LEGAL AND ETHICS: THE LETTER AND SPIRIT OF THE LAW
PROVING DAMAGES SUFFERED IN A FRAUD CASE

In both securities and property cases, unique elements must be shown and linked to the actual damages. Merely showing there were damages and there was fraud is not enough to convince the courts that the damages suffered were a result of the fraud and, thus, recoverable from the defendant. This session will analyze what is necessary in a civil case to prove or disprove damages caused by fraud.

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Mr. Summerford is a nationally recognized expert in the areas of fraud and forensic accounting. He testifies as an expert witness in federal and state courts on matters involving complicated financial transactions.

He served a three-year term as Vice Chairman of the Board of Regents for the Association of Certified Fraud Examiners, is a past Chairman of its Professional Standards and Practices Committee, and is a past Chairman of its Board of Review. Mr. Summerford was recognized by the ACFE with the 2010 Cressey Award. The Cressey Award is the ACFE’s highest honor, which recognizes a lifetime of achievement in the detection and deterrence of fraud.

He is a guest lecturer at seminars, colleges, and universities. He travels extensively to teach fraud examination courses for the ACFE.

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### Legal Principles

**Proximate Cause**

1. Principle—recoverable damages limited to those caused by the wrong is a basic and established tort law principle.
2. Causal connection between the fraud and the harm claimed is generally required.
3. Proximate cause test
   - A. Test—fraud must be a direct and proximate cause of the loss.
   - B. Without a test for proximate cause, courts would be left adrift in determining amount to award.
4. Two-Part Analysis—Restatement of Torts
   - A. Fraudulent misrepresentation subject for pecuniary loss if reliance is substantial factor in course of conduct that results in loss.
   - B. A fraudulent misrepresentation is a legal cause of a pecuniary loss resulting from action or inaction in reliance upon it, but only if loss might reasonably be expected to result from the reliance.

**Transaction and Loss Causation Required**

1. Transaction causation is "But For" causation: “but for” the fraud or misrepresentation, the person would have never entered into the transaction and suffered loss.
2. Loss causation present when defrauded person suffers. Loss causation is a murky subject with inconsistent results. Loss, however, must be tied to the fraud to sustain the loss.
3. Federal courts require both; most states (not all) follow.

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1 Unless otherwise noted, the material herein is based on the author’s experience and on the treatise *Recovery of Damages for Fraud*, Robert L. Dunn, Lawpress Corp., 3rd Ed. 2004 and respective supplements.
### PROVING DAMAGES SUFFERED IN A FRAUD CASE

1. Transaction causation alone is sufficient in some states.
2. Once causation is proved plaintiff can get losses.
3. Uncertainty as to amount of damages does not bar recovery.

#### Foreseeability
1. Case law occasionally states that recovery of consequential damages is limited to those damages that were within the contemplation of the parties or foreseeable to them at the time of the misrepresentation.
2. There appear to be no cases where the result turned on a finding that consequential damages that were proximately caused were unforeseeable and thus not recoverable by the defrauded party.
3. Some cases expressly do not make foreseeability a limitation on recoverable consequential damages.

#### Reasonable Certainty
1. Multiple cases establish that damages for fraud, like other tort damages, must be proven with reasonable certainty.

#### Economic Loss Rule
1. The “Economic Loss” rule states that recovery of economic loss unaccompanied by property damage or personal injury is not recoverable in an action alleging negligence or strict liability in the manufacture of a product.
2. Some cases in a few states have held that the economic loss rule bars recovery of damages for fraud or misrepresentation. *Check your jurisdiction.*
Measure of Damages for Fraud

**Majority Rule: “Benefit of the Bargain” (“BoB”)**

1. Defrauded purchaser of property recovers difference in actual value and represented value.
   
   A. Case Example: *Damon v. Sun Co.*, 87 F.3d 1467 (1st Cir. 1996) (Damages on claim of fraud in sale of contaminated gasoline service station properly measured by difference between value of service station if it was uncontaminated and actual value of service station as contaminated).

**Minority—“Out-of-Pocket Loss”**

1. Defrauded purchaser limited to the difference between the value of what was given and the value of what was actually received.

