RECORD NO. 081741

IN THE
SUPREME COURT OF VIRGINIA

BILLY G. DUNN and DUNN CONSTRUCTION COMPANY, INC.

Appellants,

v.

RICHARD M. CLONEY,

Appellees.

On Appeal from the Circuit Court of Mecklenburg County
(Case Nos. CL06000301, CL06000236, CL06000267
Honorable L. M. Osburn, Judge)

BRIEF AMICUS CURIAE OF PACIFIC LEGAL FOUNDATION IN SUPPORT OF NEITHER PARTY

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ASSIGNMENTS OF ERROR

I. Under *Richmond Metro. Auth. v. McDevitt St. Bovis, Inc.*, 256 Va. 553, 507 S.E.2d 344 (1998), submitting a false payment application to receive a contractual payment is a breach of contract, not fraud, because the duties breached arose under the contract. The trial court erred by submitting Cloney's fraud claim to the jury and refusing to set its verdict aside, because the evidence established a breach of contract, not fraud or any tort independent of the contract, therefore improperly comingling the realms of contract law and tort law and permitting separate claims for coterminous injuries.

II. Punitive damages cannot be recovered for a breach of contract unaccompanied by an independent, willful tort. The trial court erred by submitting Cloney's punitive damages claim to the jury and refusing to set its verdict aside because the evidence established only a breach of contract, not an independent, willful tort, and therefore impermissibly combining damages available for contract and tort law.

STATEMENT OF THE CASE

Amicus Pacific Legal Foundation adopts the Statement of the Case as presented by the parties.

QUESTIONS PRESENTED

I. Did the trial court err by submitting Cloney's fraud claim to the jury and refusing to set its verdict aside, because the alleged misrepresentations breached only duties assumed by contract, therefore improperly comingling the realms of contract law and tort law and permitting separate claims for coterminous injuries? (Assignment of Error I.)

II. Did the trial court err by submitting Cloney's punitive damages claim to the jury and refusing to set its verdict aside, because Cloney had merely established a breach of contract claim, for which punitive damages are unavailable, therefore impermissibly combining damages available for contract and tort law? (Assignment of Error II.)

STATEMENT OF FACTS

Amicus Pacific Legal Foundation adopts the Statement of Facts as presented by the parties.

PRINCIPLES OF LAW, ARGUMENTS, AND AUTHORITIES

INTRODUCTION

Pacific Legal Foundation respectfully submits this brief amicus curiae in support of neither party, pursuant to Va. Sup. Ct. R. 5:30.

Richard M. Cloney brought suit for both breach of contract and fraud against Dunn Construction Co. for damages related to a wall that was improperly built and improperly repaired. The trial court awarded both compensatory and punitive damages. But under the "economic loss rule" recognized by this Court in *Kamlar Corp. v. Haley*, 224 Va. 699, 706, 299 S.E.2d 514, 517 (1983), a party cannot bring suit in tort when the acts and harm complained of are identical to a breach of contract. This rule maintains the distinction between contract and tort, which ensures the clarity and predictability vital to private enterprise. Allowing tort suits for breaches of contract deters business and encourages economic inefficiency, but does not improve the ability of either contract or tort law to vindicate their respective concerns. Although one might argue that fraudulent concealment of a breach of contract should be separately actionable due to the wrongfulness of such behavior, this Court should reject this argument because the financial injuries suffered as the result of concealing a breach of contract are already recoverable as contract damages. This Court should not expand the reach of tort law to inflict punitive damages on parties that breach contracts.

I. THE TRIAL COURT ERRED BY SUBMITTING CLONEY'S FRAUD CLAIM TO THE JURY AND REFUSING TO SET ITS VERDICT ASIDE BECAUSE THE ALLEGED MISREPRESENTATIONS BREACHED ONLY DUTIES ASSUMED BY CONTRACT AND REALMS OF CONTRACT LAW AND TORT LAW SHOULD BE KEPT SEPARATE, NOT PERMITTING SEPARATE CLAIMS FOR COTERMINOUS INJURIES

A. The Realms of Contract Law and Tort Law Should Be Kept Separate

In this case, Cloney is pursuing a fraud claim that is coterminous with the breach of contract claim. Because these claims involve identical acts and identical harms, Cloney's argument essentially invites this Court to ignore the differences between contract and tort, beginning with the "economic loss rule." The Court should refuse that invitation.

The distinction between tort and contract is fundamental to Virginia law. *Sensenbrenner v. Rust, Orling & Neale, Architects, Inc.*, 236 Va. 419, 374 S.E.2d 55 (1988). The word "tort" has a settled meaning in Virginia. "A tort is any civil wrong or injury; a wrongful act (not involving a breach of contract) for which an action will lie." *Jewett v. Ware*, 107 Va. 802, 806, 60 S.E. 131, 132 (1908) (internal quotation marks omitted). "'Tort' is also defined as the violation of some duty owing to the plaintiff imposed by the general law or otherwise. Generally, the 'duty must arise by operation of law and not by mere agreement of the parties.'" *Glisson v. Loxley*, 235 Va. 62,

67, 366 S.E.2d 68, 71 (1988) (holding that a plaintiff cannot convert a tort claim into a breach of contract claim to evade the statute of limitations applicable to tort) (citing Black's Law Dictionary 1335 (5th ed. 1979)). Stated differently, a "tort" is a "legal wrong committed upon the person or property independent of contract." *Id.* (citing *Jewett*, 107 Va. at 806, 60 S.E. at 132).

