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Clarifying Punitive Damage Confusion

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State and federal cases applying New York law to resolve the circumstances under which punitive damages are awardable in contract and tort actions do not always present a perfect picture of clarity. A recent decision by Eastern District Court Judge Arthur D. Spatt, however, should help to provide considerable clarity to these issues.

The main culprit for much of the confusion is the issue of whether the egregious conduct in question must be aimed at the public generally to justify an award of punitive damages. While it is now widely accepted that punitive damages are recoverable in tort actions without proving the conduct at issue was aimed at the public generally, courts continue to confuse independent tortious conduct with legal duties arising strictly from a contractual relationship, where the additional requirement of harm to the public is imposed. A brief review of the relevant New York jurisprudence will place the issues in proper perspective.

In *Walker v. Sheldon*, 10 N.Y.2d 401, 223 N.Y.S.2d 488 (1961), the Court of Appeals was presented with a question of first impression - "whether punitive damages may be allowed in a fraud and deceit action." After surveying the case law and commentaries, the Court concluded that while punitive damages "have been refused in the 'ordinary'

fraud and deceit case," such damages may be recovered "in fraud and deceit actions where the fraud, aimed at the public generally, is gross and involves high moral culpability."

The Court went on to note that it "may be difficult to formulate an all-inclusive rule or principle as to what is an appropriate case for the recovery of punitive damages, but it is our conclusion that the allegations of the complaint before us, if proved, would justify such an award."

The pleading in question alleged that "defrauding the general public into entering into publishing contracts, such as the one involved in the present case, was the very basis of the defendants' business."

After *Walker*, the New York courts relaxed and then eventually eliminated the requirement that the offensive conduct be aimed at the general public to permit punitive damages to be awarded in fraud cases, leading the Court of Appeals in *Borkowski v. Borkowski*, 39 N.Y.2d 982, 983, 387 N.Y.S.2d 233 (1976), to observe: "It is not essential, as the Appellate Division stated, that punitive damages may be allowed in a fraud case only where the acts had been aimed at the public generally."

Although that should have resolved the issue, the confusion arises when the fraudulent or other tortious conduct relates in some way to an existing

contract between the parties.

In two leading cases, the Court of Appeals addressed and decided the circumstances under which punitive damages could be recovered in contract actions. See *Rocanova v. Equitable Life Assurance Society of the United States*, 83 N.Y.2d 603, 612 N.Y.S.2d 339 (1994), and *New York University v. Continental Insurance Company*, 87 N.Y.2d 308, 639 N.Y.S.2d 283 (1995).

In *New York University*, the Court explained that "the pleading elements required to state a claim for punitive damages as an additional and exemplary remedy when the claim arises from a breach of contract" are "(1) defendant's conduct must be actionable as an independent tort; (2) the tortious conduct must be of the egregious nature set forth in *Walker v. Sheldon* . . . (3) the egregious conduct must be directed to plaintiff; and (4) it must be part of a pattern directed at the public generally."

The Court further explained that "[w]here a lawsuit has its genesis in the contractual relationship between the parties, the threshold task for a court considering defendant's motion to dismiss a cause of action for punitive damages is to identify a tort independent of the contract."

Courts have understandably struggled to determine whether an action "has its genesis in the contractual relationship between the parties" or alleges independent causes of action for recognized tortious conduct apart from any contractual relationship.

'Wrap-N-Pack'

This is the context in which Judge Spatt decided the issues in *Wrap-N-Pack Inc. v. Kaye*, 2007 WL 4465474, (E.D.N.Y., Dec. 14, 2007).

In *Wrap-N-Pack*, plaintiff was a distributor of cartons and packaging and pursuant to an acquisition contract, purchased the assets of a company owned by the individual defendant. The contract contained a non-compete clause in which the defendant agreed not to compete with plaintiff for a term of years in a certain location. The defendant also entered into an employment agreement with the plaintiff for a term of years, which required "cause" for termination. The employment agreement also contained a non-compete clause.

