Can Fraud Exist Without Actual Damages? First Department Says No

Grant R. Cornehls, New York Law Journal

March 14, 2016

A recent First Department decision involving Chipotle Mexican Grill— *Connaughton v. Chipotle Mexican Grill*—highlights the importance of alleging actual damages as a necessary element of a claim for fraud.[1] The First Department's decision rejects contrary authority from the Second Department, which has held that nominal damages are sufficient to sustain a cause of action for fraud. There is now a split of authority among the Appellate Division departments, which presents an important question of New York law for the Court of Appeals to resolve.

Connaughton Case

The plaintiff, Kyle Connaughton, alleged that in 2010 he was fraudulently induced to sell his fast-food ramen concept to Chipotle and its founder, Stephen Ells. He claimed that, prior to signing an employment agreement to develop the concept with Chipotle, Chipotle and Ells failed to disclose their earlier plan to develop a ramen restaurant with David Chang, the celebrity chef behind Momofuku Noodle Bar and other well-known restaurants. They also allegedly failed to disclose that they had entered into a nondisclosure agreement with Chang in 2008, which covered design work Chang had done on the ramen concept. According to the complaint, Connaughton learned

these facts from other Chipotle executives in October 2012, who allegedly told him that Momofuku would sue Chipotle and Ells once the ramen restaurant opened.[2]

Connaughton argued that the nondisclosure agreement and the negotiations with Chang were material facts that Chipotle and Ells had a duty to disclose. Although the deal with Chang fell through, Connaughton, who later was terminated, claimed defendants' prior negotiations with Chang harmed his ability to implement the ramen concept because he feared Chang would file a lawsuit accusing them of violating the nondisclosure agreement and stealing Momofuku's ramen concept. Connaughton's complaint failed, however, to allege that "he sustained calculable damages based on defendants' actions."[3]

The First Department affirmed the dismissal of Connaughton's complaint, holding that fraud requires allegations of actual damage as a result of a plaintiff's reliance on a defendant's misrepresentations. Because damages for fraud are measured by a plaintiff's actual pecuniary loss as a direct result of the wrong, the First Department held that damages must be for losses already sustained, rather than for losses that may be suffered in the future.[4]

The court rejected Justice David Saxe's dissenting view that a plaintiff can go forward on a fraud claim as long as the possibility of future injury may reasonably be inferred from the allegations of the complaint.[5] Quoting the Court of Appeals' decision in *Lama Holding Co. v. Smith Barney*, the First Department emphasized that the "true measure of damage [for fraud] is indemnity for the actual pecuniary loss sustained as the direct result of the wrong."[6] Connaughton failed to meet this pleading standard because allegations that he would be sued by Chang and Momofuku if he went forward with the ramen concept were speculative at best.

The court observed that Connaughton "has not been accused of stealing Chang and Momofuku's ramen concept" and that "his professional reputation has not been tarnished."[7] Thus, the allegations in his complaint "at best suggest that, depending on the future actions of Chang and Momofuku, plaintiff might suffer injury. Not only is there no suggestion or indication that actual pecuniary damages were sustained, but the complaint does not allege facts from which actual damages can be inferred."[8]

The First Department also rejected the dissent's argument that a plaintiff should be allowed to pursue nominal damages for fraud.[9] In doing so, the court specifically declined to follow contrary authority from the Second Department and older New York cases,[10] which have held that "[n]otwithstanding the failure to establish damages," a plaintiff "is still entitled to nominal damages to vindicate its rights deriving from the fraud."[11]

Other Cases

The 19th century cases from which this rule developed, starting with *Allaire v. Whitney*, do not provide any rationale for allowing nominal damages for fraud beyond the sentiment "that in all matters of pecuniary dealings, in all matters of contract, a man has a legal right to demand that his neighbor shall be honest; and the consequence follows: viz. if he be drawn into a contract by fraud, this is an injury actionable per se." *Allaire* held that "actual damage is not necessary to an action [for fraud.] A violation of right with a possibility of damage, forms the ground of an action."[12]

The Court of Appeals' decision in *Pryor v. Foster* simply cites to an earlier Court of Appeals decision, *Northrop v. Hill*, for the proposition.[13] *Northrop*, in turn, describes what would today be recognized as a cause of action for breach of the implied covenant of good faith and fair dealing when it states that "[t]he acts of entering into contract relations, implies that the parties are to deal in good faith with each other." If one of them commits a fraud, "he breaks the implied promise he is under and should be made to respond in damages" and "he should, at least, recover nominal damages for the breach of the implied promise to act in good faith."[14]

The First Department held that these older decisions are inconsistent with "the current rule" expressed in the Court of Appeals' 1993 decision in *Kronos v. AVX Corp.*,[15] which refused to import the concept of nominal damages from contract law into the context of a claim for tortiously inducing a breach of contract. Whether the decision in *Kronos* effectively overruled these earlier cases, as the First Department believes, or still permits a plaintiff to pursue nominal damages for fraud is an issue that ultimately will have to be resolved by the Court of Appeals.