Tort law imposes duties of conduct based on a person's participation in society, while contract law imposes duties of quality based on the parties' participation in a private agreement. *Sensenbrenner*, 236 Va. at 425, 374 S.E.2d at 58. Tort law imposes basic standards of behavior on people living among one another. "Contraposed against this basic rule of tort law is the principle that, as a matter of efficiency and freedom of choice, parties should be able to contract freely about their affairs." *Barnes v. New Hampshire Karting Ass'n, Inc.*, 509 A.2d 151, 153 (N.H. 1986) (citing ABA Special Committee on the Tort Liability System, *Towards a Jurisprudence of Injury: The Continuing Creation of a System of Substantive Justice in American Tort Law* § 5-27 (Nov. 1984); *Morrow v. Auto Championship Racing Ass'n*, 8 Ill. App. 3d 682, 685, 291 N.E.2d 30, 32 (1972)). While tort law is primarily concerned with maintaining minimum standards of conduct in society, contract law is primarily concerned with ensuring that people can reach and rely on agreements between themselves.

Broaddus v. Broaddus, 144 Va. 727, 732, 130 S.E. 794, 795 (1926) ("The sanctity and obligation of contracts are regarded [as] essential to the public welfare."); William Powers, Jr., *Border Wars*, 72 Tex. L. Rev. 1209, 1210-11 (1994). Thus contract law works to settle the rights of the contract's two consenting parties, and tort protects the rights of unconsenting parties. Catharine Pierce Wells, *Tort Law as Corrective Justice: A Pragmatic Justification for Jury Adjudication*, 88 Mich. L. Rev. 2348, 2350, 2355 (1990); W. Page Keeton, *Prosser and Keeton on the Law of Torts* § 2 at 7 (5th ed. 1984) ("[T]he civil action for a tort . . . is commenced and maintained by the injured person, and its primary purpose is to compensate for the damage suffered, at the expense of the wrongdoer."). *See also* Va. Code Ann. § 8.5A-111 cmt. 4 (noting that consequential damages—including punitive damages—for breach of obligations under statute regulating letters of credit are excluded in part "out of the fear that imposing consequential damages on issuers would raise the cost of the letter of credit to a level that might render it uneconomic.").

This distinction is reflected in the differing nature of remedies available in tort as opposed to contract. Because contract law aims at enforcing the expectancy interests of the parties, contract remedies seek only to make the contracting parties "whole." *See* L. L. Fuller & William R. Perdue, Jr., *The*

Reliance Interest in Contract Damages I, 46 Yale L.J. 52, 53-57 (1936). By contrast, tort remedies primarily compensate for harm done to the victim, and also may punish and deter wrongful conduct in the future; thus punitive damages are available. *See Cardinal Holding Co. v. Deal*, 258 Va. 623, 632, 522 S.E.2d 614, 620 (1999) (citing *Zedd v. Jenkins*, 194 Va. 704, 707, 74 S.E.2d 791, 793 (1953)).

Some torts overlap the two legal universes. These can endanger the realm of personal autonomy protected by freedom of contract. Classically, contract law contains no precept of "fault," and pursues the efficient allocation of resources, while tort law does precisely the opposite: it seeks to make certain acts costly enough that people will not do them. *E. I. Du Pont De Nemours & Co. v. Universal Moulded Prod. Corp.*,191 Va. 525, 568-69, 62 S.E.2d 233, 253 (1951) (citing *Alleghany Iron Co. v. Teaford*, 96 Va. 372, 31 S.E. 525 (1898)) ("The object of [contract] law, in awarding damages, is to make amends or reparation. It aims to put the party injured in the same position, as far as money can do it, as he would have been if the contract had been performed."). Imposing tort concepts of fault in private contracts endangers freedom to bargain and encourages economic inefficiency.

