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Brief of Amicus Curiae Gregory Klass in Support of Plaintiff-Appellee

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BMC Software, Inc., v. International Business Machines Corporation, U.S. Court of Appeals, Fifth Circuit, No. 22-20463.

No. 22-20463

IN THE UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

BMC SOFTWARE, INC.,

Plaintiff-Appellee,

v.

INTERNATIONAL BUSINESS MACHINES CORPORATION,

Defendant-Appellant.

On Appeal from the United States District Court for
the Southern District of Texas, No. 4:17-cv-2254,
The Honorable Gray H. Miller

BRIEF OF AMICUS CURIAE GREGORY KLASS IN SUPPORT OF PLAINTIFF-APPELLEE

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SUPPLEMENTAL STATEMENT OF INTERESTED PERSONS

No. 22-20463

BMC SOFTWARE, INC.,

Plaintiff-Appellee,

v.

INTERNATIONAL BUSINESS MACHINES CORPORATION,

Defendant-Appellant.

Pursuant to Fifth Circuit Rule 29.2, I hereby supplement the Certificates of Interested Persons provided in the briefs of Defendant-Appellant and Plaintiff-Appellee and the Supplemental Statements of Interested Persons filed by Amici Curiae by adding my name as person who has an interest in the outcome of this litigation:

Gregory Klass
Amicus curiae

I certify that I have no financial interest in the outcome of the above-styled appeal and no further supplementation to make to the Certificates of Interested Persons or the Supplemental Statements of Interested Persons. These representations are made in order that the Judges of this Court may evaluate possible disqualification or recusal.

Dated: April 17, 2023

/s/ Gregory Klass
Gregory Klass

Amicus curiae

TABLE OF CONTENTS

Page

TABLE OF AUTHORITIES

Page(s)

Cases

Rules

Restatements

Other Authorities

INTEREST OF AMICUS CURIAE[1]

I am the Frederick J. Haas Chair in Law and Philosophy at Georgetown University Law Center, where I have been teaching as a contracts law professor since 2005. I am currently the Associate Dean for External Programs and was previously the Associate Dean of Research and Academic Programs at Georgetown Law. I have also taught as a Visiting Professor at the University of Freiburg and Tel Aviv University. Before joining the Georgetown Law Faculty, I served as Assistant Solicitor General for the Office of the New York State Attorney General and, prior to that, I clerked for the Honorable Guido Calabresi of the United States Court of Appeals for the Second Circuit. I hold a J.D. from Yale Law School.

I have no pecuniary interest in the outcome of this case. Nor do I have a relationship with either of the parties or their counsel. The subject matter of this case interests me because it involves the intersection of contract law and contract-related fraud, a subject to which I have devoted a considerable amount of study and scholarship over the course of my career. My sole interest in submitting this brief is sharing my knowledge regarding this subject, and ensuring that, consistent with the District Court's analysis here, courts continue to apply contract law in tandem with

[1] The parties consent to the filing of this brief. Fed. R. App. P. 29(a)(2). No party's counsel authored this brief in whole or in part, and no party, party's counsel, or person other than me contributed money that was intended to fund preparing or submitting this brief. Fed. R. App. P. 29(a)(4)(E).

the law relating to fraud in a manner that advances the interests of contracting parties and society at large. *See generally* Robin West, NORMATIVE JURISPRUDENCE: AN INTRODUCTION (2011) (arguing that a distinctive feature of legal scholarship is that it seeks not only to understand law, but also to make it better).

In my view, the District Court correctly ruled that a contracting party must be allowed to pursue tort remedies, including exemplary damages, against a counterparty who fraudulently induced it to enter the contract, notwithstanding contractual limitations on liability. To my knowledge, that is the law of New York and is widely accepted throughout the United States. The availability of tort remedies in cases of fraud is essential to deterring fraud, promoting commerce, and ensuring that contracting decisions are the product of voluntary choice. Allowing commercial parties to contractually insulate themselves from liability for fraud and to limit their exposure to contractual remedies when there has been fraud in the inducement would reward deceptive practices, erode confidence in the marketplace, and create inefficiencies in the contractual bargaining process.