2. Applied consistently in the following states: CA, DC, MN, MT, NY, PA (HI has no rule).

   A. Case Example: *Strouth v. Wilkinson*, 224 N.W. 2d 511 (Minn. 1974) (Plaintiffs hired contractor to build house for $38,000. Contractor abandoned project due to significant rock blasting requirement, leaving the plaintiff with a house valued at $12,000 for which plaintiffs had paid $25,293. Plaintiffs hired another contractor to finish house, paying $54,007 and ending up with a house worth $48,000 for which they spent $79,300. Court found that out-of-pocket rule limited recovery to $31,300 – the difference between the amount expended by Plaintiffs ($79,300) and the reasonable value of the house ($48,000). Interestingly, Plaintiffs were denied additional “benefit of the bargain” recovery of the difference between the contract price of $38,000 and the value of the completed house of $48,000).
Consequential Damages Under Benefit of Bargain and Out-of-Pocket Loss Approaches

A. Consequential damages are allowed in addition to BoB and out-of-pocket damages (although, there are some limitations, discussed below) in out-of-pocket states.
   1. Consequential damages are recoverable damages that are proximately caused by reliance on a misrepresentation.
   2. Includes damages and/or expenditures proximately caused by reliance on misrepresentation which would not otherwise have been incurred.

B. Lost Earnings
   1. Lost earnings are generally considered a compensable element of consequential damages and are recoverable in BoB and out-of-pocket jurisdictions.

C. Lost Profits
   1. Lost profits damages generally recoverable in BoB states but not recoverable in out-of-pocket loss states.
      A. Case Example: AFA Protective Systems, Inc. v. American Telephone & Telegraph Co., 57 N.Y.2d 912 (NY 1982) (In affirming dismissal of a complaint insofar as it alleged lost profits from fraud, the court stated “As for damages, the rule in this state is that all elements of profit are excluded from a computation of damages in an action grounded in fraud” [citations omitted]).
      2. In out-of-pocket loss states, plaintiffs generally only recover the consideration paid. However, in some instances courts in out-of-pocket states have approved recovery of lost profits, reasoning that the Restatement (Second) of Torts §552B (1976) does not preclude an award for lost profits where the plaintiff can show justifiable reliance on the
negligent misrepresentation and prove the amount of lost profits with reasonable certainty.

D. Operating Losses and Expenses
1. Recoverable in a variety of circumstances in an action for damages for fraud.
   A. Damages to property as a result of the fraud.
   B. Operating losses from the sale of a business involving a defrauded buyer.
   C. Expenses for the purchase of inventory, equipment, rent, and compensation for time and effort where a plaintiff was fraudulently induced to enter into a lease of a service station.

E. Emotional Distress
1. Courts sharply divided
   A. Courts denying recovery often state that it is a result of the “black letter law.”
   B. Courts allowing recovery often do so without analysis with the exception being a terminated employee recovering emotional distress damages for fraud.

F. Expense of Investigation
1. When the question has been presented, the courts have held that the cost of investigation of the opportunity to purchase property or a business, later found to be tainted by misrepresentations by the seller, may be recovered as consequential damages.

G. Attorney’s Fees and Litigation Expenses
1. The general rule (“the American Rule”) is that attorney fees, litigation expenses, and settlement costs are not recoverable in an action for fraud absent a special statute or agreement.
2. Exceptions to non-recovery of attorney fees and litigation expenses:
   A. Tort of Another—When the fraud puts a plaintiff in the position that he must prosecute or defend other litigation, judgments sustained and
### PROVING DAMAGES SUFFERED IN A FRAUD CASE

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<th>attorney fees incurred are recoverable against the defendant whose fraud caused the loss.</th>
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<td><strong>B. Other Grounds</strong>—Despite the “American Rule” courts sometimes award attorney fees for prosecution of plaintiff’s claims as damages in fraud cases; for example, a creditor has been awarded attorney fees incurred in proceedings to obtain payment of debt through enforcement of a garnishment summons. <em>Advantor Capital Corp. v. Yeary</em>, 136 F.3d 1259 (10th Cir. 1998). Also, attorney fees and litigation costs have been awarded where a party has instituted or prolonged litigation through bad faith or obstinate, unjust, vexatious, wanton, or oppressive conduct. <em>Wilko of Nashua, Inc. v. TAP Realty, Inc.</em>, 379 A.2d 798 (N.H. 1977).</td>
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<td><strong>C. Costs of Settlement</strong>—In some instances courts have held costs of settlements necessitated by the fraud are recoverable.</td>
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<td><strong>D. Attorney’s Fees and Costs incurred without litigation</strong>—Attorney fees and costs may be recoverable consequential damages in a fraud action even though actual litigation did not result from the fraud.</td>
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<td><strong>E. Damage to Reputation</strong>—Damage to reputation has occasionally been held recoverable in a fraud action.</td>
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<td><strong>3. Interest and Financing Costs</strong></td>
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<td><strong>A. Interest and financing costs on the transaction at issue are generally held recoverable in an action for fraud.</strong></td>
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<td><strong>H. Damage to Reputation</strong></td>
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<td><strong>1. Generally recoverable in fraud cases.</strong></td>
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### NOTES
Measure of Damages in Other Circumstances