The threat to freedom of contract arises because tort concepts of fault give courts power to manipulate private agreements to reach policy outcomes

the court considers preferable. As Judge Kozinski memorably explained, "[t]he right to enter into contracts . . . is too easily smothered by government officials eager to tell us what's best for us. The recent tendency of judges to insinuate tort causes of action into relationships traditionally governed by contract is just such overreaching." *Oki America, Inc. v. Microtech Int'l, Inc.*, 872 F.2d 312, 316 (9th Cir. 1989). Applying tort rules in the realm of contract would allow judges to enforce their policy concerns in contracts, thus violating the principle of separation of powers. *Cf. Chauncey F. Hutter, Inc. v. Virginia Employment Comm'n*, 50 Va. App. 590, 600, 652 S.E.2d 151, 156 (2007). Indeed, "[i]f contracting parties were required pervasively to act reasonably [by tort law], every contract term would be up for grabs. Courts could ask whether the price was reasonable, whether the delivery date was reasonable, and so on." Powers, *supra*, at 1217. But while tort law enforces certain social demands on individual behavior, contract law recognizes that, insofar as the performance is concerned, there is a realm of personal choice over which individuals should be free to set their own terms and undertake their own obligations, so long as they cause no harm to third parties. *Id.* at 1224-25.

If any part of the government has the power to interfere with these private arrangements, it should be the Legislature, which has the constitutional authority of determining and enacting the state's public policy.

See Finn v. Virginia Ret. Sys., 259 Va. 144, 151-52, 524 S.E.2d 125, 129 (2000) ("[I]t is the responsibility of the legislature, not the judiciary, to formulate public policy, to strike the appropriate balance between competing interests, and to devise standards for implementation.") (citing *Wood v. Bd. of Supervisors*, 236 Va. 104, 115, 372 S.E.2d 611, 618 (1988); *see also Ames v. Am. Nat'l Bank of Portsmouth*, 163 Va. 1, 38, 176 S.E. 204, 216 (1934) ("It is the function of the court to construe the contract made by the parties, not to make a contract for them, or to alter the contract they have made so as to conform it to the court's notion of the contract they should have made in view of the subject matter and the surrounding facts and circumstances."). Tort law imposes unchosen obligations; contract law allows for freedom of choice. Tort law enforces rules of fairness; contract allows parties to make hard-nosed bargains. Tort law apportions burdens from a socially advantageous perspective; contract law allows parties to bargain for an allocation of risk that *they* find acceptable. Tort is based on social policy; contract law is based on enforcing agreements that private parties find advantageous. Virginia courts have frequently noted the dangers of imposing social policy in private contractual arrangements through the medium of the courts. *See, e.g.*, *Bank of Southside Virginia v. Candelario*, 238 Va. 635, 640, 385 S.E.2d 601, 603 (1989) ("Courts will not rewrite contracts; parties to a

contract will be held to the terms upon which they agreed."); *Rogers v. Yourshaw*, 18 Va. App. 816, 823, 448 S.E.2d 884, 888 (1994) ("A court is not at liberty to rewrite a contract simply because the contract may appear to reach an unfair result."). *See also Stephens v. S. Pac. Co.*, 109 Cal. 86, 89, 41 P. 783 (1895) ("[P]ublic policy is an unruly horse, astride of which you are carried into unknown and uncertain paths . . . . [P]ublic policy requires and encourages the making of contracts by competent parties upon all valid and lawful considerations, and courts so recognizing have allowed parties the widest latitude in this regard . . . ."); *Old Dominion Transp. Co. v. Hamilton*, 146 Va. 594, 608, 131 S.E. 850, 855 (1926) (adopting analogy of public policy to "unruly horse").

Also, allowing tort law to reach into the realm of contract is dangerous because it is sometimes difficult to determine what sort of conduct will give rise to tort liability. Much legitimate business practice entails hard bargaining and economic advantage which will seem unfair to those who fail to profit as much as others do, or who feel "taken advantage of." By framing their (perhaps understandable) complaints about competitors' hard-nosed business tactics as torts, parties can use the law in ways which retard competition and benefit plaintiffs at the expense of the market and consumers. *Cf. Brooke Group Ltd. v. Brown & Williamson Tobacco Corp.*, 509 U.S. 209, 225 (1993),

("Even an act of pure malice by one business competitor against another does not, without more, state a claim under the federal antitrust laws."). The tort of interference with contract is a prime example: it is one of the most common forms of business litigation, even though many cases arise simply because parties find better deals elsewhere. *See* Gary D. Wexler, *Intentional Interference with Contract: Market Efficiency and Individual Liberty Considerations*, 27 Conn. L. Rev. 279, 280 (1994). For these reasons, the Court should avoid expanding the law of tort farther into the realm of contract.

B. The Court Should Not Permit Separate Claims for Coterminous Injuries

The economic loss rule draws the boundary between tort and contract in a logical place. When the alleged tort is coterminous with a breach of contract the economic loss rule prohibits recovery in tort.

