



# Fraud: The fundamentals

*The issues and law that generally arise in fraud cases*

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Matters involving fraudulent conduct are all around us. They range from the used-car lot rolling back odometers to multi-national general contractors submitting false invoices to their clients to Wall Street's involvement in the subprime fiasco. Despite the fact that fraudulent conduct is being perpetuated every day, there are not enough governmental resources to prosecute the wrongdoing. This is where the civil justice system plays a vital role; filling a void created by governmental budget cuts and other "austerity" measures that have been applied to curb government oversight.

When one takes a brief overview of the CACI Instructions, you will not find a cause action called "fraud." Rather, fraud cases are a cluster of causes of actions which include intentional misrepresentation, concealment, false promise and negligent misrepresentation. Each one has unique aspects that impact everything from pleading through proof at trial. What this article attempts to do is set forth some of the issues and law that generally arise in fraud cases at differing stages of litigation, up to and including trial.

## **Pleading rules differ in fraud cases**

The pleading rules of liberality have a few exceptions. One area that requires

allegations to be made with particularity is that of fraud. (*Committee On Children's Television, Inc. v. General Foods Corp.* (1983) 35 Cal.3d 197, 216.) The particularity requirement serves two purposes. First, it provides notice to the Respondent so as to furnish the Respondent with certain definite charges which can be intelligently met. Second, the pleading should be sufficient to enable the court to determine whether, on the facts pleaded, there is any foundation, prima facie at least, for the charge of fraud. But as discussed below, there are situations where fraud need not be alleged with particularity.

"Less specificity is required when Respondent must necessarily possess full information concerning the facts of the



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controversy.” (*Committee On Children’s Television, Inc. v. General Foods Corp.*, 35 Cal.3d at p. 217.) “Even under the strict rules of common law pleading, one of the canons was that less particularity is required when the facts lie more in the knowledge of the opposite party . . .” (*Ibid.*) Furthermore, the requirement of “particularity” in pleading fraud should not be overdone, in that complaints should be kept to a reasonable length. (*Id.* at p. 217.)

When a plaintiff files a claim for fraud, defendants almost always seem to file a demurrer based on the issue of the pleadings specific enough. The cases above should provide a basis for some push back. Ultimately, what you must demonstrate in the complaint is the “who, what, where, and how” of the fraud. To the extent that you cannot allege some of these facts, you must be able to persuasively argue that the missing facts are within the knowledge of the defendant.

### Parol evidence

There was a long-standing rule in California that prohibited the use of parol evidence to establish fraud in the inducement. The use of evidence of a prior or contemporaneous statement that contradicted the terms of a written instrument was excluded under the parol evidence rule, even if a claim of fraud was raised. (*Bank of America etc. Assn. v. Pendergrass* (1935) 4 Cal.2d 258, 263.) The long-standing prohibition of introducing evidence of fraud that may also be parol evidence was recently overturned in the matter of *River Island Cold Storage v. Fresno-Madera Production Credit Ass’n* (2013) 55 Cal.4th 1169. The California Supreme Court held that “fraud undermines the essential validity of the parties’ agreement. When fraud is proven, it cannot be maintained that the parties freely entered into an agreement reflecting a meeting of the minds.” (*Id.*, 55 Cal.4th at p. 1182.) Thus, California has re-established the fraud exception to the parol evidence rule, which was held abated for nearly 80 years.

Even with the fraud exception, expect an aggressive cross-examination of the plaintiff (or signatory) to focus on the written terms of the contract. This will especially be true when asked about the written term that is being contradicted by the claimed fraudulent statement. This lends to attacking not only the veracity of the plaintiff claiming that fraudulent oral statements were made, but also the reasonableness of plaintiff’s reliance on those fraudulent statements.

### Reasonable reliance

One of the major targets subject to attack in most fraud cases is the element of reasonable reliance. “Justifiable reliance is an essential element of a claim for fraudulent misrepresentation, and the reasonableness of the reliance is ordinarily a question of fact.” (*Guido v. Koopman* (1991) 1 Cal.App.4th 837, 843.)

Actual reliance occurs when a misrepresentation is ‘an immediate cause of [a plaintiff’s] conduct, which alters his legal relations.’ and when, absent such representations, ‘he would not, in all reasonable probability, have entered into the contract or other transaction.’ It is not . . . necessary that [a plaintiff’s] reliance upon the truth of the fraudulent misrepresentation be the sole or even the predominant or decisive factor in influencing his conduct . . . It is enough that the representation has played a substantial part, and so has been a substantial factor, in influencing his decision.

