Punitive Damages and Intentional Interference with a Contractual Relationship

By Andrew M. Bossory

At first blush, a contract is a simple thing—an offer and acceptance. But as those two terms are broken down, the highly nuanced nature of contract law becomes apparent. From the mystic parol-evidence rule to substantial performance, the intricacies are complex and factually demanding. However, issues of damages for breach of contract have always conceptually been relatively straightforward: economic relief to place the aggrieved party in as good a position as it would have been upon performance. Tortious concepts of fraud, malice, and ill will had no impact on the amount of remuneration for which a breaching defendant was responsible. These distinct ideologies are not as separate as they once were. For instance, jurisdictions have consistently recognized that a third party may wrongfully interfere with a contractual relationship. This wrongful conduct is not classified as a breach of contract—allotting only compensatory damages—but as an actionable tort in and of itself. This has given rise to a new class of damages.

Through years of statutory and case law, a bridge has developed between the historical remedy for a breach of contract and the independent tort of intentional interference with a contractual relationship. Whereas a contract has been viewed as a mere expectation of performance, the tort remedy incorporates an understanding that this expectation should be free from interference by third parties. The dichotomy between contract and tort damages illustrates this distinction. The type of action (contract or tort) that is brought may have a profound impact on the possible damages originating from the same contract.

The Historical Remedy and the Efficient Breach

At its core, the remedy for a breach of contract is intended to compensate a nonbreaching party for its economic losses. Under this stoic ideology, the breaching party's motive and intent is immaterial. Instead, inquiry is focused solely on the actual damage incurred. Any intrinsic desire to "do good" or punish wrongdoers must, to the largest extent possible, be set aside. As noted by Oliver Wendell Holmes in "The Path of the Law," 10 *Harv. L. Rev.* 457, 462 (1897):

> Nowhere is the confusion between legal and moral ideas more manifest than in the law of contract. Among other things, here again the so called primary rights and duties are invested with a mystic significance beyond what can be assigned and explained. The duty to keep a contract at common law means a prediction that you must pay damages if you do not keep it—and nothing else. If you commit a tort, you are liable to pay a compensatory sum. If you commit a contract you are liable to pay a compensatory sum unless the promised event comes to pass, and that is all the difference.

In other words, damages for breach of contract are designed to make the injured party whole. *See, e.g.*, *Kattar v. Demoulas*, 433 Mass. 1, 15, 739 N.E.2d 246 (2000) ("A fundamental principle on the rule of damages is based on compensation. Compensation is that amount of money that reasonably will make the injured party whole. Compensatory damages may not exceed this amount. Anything beyond that amount is a windfall."); *Larsen v. First Bank*, 245 Neb. 950, 966, 515 N.W.2d 804 (1994) ("[I]n a breach of contract case, the ultimate objective of a damages award is to put the injured party in the same position the injured party would have occupied if the contract had been performed, that is, to make the injured party whole."). The intent is not to punish or deter behavior, but to compensate the injured party for any economic losses it has sustained. As courts have repeatedly reiterated:

> The purpose of damages for breach of contract is "to put the plaintiff . . . in as good a position as he would have been had the defendant kept his contract." The damages should be equal to the value of performance. The injured party is not, however, entitled to be placed in a better position than he would have been if the contract had not been broken. . . .

Goodwin, Inc. v. Coe, 62 Mich. App. 405, 412–13, 233 N.W.2d 598 (1975).

Courts have widely recognized the concept of the efficient breach—the notion that a breaching party may occasionally come out ahead from a breach of contract, despite owing compensatory sums to the aggrieved party. *See, e.g., Patton v. Mid-Continental Sys., Inc.*, 841 F.2d 742, 750 (7th Cir. 1998) ("Even if the breach is deliberate, it is not necessarily blameworthy. The promisor may simply have discovered that his performance is worth something more to someone else. If so, efficiency is promoted by allowing him to break his promise, provided he makes good on the promisee's actual losses. If he is forced to pay more than that, an efficient breach may be deterred, and the law doesn't want to bring about such a result."). This mantra walks hand-in-hand with the ideology that the law does not favor an injured plaintiff garnering a windfall. *See, e.g., Goodwin*, 233 N.W.2d at 413 ("The injured party is not, however, entitled to be placed in a better position than he would have been if the contract had not been broken.") This principle is firmly engraved in contractual authorities. For example, as noted in 24 *Williston on Contracts* § 64:1 (4th ed. 2010):

> The fundamental principle that underlies the availability of contract damages is that of compensation. That is, the disappointed promise is generally entitled to an award of money damages in an amount reasonably calculated to make him or her whole and neither more nor less; any greater sum operates to punish the breaching promisor and results in an unwarranted windfall to the promise, while any lesser sum rewards the promisor for his or her wrongful act in breaching the contract and fails to provide the promise with the benefit of the bargain he or she made.

