New York Court of Appeals Elucidates the Requirement of Pleading Damages in a Fraudulent Inducement Case

On March 2, 2017, the New York Court of Appeals ruled, in a 5-0 decision, that in order to successfully allege fraudulent inducement, the plaintiff must clearly allege actual out-of-pocket loss. The Court clarified that allegations of lost opportunity, potential loss of reputation, and potential to incur litigation expenses are too speculative to permit recovery for fraudulent inducement. The Court also clarified that nominal damages are not available when actual harm is an element of the tort and, thus, because actual harm is an element of fraudulent inducement, a plaintiff claiming fraudulent inducement is not entitled to nominal damages.[1]

I. Background

British television chef Kyle Connaughton, the Plaintiff-Appellee, was hired by Defendant-Appellants, Chipotle Mexican Grill ("Chipotle") and Chipotle's Chief Executive Officer, Steven Ells, in 2011 to develop a chain of ramen-style restaurants similar to Chipotle's national chain of Mexican grills. Defendants hired Connaughton after learning that he was already in the process of developing a concept for a ramen restaurant chain. The employment agreement between Connaughton and Chipotle expressly provided that Connaughton's employment was at-will and that both parties had the right to terminate the contract at any time without notice or cause. The agreement further detailed Connaughton's compensation, which included an annual salary, monthly car and housing allowances, and eligibility for a merit bonus, increased salary, and a defined number of shares in Chipotle stock that would vest based on years of uninterrupted employment.

Throughout 2011, Connaughton engaged in development work on the ramen concept for Chipotle. In February 2012, Connaughton received his first annual review from Ells where he received his full bonus and was purportedly given entirely positive feedback.[2] In the subsequent months, Connaughton continued developing the ramen concept by approving a lease for a potential flagship ramen location, developing proprietary ramen service equipment, sampling and preparing foods, and meeting with potential new hires.

In October 2012, Connaughton, along with Chipotle's Chief Marketing Officer ("CMO"), attended a dinner at Momofuku Noodle Bar to taste food and meet the outgoing head chef whom Connaughton had proposed as a possible hire in the development of the ramen concept. During dinner, Chipotle's CMO confided in Connaughton that Chipotle would not hire any former Momofuku employees and that Momofuku would sue Chipotle when the ramen concept opened. Chipotle's CMO explained that Ells had previously signed a still-in-effect non-disclosure agreement ("NDA") with Momofuku owner and chef David Chang to design a similar ramen chain concept, but that project fell apart when Chang and Ells failed to agree on financial terms. When Connaughton confronted Ells about the NDA, Ells told him to continue to work on the ramen restaurant, but Connaughton refused. Soon thereafter, Ells fired Connaughton.

Connaughton filed suit against Chipotle and Ells in the summer of 2013 for fraudulent inducement. Connaughton, who did not learn of Ells' agreement with Chang prior to the October 2012 dinner, claimed that by virtue of his reasonable reliance on Ells' omissions about the arrangement with Chang, Defendants fraudulently induced him to work for Chipotle and share his restaurant concept to his detriment. Connaughton alleged that he would not have entered into the agreement with Defendants – and thus would not have stopped pursuing other

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[1] *Connaughton* v. *Chipotle Mexican Grill, Inc.*, 2017 N.Y. Slip Op. 03445, 2017 WL 1553000 (May 2, 2017), available at http://courts.state.ny.us/ctapps/Decisions/2017/May17/46opn17-Decision.pdf (the "Opinion").

[2] Complaint at ¶ 32, *Connaughton* v. *Chipotle Mexican Grill, Inc.*, No. 155106 (June 3, 2013), available at https://dlbjbjzgnk95t.cloudfront.net/0447000/447066/Chipotle.pdf.

investors potentially interested his ramen chain concept – had he known about the prior business arrangement. He further asserted that the ideas the Chipotle staff attributed to his design for the restaurant concept actually belonged to Chang, and that using those ideas to launch the ramen concept project would subject Connaughton to legal action. Plaintiff claimed that he was "damaged in an amount to be determined at trial, including, but not limited to, the value of his Chipotle equity and lost business opportunities in connection with his ramen concept."[3] He requested compensatory and punitive damages in amounts to be determined at trial, as well as attorney's fees and disbursements.