BACKGROUND

The facts as found by the District Court nicely illustrate the tort of promissory fraud, which occurs when one party fraudulently induces another to enter a contract by falsely representing its intention to perform.

According to the District Court, Appellee BMC develops and licenses software for mainframe computers, and AT&T was an important BMC customer. ROA.8390, 8394. Like a number of BMC's customers, AT&T used Appellant IBM as an "IT outsourcer" to service its mainframe, including the BMC software installed on it. ROA.8392–96.

To service BMC software on customers' mainframes, IBM needed a license from BMC that authorized IBM to access and use the software. ROA.8396–8402. On March 31, 2008, IBM and BMC entered into a Master Licensing Agreement ("MLA") that set forth general terms regarding IBM's licensing of BMC's software. ROA.8396–97. At the same time, IBM and BMC entered into an Outsourcing Attachment ("OA") that granted IBM the rights it would need to service BMC software on joint customers' mainframes. ROA.8389, 8403.

Because IBM, in addition to performing services as an IT outsourcer, produces and sells mainframe software that directly competes with BMC software, BMC sought to prevent IBM from "displacing" BMC software with IBM software on BMC customers' mainframes. *See* ROA.8393–94, 8397–8400, 8403.

Accordingly, the OA gave IBM a choice. It could "access and use" at no cost the software license that joint customers had already purchased from BMC, subject to the proviso that IBM not "displace any BMC Customer Licenses with [IBM] products" on those customers' mainframes. ROA.8400. Alternatively, IBM could purchase its own software license from BMC at a contractually-defined price, in which case IBM was permitted to displace BMC software with IBM software. ROA.8401. The District Court determined that the OA was unambiguous in offering these two distinct options and cited extrinsic evidence indicating that IBM actually understood the OA to work accordingly. ROA.8387, 8426. When it performed IT outsourcing work on AT&T's mainframe, IBM selected the first option, electing to access and use BMC customers' software licenses at no cost subject to abiding by the non-displacement provision. ROA.8442.

In 2013, IBM and BMC negotiated a new OA (the "2013 OA"). ROA.8404–06. During the 2013 OA negotiations, IBM proposed to BMC that the parties alter the non-displacement provision from the original OA to permit IBM to fulfill "IBM customer requests with regard to any decision to discontinue or displace as determined by the IBM customer." ROA.8406. BMC refused, and the executed 2013 OA contained a materially unmodified non-displacement provision. ROA.8404–05. According to the IBM employee responsible for managing IBM's relationship with BMC, IBM did not push the displacement issue because securing

a modified non-displacement provision would have cost IBM "a lot more money." ROA.8397, 8406.

In 2015, BMC and IBM commenced negotiations of a new amended OA (the "2015 OA"). ROA.8415. The District Court found that, to induce BMC to enter into the 2015 OA, IBM promised not to displace BMC software with IBM software on AT&T's mainframe, despite IBM's plan to do just that. ROA.8471–72.

As found by the District Court, in April 2013, AT&T and IBM began to explore the prospect of replacing BMC software with IBM software on the AT&T mainframe. ROA.8408. Both IBM and AT&T agreed to keep the plans for this displacement confidential. ROA.8409. Though talks between IBM and AT&T stalled in March 2014, they resumed in February 2015. ROA.8411–12. On June 26, 2015, unbeknownst to BMC, IBM executed a definitive agreement with AT&T to replace BMC software with IBM software on the AT&T mainframe. ROA.8414, 8481. IBM never disclosed this fact to BMC during the parties' negotiations of the 2015 OA. ROA.8476, 8481.