Nevertheless, authorities have recognized that limiting contractual damages solely to expectation damages may actually work to hinder the administration of justice. In some instances, a breaching party may completely "get off free" if the aggrieved party chooses not to pursue legal action for any number of reasons, such as the expense or inconvenience of litigation and/or the prospect of receiving only expectation damages. As noted by one commentator, "As long as this reality exists [wherein a breaching party escapes a contract financially unscathed], the justice of the law of contract remains a fiction." James H. Cook, "*Seaman's Direct Buying Service, Inc. v. Standard Oil Co.*: Tortious Breach of the Covenant of Good Faith and Fair Dealing in a Noninsurance Commercial Contract Case," 71 *Iowa L. Rev.* 893, 909–10 (1986).

This "contractual fiction" has provided a foundation for modern jurisprudence to cultivate the tort of intentional interference with a contract. Recognition of a cause of action in tort can be justified by regarding contractual rights as inviolable—rights that need to be protected against trespass by those not party to the contract. Clark A. Remington, "Intentional Interference with Contract and the Doctrine of Efficient Breach; Fine Tuning the Notion of the Contract Breacher as Wrongdoer," 47 *Buff. L. Rev.* 645, 645 (1999). When viewed in this manner, it is not difficult to understand the rationale behind imposing damages beyond compensatory sums. Arguably there is a justification for punishment and deterrence.

Gradually, courts across the country have recognized intentional interference with a contractual relationship as a cause of action. The unique damages allowed under such a cause of action have made it an attractive option for plaintiffs. Set forth below is a discussion of three states' treatment of damages in both contract and tort.

Michigan

Michigan courts have preserved the distinction between damages available in an ordinary breach-of-contract action and those available in a tortious interference action. Michigan courts have consistently held:

> [I]n breach of contract cases, the general rule is that exemplary damages are not recoverable absent allegations and proof of tortious conduct that is "independent of the breach." This is because "the plaintiff is adequately compensated" for a breach of contract "when damages are awarded by reference to the terms of the contract."

Casey v. Auto Owners Ins. Co., 273 Mich. App. 388, 402, 729 N.W.2d 277 (2006) (quoting *Kewin v. Mass. Mut. Life Ins. Co.*, 409 Mich. 401, 420–21, 295 N.W.2d 50 (1980)).

The preclusion of exemplary damages extends even to bad-faith breaches of insurance contracts—those unique instances in which courts may be inclined to award exemplary damages despite being an ordinary breach of contract. *See, e.g., Isagholian v. Transam. Ins. Corp.*, 208 Mich. App. 9, 17, 527 N.W.2d 13 (1994). Michigan courts have reasoned that a contract imposes a duty owed merely between the parties—not a duty imposed by the law upon all. *See Ferrett v. General Motors Corp.*, 438 Mich. 235, 244, 475 N.W.2d 243 (1991).

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However, Michigan courts recognize tortious interference with a contract if a plaintiff can show the following elements: "(1) a contract, (2) a breach, and (3) an unjustified instigation of the breach by the defendant." *Mahrle v. Danke*, 216 Mich. App. 343, 350, 549 N.W.2d 56 (1996). In such event, exemplary damages may be awarded. *See, e.g., Jackovich v. Gen. Adj. Bureau, Inc.*, 119 Mich. App. 221, 235, 326 N.W.2d 458 (1982). With the exception of the third element, these elements appear to be very similar to the elements required to show breach of an ordinary contract. Yet, a plaintiff—even if its actual damages remain the same—stands to recover exemplary damages if it can prove that the defendant's conduct was tortious.