Historically, punitive damages have been available for breach of contract in two major instances: contracts to marry, and public service contracts. Leslie E. John, *Formulating Standards for Awards of Punitive Damages in the Borderland of Contract and Tort*, 74 Cal. L. Rev. 2033, 2043 (1986). Both of these, however, demonstrate the consistent theme that separate tort recovery is only available where the breach of contract is accompanied by the breach of some duty beyond that imposed by the

contract itself. As this Court recently repeated, it requires "proof of an independent, wilful tort, beyond the mere breach of a duty imposed by contract, as a predicate for an award of punitive damages, regardless of the motives underlying the breach." *Kamlar*, 224 Va. at 707, 299 S.E.2d at 518. Because tort law only intervenes in cases where society or some nonconsenting party has been harmed, it will usually not apply to a private, consensual agreement between contracting parties. Thus, conduct amounting to a breach of contract becomes tortious only when it also violates *an independent duty* arising from principles of tort law. *Id.*; *see also Bettius & Sanderson, P.C. v. Nat'l Union Fire Ins. Co.*, 839 F.2d 1009, 1015 (4th Cir. 1988).

1. Concealment of Breach of Contract Should Not Be Separately Actionable from the Breach Itself

One might argue that fraud should nevertheless be exempt from the economic loss rule, and thus provide a path between the realms of tort and contract, because the fraud tort serves to vindicate society's interest in honest dealing between parties, and because fraudulent concealment of a breach of contract deprives the buyer of the opportunity to take mitigating steps and thereby avoid incurring additional consequential damages. Neither of these

theories, however, justifies blurring the clear, and salutary, line separating tort and contract law.

First, while it is the role of tort law to vindicate social policy where the behavior of an individual intrudes on the society's legitimate demands, it is not the role of tort law to enforce "correct" behavior on individuals *as an end in itself.* Tort law vindicates social interests only when society is harmed by the behavior in question. Thus not all bad acts are torts, but only those wrongs which harm others in some way. *See Hensley v. Dreyer*, 247 Va. 25, 31, 439 S.E.2d 372, 375-76 (1994); *C & W Coal Corp. v. Salyer*, 200 Va. 18, 24, 104 S.E.2d 50, 54 (1958); Keeton, *supra*, § 1 at 5-6. In contract law, however, parties form agreements which any number of people might consider unreasonable or undesirable; yet the law permits them to do so, because contract law respects people's rights to form their own agreements and settle their own arrangements. *See Whitmore & Arnold, Inc. v. Lucquet*, 233 Va. 106, 110, 353 S.E.2d 764, 766-67 (1987) ("[P]ersons are free to contract as they wish with respect to their property rights, and a court will not annul their agreement unless it is contrary to law.").

Contract damages are designed to preserve the ability of both parties to participate in future bargains, not to ensure that contracting parties behave well. Thus, so long as no harm occurs outside of the contract, tort law has no

role. As the New York Court of Appeals has explained, "Freedom of contract prevails in an arm's length transaction between sophisticated parties . . . and in the absence of countervailing public policy concerns there is no reason to relieve them of the consequences of their bargain." *Oppenheimer & Co., Inc. v. Oppenheim, Appel, Dixon & Co.*, 86 N.Y.2d 685, 695 (1995). *See also* Richard A. Epstein, *In Defense of the Contract at Will*, 51 U. Chi. L. Rev. 947, 953-54 (1984) ("Freedom of contract is an aspect of individual liberty, every bit as much as freedom of speech, or freedom in the selection of marriage partners or in the adoption of religious beliefs . . . ."). Where, as in this case, the only injury is the breach of contract between two parties, and where that injury is sufficiently compensated by contract damages, tort law has no further role to play in ensuring "good" behavior.

Fraudulent concealment of a breach of contract should not be actionable simply to vindicate the rightfulness of certain forms of conduct. If such claims are to be heard by the courts, plaintiffs must demonstrate a harm distinct from the breach of contract itself. In *Bridgestone/Firestone, Inc. v. Recovery Credit Servs. Inc.*, 98 F.3d 13 (2d Cir. 1996), the Second Circuit Court of Appeals found that under New York law the plaintiff could not state a cause of action for fraudulently concealing the breach of contract.

> To prove fraud . . . a plaintiff must show that (1) the defendant made a material false representation, (2) the defendant intended to defraud the plaintiff thereby, (3) the plaintiff reasonably relied upon the representation, and (4) the plaintiff suffered damage as a result of such reliance. BFI's complaint alleged, and its proof showed, that "[o]n numerous occasions . . . [the defendant] knowingly and falsely represented to BFI that [it] intended to remit all sums due . . . ." We may assume that these representations were intended to lull BFI into a false sense of security and that they did so to BFI's detriment. However, these facts amount to little more than intentionally-false statements by Beladino indicating his intent to perform under the contract. That is not sufficient to support a claim of fraud . . . . To maintain a claim of fraud in such a situation, a plaintiff must either: (i) demonstrate a legal duty separate from the duty to perform under the contract; or (ii) demonstrate a fraudulent misrepresentation collateral or extraneous to the contract; or (iii) seek special damages that are caused by the misrepresentation and unrecoverable as contract damages . . . .

Id. at 19-20 (citations and quotations omitted).