Instead, according to the District Court, while negotiating the 2015 OA, IBM actively concealed from BMC its intention to displace BMC software with IBM software on the AT&T mainframe without paying BMC the contractually required licensing fee. ROA.8473–76. In negotiations, IBM initially pushed BMC to delete the OA's non-displacement provision. ROA.8417. BMC refused. ROA.8417. IBM

then renewed its prior request for a non-displacement provision that would permit IBM to displace BMC software with IBM software provided the displacement was at a BMC customer's initiative. ROA.8417. BMC again refused. ROA.8417. Finally, the parties discussed applying the non-displacement provision only to a defined list of BMC customers, and IBM advocated that AT&T be removed from the list. ROA.8418. IBM's lead negotiator testified that, when he requested the removal of AT&T, he also requested the removal of three other BMC customers "as a negotiating tactic" so that "the focus wouldn't be just on AT&T," though it was only AT&T that IBM needed to remove from the scope of the non-displacement provision. ROA.8418–19. Because AT&T was an important customer, BMC refused, insisting that AT&T remain subject to the non-displacement provision. ROA.8419–20.

On September 30, 2015, BMC and IBM executed the 2015 OA, which retained the non-displacement provision from the 2008 and 2013 OAs but limited its application to a defined set of 54 BMC customers that included AT&T. ROA.8389, 8400, 8422. IBM entered into the 2015 OA even though it had already committed to AT&T that it would displace BMC software with IBM software on the AT&T mainframe, a fact it concealed from BMC. ROA.8473–76. When agreeing to the 2015 OA, BMC believed it had successfully protected its relationship with AT&T. *See* ROA.8480–81. As to IBM, its lead negotiator testified that it understood when

entering into the 2015 OA that it was going to violate the non-displacement provision as it related to AT&T but discussed internally the fact that prior disputes with BMC had "always settled for a small percent of [BMC's] claim." ROA.8415–16, 8420.

After later learning that IBM was displacing multiple BMC software products on the AT&T mainframe, BMC sued IBM for breach of the 2015 OA, as well as for fraudulent inducement in connection with the 2015 OA. ROA.8388. In response, IBM invoked, *inter alia*, the MLA's limitations on damages and liability. ROA.8448. One such provision, a "Disclaimer of Damages" (Section 9), states that, with certain exceptions, neither party is "liable for any special, indirect, incidental, punitive or consequential damages relating to or arising out of" the MLA and related products and services. ROA.8398. Another, titled "Limits on Liability" (Section 10), provides that, with similar exceptions, "[e]ach party's liability arising out of or related to" the MLA and related products is limited "to the greater of $5,000,000 or the amount paid or payable by [IBM] for the license to the applicable product giving rising to [a] claim." ROA.8398.

The District Court held that "BMC's successful fraudulent inducement claim is sufficient under New York law for the suspension of" these contractual limitations. ROA.8484.

ARGUMENT

Given its finding that IBM committed promissory fraud, the District Court was correct in awarding BMC tort remedies, including exemplary damages, notwithstanding the liability and damage limitation clauses in the MLA. Ensuring the availability of such remedies in the exceptional cases that involve promissory fraud is essential for the proper functioning of contract law.

On appeal, IBM argues that, notwithstanding the District Court's finding of promissory fraud by IBM, the limitations on liability and damages in MLA Sections 9 and 10 should limit BMC's recovery in recognition of the "freedom of contract." IBM Br. 54–56. In addition, Amicus Curiae the Chamber of Commerce of the United States of America (the "Chamber") expresses general concerns about the "tortification" of contract law and advocates for a "strong presumption against allowing a plaintiff in a contract dispute to recover in tort." CC Br. 1, 3.

For the reasons outlined below, IBM misstates the applicable law as it relates to promissory fraud. The Chamber's observations, while not entirely erroneous, are largely beside the point because all forms of fraudulent inducement, including promissory fraud, present unique remedial concerns. Indeed, the Chamber acknowledges that fraudulent inducement, as found by the District Court, is an "exception[]" to its theory of contract-related remedies. *See id.* at 3–4.