New York

Acknowledging that the traditional role of damages for breach of contract is simply to enable the injured party to be made whole, New York courts historically have not allowed a plaintiff to recover punitive damages. *M. S. R. Assoc., Ltd. v. Consolid. Mut. Ins. Co*., 396 N.Y.S. 684, 685, 58 A.D.2d 858 (1977) ("[I]t has always been held that punitive damages are not available for mere breach of contract, for in such a case only a private wrong, and not a public right, is involved."). New York courts, however, have recharacterized the nature of contractual damages. The duties assumed upon entering a contract have been expanded to include the covenants of good faith and fair dealing:

> The punitive nature of damage for the bad faith breach of contract is a characteristic of the law of contracts generally, and is not a peculiarity alone of the contract of liability insurance. In every contract "there exists an implied covenant of good faith and fair dealing."

Gordon v. Nationwide Mut. Ins. Co., 30 N.Y.2d 427, 437, 285 N.E.2d 849 (1972) (quoting *Kirke La Shelle Co. v. Armstrong Co.*, 263 N.Y. 79, 87, 188 N.E. 163 (1933)).

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Gradually, New York courts have bridged the gap between contract and tort damages and, in the process, eroded the traditional position of ignoring moral culpability for a breach. Thus, punitive damages may be awarded in an ordinary breach-of-contract case upon an "extraordinary showing of a disingenuous or dishonest failure to carry out a contract." *Id.*; *see also Scott v. KeyCorp*, 669 N.Y.S. 2d 76, 79–80, 247 A.D.2d 772 (1998).

An example of a plaintiff making such a showing in a breach-of-contract case is set forth in *Aero Garage Corp. v. Hirschfeld*, 586 N.Y.S. 2d 611, 613, 185 A.D.2d 775 (1992). The plaintiff in that case was a tenant of a parking garage structure. The plaintiff renewed the lease in 1977 for a term extending until 2000. Under the lease, the defendant landlords were required to obtain an extension for a certificate of occupancy for the property that was set to expire in 1982. In 1979, the defendants applied for an extension, but withdrew the application at some point before the expiration. The defendants informed the plaintiff that they wished to buy out the lease to construct a high-rise building. The defendants made it clear that if the plaintiff would not sell, the defendants would find some other way to terminate the lease. The plaintiff refused and submitted his own application for a certificate of occupancy, which was granted. In response, the defendants attempted to revoke the certificate through administrative appeals. In 1984, the plaintiff brought suit and obtained an injunction precluding the defendants from pursuing revocation of the certificate. The defendants violated this order and, ultimately, the trial court awarded a permanent injunction and assessed $224,000 in damages against the defendants for breach of contract, including $150,000 in punitive damages.

The New York Supreme Court affirmed the award of punitive damages. While recognizing that the remedy for a breach of contract is generally limited to compensatory damages, the court noted that the defendants' actions were in blatant violation of the lease agreement. *Id.*, 586 N.Y.S. 2d at 613. The defendants' "blatant" breach of unambiguous contractual provisions, coupled with a "willingness to go to any lengths to achieve their ends," satisfied the standard to award punitive damages in the breach of contract action.

New York courts have also formally recognized tortious interference with contractual relations as an independent tort. *See, e.g., Anesthesia Assoc. of Mount Kisco, LLP v. N. Westchester Hosp. Ctr.*, 873 N.Y.S. 2d 679, 682, 59 A.D.3d 473 (2009). As with other torts, punitive damages may be awarded. *See, e.g., Don Buchwald & Assoc., Inc. v. Rich*, 723 N.Y.S. 2d 8, 9, 281 A.D.2d 329 (2001) (noting that punitive damages may be awarded for tortious interference with economic relations upon a showing of intentional or deliberate wrongdoing, aggravating or outrageous circumstances, a fraudulent or evil motive, or a willful and wanton disregard of the rights of others).

California

The California legislature has statutorily barred recovery of exemplary damages in ordinary breach-of-contract cases. As codified in Cal. Civ. Pro. Code § 3294(a):

> In an action for the breach of an obligation not arising from contract, where it is proven by clear and convincing evidence that the defendant has been guilty of oppression, fraud, or malice, the plaintiff, in addition to the actual damages, may recover damages for the sake of example and by way of punishing the defendant.