A. Fraud damages in specific circumstances are beyond the scope of this presentation. However, be aware that there may be state-specific requirements for damages in particular types of cases, such as construction, financing, leases, employment, and other areas.

Computation of Damages

A. Offsets

1. A plaintiff in a fraud action for the purchase of property has two options: (1) affirm the contract, retain the property, and recover the BoB or out-of-pocket loss, or (2) rescind the contract, return the property, and recover the consideration paid.

2. A plaintiff who elects to affirm the contract must pay the amounts due under it and if they are unpaid, they are an offset against plaintiff’s fraud damages.

   A. Case example: Baeza v. Robert E. Lee Chrysler, Plymouth, Dodge, Inc., 309 S.E.2d 763 (S.C. App. 1983) (Plaintiff who purchased a truck from dealership later discovered that a prior accident had been concealed from him. Plaintiff failed to either return the truck or make his payments. On appeal, court held that plaintiff had clearly affirmed the transaction by keeping the truck but was seeking damage for the fraud. If plaintiff proved his damage, he was required to offset the unpaid balance of the purchase price against the damage award.)

B. Date Measured

1. Valuation at date of sale. BoB and out-of-pocket seek to measure the damages by comparing values on the date of the sale of the property; that is, the valuation must be at the date of the transaction at issue.
2. Occasionally, valuation near the date of sale has been considered adequate. This is typically when the value of the property will not change much over a short period of time.

3. Damage is rarely measured at date of discovery of the fraud.

C. Tax Treatment
   1. Most cases hold that tax benefits or adverse tax consequences are irrelevant to computation of damages on fraud claims.
      A. However, the U.S. Supreme Court, in Randall v. Lofstgaard, 478 U.S. 647 (1986) considered the issue of tax offsets in a securities fraud case but did not decisively answer the question. The Court did state “…we do not consider whether courts may ever refuse to allow a rescissionary recovery under §10(b) where the “premium” for expected tax benefits represented a large portion of the purchase price, in which event the out-of-pocket measure might yield a significantly smaller recovery.”

D. Who Pays
   1. A corporate agent who is personally involved in the commission of fraud can be liable for compensatory and punitive damages, even though the agent was acting on behalf of the corporation and the corporation is also liable.

E. Evidence
   1. BoB States
      A. Plaintiff must offer evidence of the value of the property received in comparison to the value as represented.
   
   2. Out-of-pocket States
      A. Plaintiff is required to offer evidence of the value of the property received in comparison to the price paid.
### PROVING DAMAGES SUFFERED IN A FRAUD CASE

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<th>F. Expert Testimony</th>
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<td>1. Expert witness testimony is universally held admissible on the question of valuation of property in fraud cases.</td>
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<th>G. Price paid as evidence of value</th>
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<td>1. Occasionally, in BoB jurisdictions, a purchaser will put in evidence as to the purchase price and no other evidence as to the value as represented. Most courts hold that evidence of the purchase price is sufficient to establish the value of the property as represented with no other evidence being necessary.</td>
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<th>H. Owner’s Testimony</th>
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<td>1. The owner may testify as an expert to the value of property in a fraud case.</td>
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<th>I. Cut-Off Date</th>
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<td>1. Normally fraud damages cut off at date the fraud is discovered.</td>
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<td>2. Once the fraud is discovered, continued reliance is usually not reasonable.</td>
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<td>3. Continuing commercial relationship can extend fraud damages period.</td>
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<td>A. Only extended for a “reasonable period.”</td>
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<td>B. Facts and circumstances determine what a reasonable period is. Typically only occurs where immediate termination of a business relationship (due to the discovery of the fraud) will result in economic waste or is not feasible.</td>
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<td>C. Case Example: <em>Clements Auto Co. v. Service Bureau Corp.</em>, 444 F.2d 169 (8th Cir. 1971) (Action for damages claiming fraud arising from the sale of an electronic data processing system. Court found that there had been a fraudulent misrepresentation concerning whether the system would provide effective inventory control. At the trial-court level, damages had been cut off closer to the time of...</td>
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discovering the fraud. The Appeals Court overturned the early cutoff, stating the following principle, “...it is clear that a party to an executory contract, who prior to its performance discovers fraud, may not go forward with performance of the contract and subsequently sue for damages. The exception to the above principle is that where the defrauded party discovers the fraud after substantial performance or where it would be economically unreasonable to terminate the relationship, he may affirm or continue the contract and then bring suit for his entire damages.”) [citations omitted].