(*Engalla v. Permanente Medical Group, Inc.* (1997) 15 Cal.4th 951, 976-77, internal citations omitted.)

In assessing actual reliance, one needs to look at the conduct of the plaintiff before the representations were made versus after. If the misrepresentation is an “inducing cause of the party’s assent,” then actual reliance exists. (1 Witkin, Summary of California Law, Contracts (10th Ed.), §300; citing Rest.2d, Contracts §167.)

In assessing whether one’s reliance was justified, the focus is on the plaintiff’s belief in light of his own knowledge and experience. (*Gray v. Don Miller & Associates, Inc.* (1984) 35 Cal.3d 498, 503.) However, a plaintiff cannot put his faith in representations that are patently and obviously false that “he must have closed his eyes to avoid discovery of the truth.” (*Blankenheim v. E.F. Hutton, Co., Inc.* (1990) 217 Cal.App.3d 1463, 1474.)

Where a defendant asserts that a plaintiff’s reliance was “preposterous” or “shown to be patently and obviously false,” the burden shifts to the defendant. (*Hartong v. Partake, Inc.* (1968) 266 Cal.App.2d 942, 965.) “Where a plaintiff commences an investigation, his failure to discover the truth may be excused by the defendant’s superior knowledge of the facts, [or] the difficulty in ascertaining all of the facts.” (*Id.*, at p. 966.) “Even if the plaintiff discovers some suspicious circumstances, his reliance is reasonable if the defendant allays his doubts with further assurances.” (*Ibid.*)

When the issue of reasonable reliance is a close one, defendant’s discovery will delve into the sophistication of the plaintiff. (See CACI 1908.) Discovery will also focus on the circumstances surrounding the transaction, including the available evidence at the time of the transaction, assistance of other professionals, the amount being paid for what was received, etc. These issues usually take center stage at trial.

In addition, the misrepresentation or concealed fact does not need to be the only reason why the plaintiff acted. “[I]t is well settled that the alleged fraud need not be the sole cause of a party’s reliance.” (*Sangster v. Paethau* (1998) 68 Cal.App.4th 151, 170.) Rather, all that needs to be shown is that the misrepresentation or concealed fact substantially influenced plaintiff’s choice, even if it was not the only reason for his conduct. (CACI 1907.) In fact a “presumption, or at least an inference, of reliance arises wherever there is a showing that a



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misrepresentation was material.” (*Engalla v. Permanente Medical Group, Inc.*, 15 Cal.4th at p. 977.)

On the issues of reliance and causation, expect a slew of discovery regarding the reasons why someone entered into the contract. Obviously, people are motivated to enter into a contract for a whole host of reasons. What is important to establish is that the misrepresented or concealed fact was material or substantial enough to warrant a finding of causation.

### Is rescission required?

The majority of fraud cases arise from contract. The issue always faced is whether a party must rescind the contract and seek restitution or affirm the contract and sue for fraud damages. First off, the plaintiff is allowed to make the election. (*Campbell v. Birch* (1942) 19 Cal.2d 778, 791.) Second, as a practical matter, the party may be forced to have to elect to affirm the contract and seek damages. For instance, an improvement made to your real property or business requires you, as a practical matter, to pursue damages. It would make little sense for instance, unless the job improvement was done in a manner that requires it to be torn out and redone, to rescind a roofing job if the fraud was centered on false bills for material and labor, but the job was otherwise adequate. This issue is one that needs to be addressed very early in the case.

### Damages

California courts have recognized two measures of damages in fraud related cases: the “out-of-pocket” measure and the “benefit-of-the-bargain” measure. The “out-of-pocket” measure of damages is directed at restoring plaintiffs to the financial position that they enjoyed before the fraudulent transfer. (*Stout v. Turney* (1978) 22 Cal.3d 718, 725.) The “benefit-of-the-bargain” measure is concerned with satisfying the expectancy interest of defrauded plaintiffs by putting them in the position they would have enjoyed had

the false representation been true. (*Alliance Mortgage Co. v. Rothwell* (1995) 10 Cal.4th 1226, 1240.)