Kronos was a statute of limitations case and addressed whether the plaintiff's cause of action against the defendant for tortiously inducing the breach of one of its contracts was time-barred.[16] Because "damage is an essential element of the tort," the resolution of this issue turned on when the plaintiff first suffered damage. The plaintiff argued that its cause of action did not accrue until it suffered actual damages in 1988, whereas the defendant maintained that "the damage element must be construed as arising in 1984 because the law always infers at least nominal damages for a contractual breach."[17]

The Court of Appeals rejected the defendant's position and held that "no cause of action for tortious inducement to breach a contract arises until actual damages are sustained; nominal damages associated with the underlying breach of contract will not stand in the stead of actual damages."[18]

In reaching its holding, the Court of Appeals spoke more broadly and cautioned against ignoring "fundamental differences between tort and contract principles." While nominal damages are "always available" for a breach of contract, "they are allowed in tort only when needed to protect an 'important technical right.'" As an example, the court identified "a continuing trespass [onto real property, which] may ripen into a prescriptive right and deprive a property owner of title to his or her land." Where "[t]here is no similarly compelling reason for departing from the actual injury rule," however, "actual loss must be demonstrated."[19]

It is difficult to see what "important technical right" would be served by allowing a plaintiff to recover nominal damages for fraud where there has been no actual injury. There is no compelling reason why courts should be burdened with actions for fraud filed by plaintiffs who have suffered no actual injury. The First Department has the better view on this issue, but the Court of Appeals should clarify this unsettled question of law by affirming that actual damages are required to establish liability for fraud.

Endnotes:

1. *Connaughton v. Chipotle Mexican Grill*, 135 A.D.3d 535, 23 N.Y.S.3d 216 (1st Dept. 2016).

2. See id. at 217.

3. See id. at 217-18.

4. See id. at 218-19, citing *Lama Holding Co. Smith Barney*, 88 N.Y.2d 413, 421, 646 N.Y.S.2d 76, 80 (1996).

5. See 23 N.Y.S.3d at 224 (Saxe, J., dissenting) ("damages need not be demonstrated at the pleading stage as long as the possibility of damages may be reasonably inferred….Here, it is implicit from the allegations contained in the pleaded complaint…that the position in which plaintiff was placed due to defendant's conduct *may cause him*, or may have already caused him, compensable damages") (emphasis added.

6. See 23 N.Y.S.3d at 219, quoting *Lama*, 88 N.Y.2d at 421, 646 N.Y.S.2d at 80.

7. See 23 N.Y.S.3d at 218.

8. See id. at 219 (citations omitted).

9. See id. at 225 (Saxe, J., dissenting).

10. See *Clearview Concrete Prods. Corp. v. S. Charles Gherardi*, 88 A.D.2d 461, 453 N.Y.S.2d 750 (2d Dept. 1982); *Pryor v. Foster*, 130 N.Y. 171, 178 (1891); *Northrop v. Hill*, 57 N.Y. 351, 354 (1874).

11. *Clearview*, 88 A.D.2d at 470, 453 N.Y.S.2d 756; see also *Pryor*, 130 N.Y. at 178 ("when a party to a contract perpetrates a fraud he commits a wrong for which he is liable to the defrauded party in at least nominal damages, even though no actual damages be shown").

12. 1 Hill 484, 487 (N.Y. 1841).

13. 130 N.Y. 171, 178 (1891), citing *Northrop v. Hill*, 57 N.Y. 351, 354 (1874).

14. *Northrop*, 57 N.Y. at 354.

15. 81 N.Y.2d 90, 595 N.Y.S.2d 931 (1993).

16. Id. at 92, 595 N.Y.S.2d at 932.

17. Id. at 94- 95, 595 N.Y.S.2d at 934.

18. 81 N.Y.2d at 97, 595 N.Y.S.2d at 936.

19. Id. at 95, 595 N.Y.S.2d at 934.