I. THE AVAILABILITY OF TORT REMEDIES, INCLUDING EXEMPLARY DAMAGES, IS NECESSARY TO DETER FRAUD AND PROMOTE EFFICIENT AND VOLUNTARY EXCHANGES

The availability of tort remedies, including exemplary damages, in cases involving promissory fraud is an essential piece of any contract law that seeks to promote efficient and voluntary commercial transactions. Ensuring the availability of tort remedies keeps contracting parties honest and encourages reliance on the parties' respective promises to perform. Limiting liability for promissory fraud to contract-based remedies, which often do not fully compensate the non-breaching party, would reward promissory fraud, erode confidence in the marketplace, discourage good faith reliance on parties' contract-related representations, and increase the cost and burdens of contractual bargaining. The way to deter promissory fraud *ex ante* is to permit fraud victims to recover more than standard contract remedies allow *ex post.*

A. Victims Of Fraudulent Inducement Are Entitled To Tort Remedies, Including Exemplary Damages

Our law generally supplies tort remedies designed to deter fraud in the inducement, including promissory fraud. When a party intentionally or recklessly makes a misrepresentation to its counterparty during contract formation, that party is liable in tort and is subject to tort remedies, including exemplary damages. Restatement (Third) of Torts: Liability for Economic Harm § 9 & cmt. b; Restatement (Second) of Torts § 908. As then-Judge Fuld explained:

> Exemplary damages are more likely to serve their desired purpose of deterring similar conduct in a fraud case . . . than in any other area of tort. . . . A judgment simply for compensatory damages would require the offender to do no more than return the money which he had taken from the plaintiff. In the calculation of his expected profits, the wrongdoer is likely to allow for a certain amount of money which will have to be returned to those victims who object too vigorously, and he will be perfectly content to bear the additional cost of litigation as the price for continuing his illicit business. It stands to reason that the chances of deterring him are materially increased by subjecting him to the payment of punitive damages.

Walker v. Sheldon, 10 N.Y.2d 401, 406 (1961); *see also Ben. Personnel Servs. v. Rey*, 927 S.W.2d 157, 172 (Tex. App. – El Paso [8th Dist.] 1996, case dism'd) (explaining necessity of exemplary damages to deter defendants).

Courts have long recognized that a promise to perform under a contract includes an implied representation to the promisee that the promisor presently intends to perform. Restatement (Second) of Torts § 530 cmt. c ("[A] promise necessarily carries with it the implied assertion of an intention to perform."); Restatement (Second) of Contracts § 171(2); Ian Ayres & Gregory Klass, INSINCERE PROMISES: THE LAW OF MISREPRESENTED INTENT 8–12 (2005). This representation of a present intention to perform can be false like any other, and when it is false at the time of contracting and the other elements of fraud are satisfied, it supports an action in tort for promissory fraud. Restatement (Third) of Torts: Liability for Economic Harm § 15 (citing Ayres & Klass, *supra*); *Formosa Plastics Corp. USA v. Presidio Eng'rs & Contractors, Inc.*, 960 S.W.2d 41, 47 (Tex. 1998) ("[A]

promise to do an act in the future is actionable fraud when made with the intention, design and purpose of deceiving, and with no intention of performing the act." (citation omitted)). As in other actions for fraud, the remedies for promissory fraud include both compensatory and exemplary damages. *Clarence Bev., Inc. v. BRL Hardy (USA) Inc.*, 2000 U.S. Dist. LEXIS 1665, at *19 (W.D.N.Y. Feb. 8, 2000); *Myers v. Walker*, 61 S.W.3d 722, 731–32 (Tex. App. – Eastland [11th Dist.] 2001, pet. denied).