Second, even when the fraudulent concealment of a breach of contract does cause some harm over and above the injury complained of in the action for breach, tort law ought to apply only in unusual circumstances. In a case where concealment of a contract breach gives rise to larger damages than the mere value of the contract—for instance, where the purchaser forgoes opportunities or incurs greater liability on the basis of the contract—those damages are often already compensable in contract law as *consequential* damages. Yet there are two significant differences between classifying those damages as consequential damages in contract, or as damages for the

concealment of the breach in tort. In contract, consequential damages are already limited by the rule of contemplation in *Hadley v. Baxendale*, 156 Eng. Rep. 145 (1854); *Roanoke Hosp. Ass'n v. Doyle & Russell, Inc.*, 215 Va. 796, 801 n.4, 214 S.E.2d 155, 160 n.4 (1975) (incorporating *Hadley*). Tort damages generally are limited by the far more elastic principle of forseeability. And tort law makes punitive damages available. Were this Court to allow a party to sue both for a breach of contract and for damages incurred as a result of the intentional (or even negligent) concealment of the breach, parties would phrase their consequential damages claims not as contract actions but as tort actions; this implicates the same risks discussed above. *See further* Thomas A. Diamond & Howard Foss, *Consequential Damages for Commercial Loss: An Alternative to* Hadley v. Baxendale, 63 Fordham L. Rev. 665, 674-77 (1994).

2. This Court Should Follow the Hawaii Supreme Court's Test for Evaluating Contract-Plus-Tort Claims

The Hawaii Supreme Court carefully considered the applicability of tort remedies in the contract in *Francis v. Lee Enters., Inc.*, 971 P.2d 707 (Haw. 1999). There, the court held that plaintiffs could not recover tort damages for breach of contract "in the absence of conduct that (1) violates a duty that is independently recognized by principles of tort law and (2) transcends the

breach of the contract." *Id.* at 708. In other words, both the nature of the wrong and the harm done must be distinguishable from the breach of contract itself in order to permit tort recovery. The court explained that while contract law seeks "'to ascertain and effectuate the intention of the parties,'" *id.* at 712 (citation omitted), and to ensure "[p]redictability about the cost of contractual relationships," *id.* at 714 (citation omitted), tort law seeks "*to vindicate social policy*." *Id.* at 715. Thus, "'[i]f tort and contract remedies were allowed to overlap, certainty and predictability in allocating risk would decrease and impede future business activity.'" *Id.* at 714 (quoting *Berschauer/Phillips Constr. Co. v. Seattle Sch. Dist. No. 1*, 881 P.2d 986, 992 (Wash. 1994)). Permitting tort and contract thus to overlap would enable parties to "relabel" their breach of contract claims as torts for tactical reasons. *Francis*, 971 P.2d at 717.

The *Francis* decision is praiseworthy for its requirement of two separate elements in cases where plaintiffs allege both breach of contract and tort claims. First, stating a tort claim requires that there be a breach of some duty independent of the contract itself. Secondly, that breach must create some harm that transcends the breach of contract. Only by requiring both of these elements can the Court ensure that parties do not merely frame their breach of contract action as a tort claim. If the injury is the same, and the acts are

the same, the court should not allow double recovery even if the duty breached is distinguishable from the duties undertaken in the contract. This Court should require *both* (1) that the breach of contract and the alleged tortious conduct are distinguishable, *and* (2) that the harms suffered by the complained-of actions are distinguishable. In other words, when the alleged tort and the breach of contract are coterminous, a plaintiff should not be able to allege separate causes of action.

II. THE TRIAL COURT ERRED BY SUBMITTING CLONEY'S PUNITIVE DAMAGES CLAIM TO THE JURY AND REFUSING TO SET ITS VERDICT ASIDE BECAUSE CLONEY HAD MERELY ESTABLISHED A BREACH OF CONTRACT CLAIM, FOR WHICH PUNITIVE DAMAGES ARE UNAVAILABLE, THEREFORE IMPERMISSIBLY COMBINING DAMAGES AVAILABLE FOR CONTRACT AND TORT LAW

The economic loss rule guards the border between contract and tort law. It prevents tort claims in breach of contract cases where the injury has not gone outside the boundaries of the breach of contract itself. As such, it accomplishes at least two vital purposes: First, it preserves the separate values of contract and tort law, but allows each to operate in their appropriate contexts. Second, it limits liability in a predictable manner, thus ensuring efficiency and the continued freedom of economic opportunity.