As with many other states, California courts have not allowed exemplary damages to be recovered in a breach-of-contract case. For example, in *Crogan v. Metz*, 47 Cal.2d 398, 402–03, 303 P.2d

1029 (1956), a property owner arranged for his real-estate broker to sell the property for $100,000. The broker conspired with two other brokers to negotiate a "three cornered deal"—a scheme with the goal of selling the property in excess of asking price to guarantee a commission. Thereafter, the plaintiff, a client of one of the brokers, purchased the property for $115,000. After learning of the inflated purchase price, the plaintiff brought suit against the brokers. Following a trial, the trial court entered a verdict in the plaintiff's favor. The court found that the defendants acted willfully and fraudulently, and, therefore, the court awarded punitive damages. *Id.*, 47 Cal.2d at 402–03.

The California Supreme Court, however, reversed and vacated the award of punitive damages. The court stood firm in the deeply rooted tradition of denying exemplary damages "in an action based on breach of contract even though the defendant's breach was willful and fraudulent." *Id.* at 405. California courts have continued to follow this reasoning today. *See, e.g., Brewer v. Premier Golf Properties*, 168 Cal. App. 4th 1243, 1255–56 (2008); *Tomaselli v. Transam. Ins. Co.*, 25 Cal. App. 4th 1269, 1286 (1994) ("It has been examined many times in appellate decisions, and we but summarize. First, simple breach of contract, no matter how willful and hence tortious, is not a ground for punitive damages.").

California courts have nevertheless carved out exceptions to this doctrine. For example, where an insurance company wrongfully withholds payments under a policy, it has been held:

> [W]hen an insurer fails to deal fairly and in good faith with its insured by refusing, without proper cause, to compensate its insured for a loss covered by the policy, such conduct may give rise to a cause of action in tort for breach of an implied covenant of good faith and fair dealing.

Neal v. Farmers Ins. Exchange, 21 Cal.3d 910, 920, 582 P.2d 980 (1978).

As with the tort of intentional interference with a contractual relationship, California courts have blended concepts of good faith and fair dealing with the availability of exemplary damages. Nevertheless, California courts have reserved this "good-faith" tort action to insurance cases. *See Freeman & Mills, Inc. v. Belcher Oil Co.*, 11 Cal. 4th 85, 88, 900 P.2d 669 (1995) (holding that tort recovery does not lie in action for noninsurance contract breach in absence of violation of independent duty arising from principles of tort law other than bad-faith denial of existence of, or liability under, breached contract).

Thus, California courts hold fairly rigidly to the historical rule that an award of exemplary damages is not available for breach of an ordinary contract, even when done fraudulently and willfully. In such an instance, the only recourse to a breach is the compensatory sum to make the injured party whole.

California courts also recognize intentional interference with a contract as an independent tort in its own right. To recover against a defendant for intentional interference with a contractual relationship, a plaintiff must show that there is a valid, existing contract; that the defendant had knowledge of the contract and intended to induce its breach; that the contract was in fact breached by the other contracting party; that the breach was caused by the defendant's unjustified and wrongful conduct; and that the plaintiff has suffered damage. *Charles C. Chapman Bldg. Co. v. Calif. Mart*, 2 Cal. App. 3d 846, 853 (1969). Unlike damages for breach of contract, California courts allow a plaintiff to recover punitive damages when a defendant has intentionally interfered with a contractual relationship. *See, e.g., Ramona Manor Convalescent Hosp. v. Care Enter.*, 177 Cal. App. 3d 1120, 1127–28, 1142 (1986).

A Case Study

The California Court of Appeal's decision in *Webber v. Inland Empire Investments*, 74 Cal. App. 4th 884 (1999), highlights the role of exemplary damages in quasi-contract litigation. In 1989, Hyatt Land Development Corp. (HLDC) sold four parcels of property to Forecast Mortgage Corp. (FMC). As part of the financing, FMC executed a note for $754,000 in favor of HLDC, secured by a deed of trust on one of the four parcels. This deed was originally held by HLDC and eventually transferred to the plaintiff. *Id.* at 893.