B. The Availability Of Tort Remedies In Cases Of Promissory Fraud Promotes Efficiency By Fostering A More Honest Marketplace

Ensuring the availability of tort remedies for fraudulent inducement, including promissory fraud, enhances market efficiency by addressing uncertainty about a contractual counterparty's intent at the time of formation to perform its side of a deal.[2] Honest exchanges of information in bargaining facilitate commerce. To know whether a proposed exchange is in its interest, a party must know something about the performance the other side is offering. A collector considering whether to purchase a piece of art wants to know if its authenticity is in doubt. A company

[2] Unlike the civil law, the common law imposes no duty of good faith in negotiations. Similarly, although contract formation gives rise to a duty of good faith, that duty is relatively thin. Good faith requires that parties not exploit the contract in ways not understood at the time of formation. It does not include duties of care or loyalty, as, for example, fiduciary obligations do. *See Mkt. Street Assocs. v. Frey*, 941 F.2d 588, 595 (7th Cir. 1991) (Posner, J.); Daniel Markovits, *Good Faith as Contract's Core Value*, *in* THE PHILOSOPHICAL FOUNDATIONS OF CONTRACT LAW 276–78 (G. Klass et al. eds., 2014).

considering an acquisition wants to understand the target firm's assets and liabilities. And because contractual remedies often fail to fully compensate, parties almost always want to know whether the other side intends to perform. Honest representations about such matters—that the painting is authentic, that the balance sheet is accurate, that one intends to perform—allow the other party to assess whether the proposed exchange is value-creating. If parties are able to intentionally deceive their counterparties during contract formation without the aggrieved party having adequate means of redress, the incidence of fraud will increase, trust in the marketplace will be eroded, parties will anticipate a lower probability of satisfactory performance under contracts, and fewer value-creating exchanges will occur.

The availability of contractual remedies alone does not adequately deter fraudulent inducement. Contracting parties appreciate that contractual remedies, particularly if limited in the contract, may not fully compensate an aggrieved party for the breaching party's nonperformance. Pursuing recovery of contractual damages can be expensive, uncertain, and incomplete. For many parties, the costs of detecting and litigating breach deter efficient transactions or prevent the parties from ever bringing a suit. *See* Daniel A. Farber, *Reassessing the Economic Efficiency of Compensatory Damages for Breach of Contract*, 66 VA. L. REV. 1443, 1448–64 (1980). Even contractual nonperformance that is observable by both parties might, due to lack of evidence or factfinder error, be impossible to verify in

court. Lisa Bernstein, *Merchant Law in a Merchant Court: Rethinking the Code's Search for Immanent Business Norms*, 144 U. PA. L. REV. 1765, 1791–94 (1996). And limits on recovery in contract for losses that might have been avoided, that were not foreseeable, that are speculative, that are nonpecuniary, or that exceed contractual damages limitations all tend to depress contract awards below full compensation. *See* George M. Cohen, *The Fault Lines in Contract Damages*, 80 VA. L. REV. 1225, 1229 (1994). In short, many breaching parties never fully internalize the costs of their breaches. Gregory Klass, *Efficient Breach*, *in* THE PHILOSOPHICAL FOUNDATIONS OF CONTRACT LAW, *supra*, at 362, 368–69.

Left unchecked, the threat of dishonesty by a counterparty and the incompleteness of the remedies for breach have the tendency to depress prices, reduce trade, and erode trust in the marketplace. Buyers pay less for unreliable promises; legitimate sellers who might be willing to incur the cost of performance exit the market rather than receive the buyers' discounted price; and their exit leaves behind only sellers whose promises are even less reliable. *See* George A. Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q.J. ECON. 488 (1970). This dynamic explains why, in the late eighteenth and early nineteenth centuries, it was the business community that led the move away from *caveat emptor*. Businesses recognized that pervasive distrust in the market was acting as a drag on economic activity. *See* Edward J. Balleisen,

FRAUD: AN AMERICAN HISTORY FROM BARNUM TO MADOFF 174–207 (2017). The availability of tort remedies, including exemplary damages, for fraudulent inducement helps to correct this dynamic by creating further assurance of fraud-free contractual bargaining.