Limiting the reach of tort liability always has been an important priority for courts. *See* Harvey S. Perlman, *Interference with Contract and Other Economic Expectancies: A Clash of Tort and Contract Doctrine*, 49 U. Chi. L. Rev. 61, 70-76 (1982). Because "[t]he consequences of any act can be traced indefinitely," *id.* at 70, courts have had to find logical ways to limit liability to those harms fairly traceable to the defendant's actions, rather than holding defendants liable for remote effects of their actions. Courts can do this in several ways. "The amount of physical damage that can be inflicted by a speeding automobile or a thrown fist has a self-defining limit," *id.* at 71, but torts involving purely economic harms are not so easily limited, because "the chain reaction of economic harm flows from one person to another without the intervention of other forces. Courts facing a case of pure economic loss thus confront the potential for liability of enormous scope, with no easily marked intermediate points . . . ." *Id.* at 72. Yet courts must devise some limiting principle, so that people will not be exposed to extreme liability for the most minor acts. In many cases, courts have used concepts such as "proximate cause" to limit potential tort liability. *Id.* at 70. The economic loss rule is another such limiting concept. Sidney R. Barrett, Jr., *Recovery of Economic Loss in Tort for Construction Defects: A Critical Analysis*, 40 S.C. L. Rev. 891, 898 (1989). *See also Wright v. Everett,* 197 Va. 608, 615, 90 S.E.2d

855, 860 (1956) (describing distinction between tort and contract damage limitations).

A. Under the Economic Loss Rule, Contract and Tort Law Can Enforce Their Respective Interests

The economic loss rule ensures that contract disputes that remain within the boundaries of interests protected by contract law—that is, which do not cause harms above and beyond the breach of contract or breach of warranty—are not brought to court dressed as a tort action; and thus ensures that contracts will be respected. At the same time, the rule allows tort claims where the alleged wrong goes beyond a contract dispute. When a product fails, causing harm to persons or other property, properly cognizable in tort, the rule allows plaintiffs to seek recovery in tort.

The historical division between tort law and contract law often refers to the difference between obligations "*ex contractu*" and obligations "*ex delicto.*" *Kamlar*, 224 Va. at 707, 299 S.E.2d at 518 (citing *Goodstein v. Weinberg*, 219 Va. 105, 109, 245 S.E.2d 140, 143 (1978)). This reflects the different nature of the interests protected by these laws. A breach of contract simply is not the sort of socially reprehensible conduct targeted by tort law. Indeed, breaches of contract can be socially desirable in some circumstances. Michael Dorff, *Attaching Tort Claims to Contract Actions: An Economic*

Analysis of Contort, 28 Seton Hall L. Rev. 390, 395 (1997); *Marcus, Stowell & Beye Gov't Secs., Inc. v. Jefferson Inv. Corp.*, 797 F.2d 227, 232 (5th Cir. 1986) (discussing the appropriateness of efficient breaches of contract); *Lake River Corp. v. Carborundum Co.*, 769 F.2d 1284, 1289 (7th Cir.1985) (discussing how efficient breaches are socially beneficial since both parties are either in the same or better position than they would have been if the contract had been performed); *TruGreen Companies, L.L.C. v. Mower Bros., Inc.*, 199 P.3d 929, 933 (Utah 2008) (relying on doctrine of efficient breach to hold "as a policy matter, we do not wish to adopt a remedy for breach of contract that punishes the breaching party").

The value of tort and contract damages may be significantly different because although punitive and emotional loss damages are generally not available in contracts, those damages are potentially available in tort. *Compare Restatement (Second) of Contracts* §§ 353, 355 (1981) *with Restatement (Second) of Torts* § 901 (1979). Furthermore, the standard of proof for contract damages is significantly more restrictive than the standard in tort cases. *Compare Restatement (Second) of Contracts* § 352 (1981) ("Damages are not recoverable for loss beyond an amount that the evidence permits to be established with reasonable certainty."), *with Restatement*

(Second) of Torts § 912 (1979) (requiring as much certainty as the nature of the tort and the circumstances permit).

Punitive damages are thus not awarded in contract cases because doing so would result in a net social loss. Dorff, *supra*, at 404. As the Hawaii Supreme Court has noted, "society views intentional torts as reprehensible, [but] many people have argued that intentional breaches of contract are morally neutral." *Francis v. Lee Enterprises, Inc.*, 971 P.2d at 716. When a contracting party delivers faulty goods which nevertheless do not cause physical damage, such conduct may be seen as shoddy workmanship, bad business, or ineptitude. Such ineptitude brings liability in contract law. But absent some greater harm, it does not entail the same commonsense moral reprehensibility that battery, or conversion, or other intentional torts do. *See Giampapa v. Am. Family Mut. Ins. Co.*, 64 P.3d 230, 250-51 (Colo. 2003) ("Under tort law, liability is typically premised upon the defendant's wrongful conduct. In contrast, in contract, breach is not always thought to be a morally reprehensible action. Farnsworth, *Farnsworth on Contracts* § 12.1 ('[A]long with the celebrated freedom to make contracts goes a considerable freedom to break them as well.').").

B. Mixing Tort and Contract Law Creates a Realistic Risk of Over-Deterrence

The economic loss rule prevents the significant harms which can arise from over-deterrence. As noted above, contracting parties must be able to predict their likely costs in future circumstances so that they can knowledgeably negotiate appropriate prices for goods and services. Parties must insure against uncertainty in some way, and if not through a purchased insurance policy, it will be "virtually insured" by a decrease in economic output and available goods. The indefinite nature of potential tort liability may therefore deter more than just wrongful conduct, which poses a serious harm to consumers. *See* Paul H. Rubin, *et al., BMW v. Gore: Mitigating the Punitive Economics of Punitive Damages*, 5 Sup. Ct. Econ. Rev. 179, 184-87 (1997) (describing danger of over-deterrence). This can occur in at least two ways. First, the potential of increased liability may simply deter some from entering the market or expanding their current operations. Second, such liability may cause those already engaged in deals to over-invest in monitoring compliance with contracts.

