreover, if it is a claim for benefits under ERISA, an insured has an even more difficult task as courts have a strong policy in favoring exhaustion of administrative remedies in ERISA cases. *Paese v. Hartford Life & Accident Ins. Co.*, 449 F.3d 435, 443 (2d Cir. 2006).
4. A claimant who is taken advantage of by an insurer may also have relief under breach of the implied covenant of good faith and fair dealings (as a contractual remedy), or N.Y. Gen. Bus. Law § 349, which prohibits “deceptive acts or practices in the conduct of any business, trade or commerce....” These causes of action will be the subject of a different article.
5. See *New York Court of Appeals Holds that Insurers May Be Liable for Consequential Damages*, 122 HARV. L. REV. 998 (2009).
6. See *supra* note 5, citing Keith J. Crocker & Sharon Tennyson, *Insurance Fraud and Optimal Claims Settlement Strategies*, 45 J.L. & ECON. 469, 504 (2002) (finding that underpayment is an optimal strategy for insurance companies under certain circumstances).
7. See *Montour v. Hartford Life & Accident Ins. Co.*, 2009 WL 2914516 (9th Cir. 2009).
8. See *Culley v. Liberty Life Assur. Co.*, 339 Fed. App’x. 240 (3d Cir. 2009).
9. *Id.*
10. <http://www.insurancejournal.com/news/national/2010/01/11/106510.htm>.
11. Rand Institute for Civil Justice, *The U.S. Experience with No-Fault Automobile Insurance: A Retrospective*, James Anderson, Paul Heaton and Stephen Carroll, available at http://www.rand.org/pubs/research_briefs/RB9505/index1.html.
12. Coalition Against Insurance Fraud, citing *Journal of the Medical Association*.
13. FED. R.Civ. P. 9(b); see also CPLR 3016(b): “[C]auses of action based on fraud or misrepresentation must state in detail the circumstances constituting the wrong.” *Id.*
14. *Crigger v. Frahnestock & Co., Inc.*, 443 F.3d 230, 234 (2d Cir. 2006).
15. *Papa’s-June Music v. McLean*, 921 F. Supp. 1154, 1162 (S.D.N.Y. 1996).
16. See *id.*
17. See *Foley v. Interactive Data Cooperation*, 47 Ca. 3d 654 (CA. 1988) (“...[t]he propriety of a tort action for breach of the implied covenant in the insurance context was based on the ‘special relationship’ of insurer and insured...”).
18. See *Graubard Mollen Dannett & Horowitz v. Moskovitz*, 86 N.Y.2d 112 (permitting plaintiffs to sue under fraud and breach of contract theories because the defendant partner owed a fiduciary duty not to solicit clients from his former law firm, where he made earlier assurances to encourage those clients to remain with the firm).
19. See *International Electronics v. Media Syndication Global*, 2002 U.S. Dist. LEXIS 15200 (S.D.N.Y. 2002) (finding that defendants owed plaintiffs a duty to disclose the market conditions for plaintiff’s product).
20. See *Batas v. Prudential Ins. Co. of America*, 281 A.D.2d 260 (1st Dep’t 2001).
21. *Id.* (“holding that no special relationship of trust or confidence arises out of an insurance contract between the insured and the insurer; the relationship is legal rather than equitable.”)
22. *New York University vs. Continental Ins. Co.*, 87 N.Y.2d 308 (1995).
23. *Rojo v. Deutsche Bank*, 2008 U.S. Dist. LEXIS 94007 (S.D.N.Y. 2008) (finding fraud in the inducement where Deutsche’s misrepresentations concerned the structure of the deal that caused Rojo to accept Deutsche’s offer).
24. *Freedman v. Pearlman*, 271 A.D.2d 301 (1st Dep’t 2000).
25. *Id.* (emphasis added).
26. *Eagle Comtronics v. Pico Prods.*, 270 A.D.2d 832 (4th Dep’t, 2000).
27. *Jordan Investment Co.*, No. 00 Civ. 9214 (RWS) (S.D.N.Y. 2003).
28. *Id.* The Court noted that there was no contractual agreement between this specific co-defendant and the plaintiff, and therefore the defendant could not claim duplicative claims, but this dicta was secondary to the Court’s ruling that fraud was an actionable tort in this case.
29. *Hadley v. Baxendale*, 156 Eng. Rep. 145 (1854).
30. *Spring Motors Distributors, Inc. v. Ford Motor Co.*, 489 A.2d 660, 672 (N.J. 1985).
31. See Catherine Paskoff Chang, *Two Wrongs Can Make Two Rights: Why Courts Should Allow Tortious Recovery for Intentional Concealment of Contract Breach*, 39 COLUM. J.L. & SOC. PROBS. 47 (2005).
32. *Rocanova v. Equitable Life Assurance Society of the U.S., et al.*, 83 N.Y.2d 603 (1994).
33. New York courts are not consistent in their application of the public harm rule to “fraud in the inducement cases.” See *Sofi Classic et al. v. Hurowitz*, 444 F. Supp. 2d 231 (S.D.N.Y. 2006) (“the Court concludes that the public harm requirement applies to Plaintiffs’ fraudulent inducement claim.”). But see *Axa Versicherung v. New Hampshire Inc. Co. et al.*, 2008 U.S. Dist. LEXIS 33950 (S.D.N.Y. 2008) (declining to apply the public harm standard to plaintiff’s claim that defendants induced them to enter a contract through misrepresentations.).