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In addition to the note, FMC took a loan from Sanwa Bank, using this money as payment to HLDC. As security on the loan, FMC gave Sanwa Bank a deed of trust on all four parcels. This deed was recorded prior to the HLDC deed and, therefore, was senior to the existing deed on the fourth parcel. In 1990, FMC transferred title to all four parcels to Forecast Corp. (FC), which, in turn, transferred title to All Cities Mini-Storage in 1992. FMC failed to make any payments on the HLDC note—now owned by the plaintiff.

The multiple transfers were designed to further a scheme of FC's owner, James Previti. Previti, in lieu of paying on the note, developed a plan to avoid payments to the plaintiff, wherein he ultimately planned to transfer the title to the four parcels now owned by FC to All Cities Mini-Storage, which he also owned; use an additional corporation he controlled, Inland

Empire Investments (IEI), to purchase the note from Sanwa Bank; have FMC default on the note now in possession of IEI, and senior to that owned by the plaintiff; and then have IEI foreclose on the property, thus eliminating the plaintiff's junior interest. IEI, in fact, purchased the note from Sanwa Bank, and the note and deed were assigned to IEI. FMC failed to pay on the note, allowing IEI to purchase the property at foreclosure. Consequently, the plaintiff's $745,000 junior lien was extinguished. *Id.* at 893–94.

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The plaintiff brought suit against Previti and the corporate entities. The plaintiff pursued multiple theories, including a claim for conspiracy to interfere with a contract. Following trial, the jury determined that the defendants had conspired to interfere with the contracted relationship. The trial court entered a judgment on the jury's award of more than $1 million in compensatory damages against Previti, FC, and IEI, plus $50,000 in punitive damages, against both FC and IEI.

Citing *Applied Equipment Corp. v. Litton Saudi Arabia Ltd.*, 7 Cal. 4th 503, 869 P.2d 454 (1994), the defendants argued that a party cannot be liable for interfering with its own contract. The defendants contended they were mere alter egos of Previti and, therefore, could not be held responsible for interfering with a contract to which they essentially were a party. They claimed that the multiple title transfers orchestrated by Previti were intended to protect his own economic interests related to contracts made by his corporations. In other words, Previti argued that FMC, FC, All Cities, and IEI were alter egos, and there was no "outside" contractual interference. According to the defendants, "consistent with its underlying policy of protecting the expectations of contracting parties against frustration *by outsiders* who have no legitimate social or economic interests in the contractual relationship, the tort cause of action . . . does not lie against a party to the contract." *Webber*, 74 Cal. App. 4th at 898.

The California Court of Appeal agreed that if each individual defendant were treated as one collective corporate entity, there could be no interference with its own contract, and the plaintiff would not be able to recover in tort. The court, however, rejected the defendants' ploy and incorporated the "sword and shield doctrine." The court noted that the defendants were attempting to use the alter ego doctrine as a sword—using the multiple corporations to secure the surreptitious acquisition of the note and deed, while simultaneously relying on the doctrine as a shield to protect Previti from tort liability and exemplary damages. *Id.* at 901. According to the court, the alter ego doctrine was designed to:

> prevent a corporation from using its statutory separate corporate form as a shield from liability only where to recognize its corporate status would defeat the rights and equities of third parties; it is not a doctrine that allows the persons who actually control the corporation to disregard the corporate form. . . . In other words, "Alter ego is a limited doctrine, invoked only where recognition of the corporate form would work an injustice to a third person."

Id. (quoting *Communist Party v. 522 Valencia, Inc.*, 35 Cal. App. 4th 980, 995 (1995)). By holding the alter ego doctrine nonapplicable, the court distinguished the holding of *Applied Equipment* and permitted the individual defendants to be treated as separate entities relative to the counts involving conspiracy.

Conclusion

Intentional interference with a contractual relationship has intertwined foundational principles of both tort and contract law. The practical implications on contract-based litigation may be subtle, yet could result in severe consequences. Parties can face difficult choices with unclear outcomes. For instance, should a party induce a breach between two contracting parties (premised on the fact that, historically, the breaching party is liable only for compensatory damages) to secure an advantageous economic position while risking a potential exemplary damage award for malicious or willful conduct? Can a parent corporation be held responsible for punitive damages if it encourages a subsidiary to breach a contract with a third party? Contract and tort law is becoming less distinct, and counsel should closely review state law before advising clients. ■

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