The “benefit-of-the-bargain” measure applies general tort damages. Civil Code section 3333 provides for an “amount which will compensate for all the detriment proximately caused thereby, whether it could have been anticipated or not.” (Civ.Code, §3333.) Furthermore, the “benefit-of-the-bargain” rule has been viewed as an effective deterrent measure of damages, especially in cases of fraud. “Unlike the ‘out-of-pocket’ measure of damages, which are usually calculated at the time of the transaction, ‘benefit-of-the-bargain’ damages may be appropriately calculated as of the date of discovery of the fraud.” (*Salahuddin v. Valley of California, Inc.* (1994) 24 Cal.App.4th 555, 568.)

The “benefit-of-the-bargain” measure of damages is concerned with satisfying the expectancy interest of the defrauded plaintiff by putting him in the position he would have enjoyed if the false representation relied upon had been true. (*Stout*, 22 Cal.3d at p. 725.) The “benefit-of-the-bargain” awards the difference in value between what the plaintiff actually received and what he was fraudulently led to believe he would receive. In fact, the “benefit-of-the-bargain” rule “contemplates an award even when the property received has a value equal to what was given for it.” (*Stout*, 22 Cal.3d at p. 725.) For this reason, courts have considered it a more effective deterrent to fraud.

Where a fiduciary is involved, an award of damages under Civil Code section 3343 is much more expansive than the “out-of-pocket” standard. (See *Salahuddin*, supra, 24 Cal.App.4th at p. 565.) In fact, application of the “benefit-of-the-bargain” measure of damages may be the just remedy in cases of fraud. Where there is a fiduciary involved, it benefits the plaintiff in both the issue of reliance (it is reasonable to rely on a fiduciary) and damages (more expansive approach to damages).

The “out-of-pocket” measure of damages is straightforward. It ultimately allows recovery of any monies that were spent as a direct result of the fraud. The “benefit-of-the-bargain” measure allows a more creative approach to damages. It allows you to argue a measure of damages which is the difference of what the plaintiff expected to get and what he or she actually received because of the fraud. It is always important before you get anywhere near trial that you decide which of these two measures of damages you will seek as the two can vary widely based on the circumstances of the case. Hiring experts early in these types of cases may be warranted.

### Inconsistent findings on the verdict form

One issue that always seems to arise is the conflict of proof in an intentional misrepresentation/concealment claim versus a negligent misrepresentation claim. Inevitably (unless there was some form of waiver under contract), when one makes a claim for an intentional fraud, a negligent misrepresentation claim is also asserted. The trouble arises with the element requiring evidence that the defendant knew that the representation was false when it was made (intentional fraud) versus that the defendant may have honestly believed that the representation was true but had no reasonable grounds for believing it to be so (negligent misrepresentation). You can see that the difference in the two is the issue of the defendant’s state of mind. In the intentional-fraud context, the defendant knew that the statement made was false. In the negligent-representation claim, although the defendant may have believed the statement to be true, there was no reasonable basis to make it. If the jury makes a finding that both states of mind existed, you have a contradictory finding and created a hornet’s nest of problems on appeal.

A solution to this problem that my office has employed is two-fold. First, we



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spend a considerable amount of time during closing argument explaining the differences between these two elements in the differing claims. While displaying the actual jury instructions, we argue that it is either one or the other, hopefully having enough circumstantial evidence to prove the intentional conduct.

Second, my office has employed a practice of placing the questions related to the intentional-fraud claim before the negligent-misrepresentation claim in the verdict form. We place a transition instruction after the intentional-fraud claim, after the damages question, which instructs the jury to skip the negligent-misrepresentation claim entirely. We understand that doing this waives our ability to raise issues on appeal related to the negligent-misrepresentation claim, but by doing so, we avoid the all too common problem of having inconsistent findings

by the jury related to the defendant's state of mind.

### Conclusion

In no way does this article attempt to become the reference guide for fraud cases. A comprehensive analysis on this topic could fill a book. The hope here is to provide enough information to serve as a starter for more trial lawyers to take up these cases. It is the author's belief that by taking up more of these cases, it will aid in re-establishing the profession of law as a noble profession. Not only does prosecuting these cases bring an individual justice, but it also serves a societal function of holding those who prey on the vulnerable accountable under the law. There are not too many out there (except for the extreme fringes of the Chamber of Commerce) who believe that fraud on children, families and the elderly are

positive actions and that prosecuting such cases is the equivalent of "ambulance chasing." These cases tend to have the jury bias going in the plaintiff's direction and based on my own anecdotal research (whatever that's worth), most folks believe that these cases should be prosecuted.



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