1. The Threat of Punitive Damages Will Chill Entrepreneurial Activity

This Court should not permit a party who has breached a contract to be liable for the attenuated harms, or for double liability, or even for punitive liability, where the harm complained of is simply a breach of contract. Otherwise, contracting parties will be unable to predict the costs and benefits of future contracts, or of future performance on existing contracts. *See Myers v. Moore*, 204 Va. 409, 413, 131 S.E.2d 414, 417 (1963) ("[I]n a well ordered society it is important for people to know what their legal rights are, not only under constitutions and legislative enactments but also as defined by judicial precedent . . . ."). When parties are exposed to the potential of liability both in contract and tort law, and where liability in tort may be tens of times greater than the value of the contract itself, they will be less likely to make contracts in the future, thus harming the economy of Virginia. *See* Matthew J. Barrett, Note, *"Contort": Tortious Breach of the Implied Covenant of Good Faith and Fair Dealing in Noninsurance, Commercial Contracts—Its Existence and Desirability*, 60 Notre Dame L. Rev. 510, 526-27 (1985) ("When courts interject tort remedies into commercial contracts, they frustrate the contracting parties' expectations because, in most cases, the parties anticipate contract damages as the only remedy for purposeful breaches of contract.").

Compensatory damages are designed to ensure that the price of breach is certain and predictable. "This predictable exit price limits the risk of making promises and encourages trading. Any escalation of damages for bad conduct or otherwise would raise the cost of promise-breaking and thus discourage exchanges." Nicholas J. Johnson, *The Boundaries of Extra-compensatory Relief for Abusive Breach of Contract*, 33 Conn. L. Rev. 181, 182 (2000) (citations omitted). Thus, courts "typically refuse to award punitive damages for breach of contract and narrowly limit consequential damages to those that were easily contemplated when the deal was struck." *Id.* at 182-83 (citations omitted). But judges and juries have vast discretion to impose punitive damages on *tort* defendants, making it much more difficult to predict and insure against tort claims than against contract claims. *See* Alan Schwartz, *Proposals for Products Liability Reform: A Theoretical Synthesis*, 97 Yale L.J. 353, 411 (1988). The Fourth Circuit Court of Appeals reiterated that

> [c]ontract law is simply more restrictive than tort law in awarding damages . . . [because] tort and contract law serve different goals. Tort law emerges from duties individuals owe generally to other members of society; it is faultbased and seeks both to compensate the victim and punish the wrongdoer. Accordingly, punitive awards may be appropriate where the requisite standards of culpability under state law have been met. Contract law, by contrast, arises out of the attempt by private individuals to order relationships among themselves. When such relationships

> collapse, the law has long recognized that compensating the individual only for actual loss will suffice . . . . Parties contract partly to minimize their future risks. Importing tort law principles of punishment into contract undermines their ability to do so. Punitive damages, because they depend heavily on an individual jury's perception of the degree of fault involved, are necessarily uncertain. Their availability would turn every potential contractual relationship into a riskier proposition.

Strum v. Exxon Co., U.S.A., 15 F.3d 327, 330 (4th Cir. 1994).

Some have argued that punitive damages are necessary in contract law because expectancy damages fail to adequately compensate nonbreaching parties. *See* Mark Pennington, *Punitive Damages for Breach of Contract: A Core Sample from the Decisions of the Last Ten Years*, 42 Ark. L. Rev. 31, 35 (1989). But if this happens, the fault lies in a court's mistaken calculation of compensatory damages. The solution is not to open the door to the greater mischief that can be wrought by allowing punitive damages in breach of contract cases. As even Pennington acknowledges, punitive damages for breach of contract will deter wrongful breaches, but "[a]t some point, punitive damages will deter desirable activity." *Id.* at 100.

2. The Availability of Punitive Damages in Contract Disputes Would Lead to Economically Inefficient Over-Monitoring

Allowing indefinitely large tort awards for breach of contract would lead to the problem some commentators describe as over-investing in monitoring

compliance with contracts—that is, investing more than they would with an expectation of consequential damages in policing agreements, in hopes that the other party's breach may result in a large punitive damage payoff. *See* Dorff, *supra*, at 405-06. Such investment is wasteful from a social perspective, but predictable in a regime where parties can use the courts to take disproportionate economic advantage of each other. Basic public-choice economics reveals that any government agency with the power to reward a party with $X worth of benefits will find itself subject to a competition between parties, who find it in their interest to spend up to $X to convince the agency to exercise that power in their favor. *See* James M. Buchanan & Gordon Tullock, *The Calculus of Consent* 286 (Ann Arbor Paperbacks 2001) ("[I]nterest-group activity, measured in terms of organizational costs, is a direct function of the 'profits' expected from the political process by functional groups."). If courts can grant disproportionately large punitive damages awards[1] to contracting firms, the firms will increasingly invest their energies