In the New York Supreme Court and, subsequently, the First Department, Defendants sought to dismiss the fraudulent inducement claim.[4] Defendants argued that any agreement or relationship it had with Chang could not be the basis for a fraud claim when Connaughton's allegations failed to outline any affirmative misrepresentations by Chipotle that meet the state's heightened pleading standards for fraud. In the lower courts, Defendants successfully claimed that Chipotle had no fiduciary relationship with Connaughton that required it to disclose its alleged dealings with Chang, as Connaughton was an at-will employee. Defendants further successfully argued that Connaughton's allegation that he "lost business opportunities" because of the undisclosed Chang deal was not a specific enough injury to sustain the fraud claim.[5]

II. The New York Court of Appeals Decision

On May 2, 2017, the New York Court of Appeals affirmed the First Department's decision. In so doing, the Court of Appeals espoused the "out-of-pocket" rule.[6] Under that rule, "[d]amages are to be calculated to compensate plaintiffs for what they lost because of the fraud, not to compensate them for what they might have gained. . . . [T]here can be no recovery of profits which would have been realized in the absence of fraud."[7]

According to the Court, that Plaintiff stopped soliciting potential investors in reliance on defendants' fraudulent omissions was insufficient to satisfy this rule. Such an allegation, the Court explained, asserts a lost opportunity, which is too speculative to amount to a recoverable out-of-pocket loss. The Court clarified that for Plaintiff to have been successful in his fraudulent inducement claim, he would have needed to allege that in stopping his soliciting, he actually rejected another prospective buyer's offer to purchase his concept.[8]

Similarly, the Court found that Plaintiff's allegations that he might incur litigation expenses and potential loss of reputation if named in a civil action by Chang were too speculative to amount to a claim of actual out-of-pocket loss. In so finding, the Court noted that Plaintiff "did not assert or provide facts from which it could be inferred that he lost standing within the restaurant industry, or that he is unemployable as a result of his association with Chipotle."[9]

Finally, the Court ruled that Plaintiff was not entitled to nominal damages. The Court explained that "while nominal damages are typically available in a contracts case to vindicate a party's contractual rights,

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[3] Opinion at *4.

[4] *See Connaughton* v. *Chipotle Mexican Grill, Inc.*, 23 N.Y.S.3d 216 (N.Y. App. Div. 2016), *aff'd*, 2017 WL 1553000 (N.Y. May 2, 2017).

[5] *Id.* at 218.

[6] Opinion at *7.

[7] *Id.* (citations omitted).

[8] *Id.* at *7–8.

[9] *Id.* at *8.

nominal damages are only available in tort actions to 'protect an important technical right'" and they are not available "when actual harm is an element of the tort."[10] Because "actual harm is an element of fraudulent inducement," the Court found that Plaintiff was not entitled to nominal damages.[11]

III. Significance of the Decision

The *Chipotle* decision clarifies that claims for fraudulent inducement in New York must include allegations of actual damages. The opinion reinforces the rigidity inherent in the "out-of-pocket" rule. Accordingly, a plaintiff will not be successful in pleading fraudulent inducement on the basis of speculative damages.

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Charles A. Gilman at 212.701.3403 or cgilman@cahill.com; Bradley J. Bondi at 202.862.8910 or bbondi@cahill.com; Kimberly Petillo-Décossard at 212.701.3265 or kpetillo-decossard@cahill.com; John Schuster at 212.701.3323 or jschuster@cahill.com; or Nicole Ligon at 212.701.3372 or nligon@cahill.com.

[10] *Id.* at *9 (citation omitted).

[11] *Id.*