Plaintiff alleged that the defendant wrongfully competed against plaintiff and otherwise breached his fiduciary duties during the term of the employment relationship. While plaintiff alleged claims of breach of contract, it also alleged various tort claims (as described further below) as well.

After discovery, plaintiff sought to amend its complaint to add a request for punitive damages "in connection with the second ('breach of fiduciary duty of good faith and loyalty'), third ('diversion of corporate opportunities'), fourth ('misappropriation of confidential information and trade secrets'), fifth ('unfair competition'), and seventh ('tortious interference with prospective economic advantage') causes of action."

The defendant argued that plaintiff should not be permitted to amend his complaint to add any claims for punitive damages because New York law did not allow such damages where the case essentially involved a breach of contract and there was no proof that the wrong was directed at the public generally.

After reviewing the Court of Appeals decisions in *Rocanova* and *New York University*, Judge Spatt distinguished those cases because the defendants there had no duty to the plaintiff in the absence of a contract "and, thus, the contract in each of those cases was essential to the plaintiffs' claims."

The court continued: "Here, it is less clear whether the plaintiff's causes of action for breach of the fiduciary duty of good faith and loyalty; diversion of corporate opportunity; misappropriation of confidential information and trade secrets; unfair competition; and tortious interference with prospective economic advantage depend on the Employment Agreement between the parties."

Surveying various cases describing a host of recognized tort theories that can be alleged against a "disloyal employee" such as the defendant, the court found that the claims asserted in the complaint could be made "regardless of the existence of an employment contract."

The court relied upon a recent decision of Eastern District Judge Leonard D. Wexler in *Paz Systems, Inc. v. Dakota Group Corp.*, No. 05CV4763, 2007 WL 2750973, in which the court found an employee liable for misappropriation of trade secrets, unfair competition and breach of fiduciary duty under New York law in the absence of any employment contract: "Under New York law, an employee has a common law duty of good faith and fair dealing to the employer not to exploit confidential information for the benefit of himself and others."

Judge Wexler awarded punitive damages on the plaintiff's misappropriation and unfair competition claims because the defendant's conduct was "particularly egregious, in the apparently calculated nature of the misappropriation . . ."

Judge Spatt, therefore, rejected defendant's argument in *Wrap-N-Pack* and granted plaintiff's motion to amend, finding "that the plaintiff's tort claims are independent of the parties' contract and it is not essential that the plaintiff allege a pattern of conduct directed at the public in general to assert a claim for punitive damages here."

Further buttressing its decision, the court cited specific cases determining that "punitive damages may be awarded for each of the activities alleged in the amended complaint" - unfair competition, misappropriation of trade secrets, breach of fiduciary duty, tortious interference with prospective business

relations and diversion of corporate opportunities.

It appears there are other recent decisions still confusing the standards to be applied to claims for punitive damages in tort and contract actions.

For example, in *Conocophillips v. 261 East Merrick Road Corp.*, 428 F.Supp.2d 111 (E.D.N.Y. 2006), the court stated in rather unfortunate broad terms that the public harm requirement is still required in all tort cases. The court, therefore, granted summary judgment to the defendant dismissing claims for punitive damages in connection with causes of action for tortious interference with contract and conversion - two independent torts.

While the court could have based its conclusion upon the fact that these two claims were closely intertwined with the contract claims upon which the case was based, the court appears to have incorrectly relied principally upon the Court of Appeals opinion in *Walker v. Sheldon* to conclude that the public harm requirement is applicable to all tort actions.

As noted above, however, the Court of Appeals in *Borkowski* clarified that the "general public" requirement noted in *Walker* was no longer applicable to fraud actions as stated in *Walker*. Moreover, as observed by Judge Spatt in *Wrap-N-Pack*, numerous other cases have allowed punitive damages in the whole gamut of tort actions without proof of conduct aimed at the public.

Conclusion

Notwithstanding the occasional continued confusion, it appears that under New York law, it is not required to establish that the egregious conduct in question was directed at the public generally to obtain punitive damages in tort actions. Where, however, the alleged tortious conduct is based upon a contractual relationship between the parties, arguments will continue to be made that the defendant's conduct must be aimed at the general public to justify an award of punitive damages.