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[1] The Fourteenth Amendment limits the discretion courts have in awarding punitive damages. *BMW of N. Am., Inc. v. Gore*, 517 U.S. 559 (1996). But such limits remain vague, and have not prevented the awarding of extremely large punitive damages awards. *See TXO Prod. Corp. v. Alliance Res. Corp.*, 509 U.S. 443, 458 n.24 (1993) ("A violation of a state law 'reasonableness' requirement would not, however, necessarily establish that the award is so 'grossly excessive' as to violate the Federal Constitution."); Robert A. Levy, (continued...)

in exploiting that process by bringing more lawsuits over ever more minor breaches. Such an "increased investment in organization aimed at securing differential gains . . . is a predictable result" of the mixture of tort and contract. *Id.* at 287; *see also* Anthony de Jasay, *Justice and Its Surroundings* 81 (2002) (noting that parties seeking economic gains will try to alter rules through legal interpretation "to let progressively narrower coalitions despoil ever larger minorities").

In such a circumstance, the "tort tail" comes to wag the "contract dog." *Story v. City of Bozeman*, 791 P.2d 767, 772 (Mont. 1990). This not only rewards firms for nonproductive behavior, and encourages waste; it also increases the burden on the courts. Pennington, *supra*, at 100 ("[T]he potential availability of punitive damages will lead to more complex litigation. A typical contract case is a good candidate for summary judgment or for a brief trial . . . [but] tort cases, especially those aimed at ascertaining the defendant's state of mind, are frequently involved and burdensome."). *See also* Mark Gergen, *A Cautionary Tale About Contractual Good Faith in Texas*,

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[1] (...continued)
The Conservative Split on Punitive Damages, in Cato Supreme Court Review 2002-2003 at 159, 164 (James L. Swanson ed., 2003) ("In the seven years since *BMW*, punitive awards have continued their upward spiral. The Court's initial step was not enough.")

72 Tex. L. Rev. 1235, 1236 (1994) ("Opening the door to tort claims in contract, with their lure of emotional and exemplary damages, creates a crush of claims as plaintiffs and their lawyers attempt to cash in."). As one California court of appeal noted in blunt terms, allowing tort claims in the contract realm would mean that

> any party attempting to defend a disputed contract claim would risk, at the very least, exposure to the imposition of tort damages and an expensive and time-consuming expansion of the litigation into an inquiry as to the motives and state of mind of the breaching party. The distinction between tort and contract actions, and their purposefully different measures of damages, would be blurred if not erased. The insult to commercial predictability and certainty would only be exceeded by the increased burden on an already overworked judicial system.

Dubarry Int'l, Inc. v. Sw. Forest Indus., Inc., 231 Cal. App. 3d 552, 569, 282 Cal. Rptr. 181 (1991).

The economic loss rule prevents unfair liability and its pernicious consequences by ensuring a clear boundary between tort and contract law. It is a reasonable boundary which has withstood the test of time and experience. It protects persons and property by ensuring that they may still be vindicated in tort suits, and it preserves the interests of contract law by ensuring that parties receive the benefit of those bargains—and only that benefit. *See Klaiber v. Freemason Assoc., Inc*, 266 Va. 478, 489, 587 S.E.2d 555, 561 (2003). The economic loss rule prevents the public choice-style

manipulation of the court system, while comporting with justice and fairness in providing a clear and predictable rule. This Court should not disturb it.

CONCLUSION

The economic loss rule is an important and effective barrier that prevents breach of contract actions from being framed as tort claims. The Court should not hold that fraud is an exception to the economic loss rule to punish bad acts. While fraudulent concealment of a breach of contract might be actionable, the plaintiff in such a case must show that the concealment has caused harm over and above the breach of contract. Keeping the two branches of law separate is essential to protecting the freedom to bargain and

thus preserving the economic opportunity essential to Virginia's commercial health.

DATED: February 27, 2009.

Respectfully submitted,

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CERTIFICATE OF SERVICE

In accordance with Rules 5:17(e), 5:27, and 5:26(d) of the Rules of the Supreme Court of Virginia, I certify the following:

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On February 27, 2009, twelve (12) true copies, together with a PDF version on a CD, of BRIEF AMICUS CURIAE OF PACIFIC LEGAL FOUNDATION IN SUPPORT OF NEITHER PARTY were personally delivered to the Supreme Court of Virginia. Three (3) copies of said BRIEF AMICUS CURIAE OF PACIFIC LEGAL FOUNDATION IN SUPPORT OF NEITHER PARTY were mailed, postage prepaid, to counsel for the parties on the same date.

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