J. No double recovery

1. Significant, complex analysis required to determine if there is a double recovery.

   A. Case example: Ostanzo Commerzanstalt v. Telewide Systems, Inc., 880 F.2d 642 (2nd Cir. 1989) (Action by a licensee alleging breach of contract and fraud by the licensor. Court stated that the plaintiff cannot recover both benefit of the bargain damages for breach of contract and warranty and out-of-pocket expenses for fraud. Such a double recovery would put them in a better position than they would have been if the contract had been satisfactorily performed.)

   B. Case example: Brown v. Richards, 840 P.2d 143 (Utah App. 1992) (Case alleging misrepresentations in sale of corporate stock. Court held that the purchaser could not retain ownership of the stock for the amount already paid and receive fraud damages. Here, the original purchase price was $900,000. The jury awarded the purchaser $500,000 in fraud damages. The damages are credited against the
### Nominal Damages
A. Nominal damages are an award of a trifling sum, often where plaintiff’s evidence fails to show the amount of loss (absence of proof of compensatory damages).
B. Split in authority
   1. Many texts and older cases state that nominal damages are not recoverable in fraud actions.
   2. A substantial number of more recent cases hold that nominal damages are recoverable in fraud cases.
C. Important because nominal damages show a definition judicial declaration that a wrong has occurred even though no compensatory damages are awarded.
D. In most jurisdictions, nominal damages support an award of punitive damages even in the absence of compensatory damages.

### Punitive Damages
A. Generally recoverable in all states except CT, LA, MA, MI, NE, NH, WA.
B. Level of culpability required
   1. The level of culpability required varies significantly from state to state. For example, New York (which is an out-of-pocket state) imposes a stricter test for an award of punitive damages than simply proof of the fraud, while North Carolina allows punitive damages in any fraud case.
   2. Some states only require that a fraud be proven to be capable of supporting a punitive damage award.
   3. Some states require higher level of culpability to support punitive damages (NY).
C. Same standard as fraud
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<td><strong>PROVING DAMAGES SUFFERED IN A FRAUD CASE</strong></td>
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<td>1. States that require a similar or the same standard as fraud usually define the standard as “willful” or “without regard for plaintiff’s rights,” which is essentially the same as the standard for fraud. In other words, if the fraud is proven, then punitive damages may be awarded.</td>
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<td><strong>D. Lesser standard than fraud</strong></td>
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<td>1. States that require a lesser standard than fraud, often referred to as “fraudulent breach of contract” or “breach of a contract accompanied by a fraudulent act” (Usually found in contract cases where the courts find some elements of fraud present—not consistently applied).</td>
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<td><strong>E. Higher standard than fraud</strong></td>
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<td>1. Some courts hold that an award of punitive damages requires a higher standard of culpability than simply proof of fraud. The cases are not always clear what additional element(s) is required, although a showing of malice or reckless indifference will typically suffice.</td>
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<td><strong>A. Case Example:</strong> Higher standard met: <em>Sessums v. Northtown Limousines, Inc.</em>, 664 So. 2d 164 (Miss. 1995) <em>(Conduct in turning back odometer of used vehicle together with other misrepresentations regarding mileage and ownership of vehicle justified award of punitive damages.)</em></td>
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<td><strong>B. Case Example:</strong> Higher standard not met: <em>Jukan v. Friedman</em>, 646 A.2d 1112 (N.J. 1994) <em>(Judgment debtor’s actions in transferring assets and otherwise interfering with judgment creditor’s efforts to collect on judgment do not support an award of punitive damages.)</em></td>
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