C. The Availability Of Tort Remedies For Fraudulent Inducement Promotes Voluntary Contractual Bargaining

Imposing tort liability for fraudulent inducement also helps to ensure that parties' contracting decisions are voluntary. A lie about an intention to perform under the contract during contract formation is a form of manipulation. When the lie succeeds, the deceived party's agreement to the transaction is not fully voluntary; it has been caused by the other side's deception. Accordingly, far from threatening the "norm that individuals should be able to agree between and among themselves how to allocate resources," CC Br. 13 (quoting William Powers, Jr., *Border Wars*, 72 TEX. L. REV. 1209, 1211 (1994)), tort liability for fraudulent inducement protects that norm by deterring the use of deception to secure an agreement from the deceived party that would not otherwise have been obtained.[3] As the Restatement explains:

> Claims for fraud rarely cause [] interference [with contractual allocations of risk] because parties to a contract do not usually treat the chance that they are lying to each other as a risk for their contract to allocate. . . . Liability in tort for fraud thus helps to protect the integrity

[3] Indeed, the late Professor Powers acknowledged that contract law may give way to tort law when needed to promote contract law's goal of voluntary exchange. Powers, *supra*, at 1224.

> of the contractual process and sometimes furnishes useful remedies that the law of contract does not as readily provide.

Restatement (Third) of Torts: Liability for Economic Harm § 9 cmt. a.

II. A DEFRAUDED PARTY IS NOT BOUND BY CONTRACTUAL LIMITATIONS ON LIABILITY AND DAMAGES

Like other rules that ensure that contracting is voluntary, the availability of tort remedies for promissory fraud and other forms of fraudulent inducement is mandatory and cannot be contracted away. Consider the most fundamental rule of contract formation: each party must agree to the exchange. Restatement (Second) of Contracts § 17(1). Parties do not have the power to contract out of the agreement requirement, or of associated doctrines designed to ensure that agreement was sufficiently voluntary. The law has no interest in enforcing apparent agreements against a party whose choice was compromised. These formation rules protect parties against contractual obligations they have not freely chosen.

This abstract point can be illustrated with some familiar examples. Although an offeror typically has the power to specify what counts as acceptance of their offer, an offeror generally cannot treat silence as acceptance. *Id.* §§ 30, 58 & 69. The reason is that the offeree's silence is rarely sufficient evidence of their agreement to the deal. *See Albrecht Chem. Co. v. Anderson Trading Corp.*, 298 N.Y. 437, 440 (1949). This mandatory limit on an offeror's power protects offerees from contractual obligations they did not in fact agree to.

For the same reason, the procedural contract defenses—capacity, mistake, misrepresentation, duress, undue influence—are also mandatory rules. These defenses ensure that contracting parties had the capacity to make a reasoned decision (the rules for infants, persons under guardianship, intoxicated persons), that their agreement was not based on a fundamental mistake of fact (mistake, misrepresentation), and that their choice was not manipulated or forced by another (misrepresentation, duress, undue influence). This is also why the victim of fraud is almost always free to offer extrinsic evidence relevant to the fraud despite a contractual merger clause. *Sabo v. Delman*, 3 N.Y.2d 155, 162 (1957); Restatement (Second) of Contracts §§ 214(d) & (e). The parties generally do not have the power to exclude evidence that one side's assent was compromised.

In the same vein, the law does not give a defrauding party the power to contract out of tort liability for fraud in the inducement, including promissory fraud. Restatement (Second) of Contracts §§ 195 & 196. When a party's agreement has been fraudulently induced, that party's choice was compromised. Moreover, as explained in Point I, by promoting honesty during contract formation, tort liability for fraudulent inducement deters bad actors from fraud that would undermine efficient markets. Parties lack the power to defeat society's interest in having a market in which transactions are freely chosen and value-creating.

New York courts have recognized that tort liability for fraudulent inducement plays an essential, non-waivable role in ensuring voluntary and efficient exchange by declining to enforce contractual clauses that seek to exculpate parties from liability for fraud. The New York Court of Appeals has explained that "an exculpatory agreement, no matter how flat and unqualified its terms," will "not apply to [exculpate] willful or grossly negligent acts." *Kalisch-Jarcho, Inc. v. City of New York*, 58 N.Y.2d 377, 384–85 (1983); *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Wise Metals Grp., LLC*, 19 A.D.3d 273, 275 (1st Dep't 2005) (limitation of liability "subject to defeasance" as a result of fraudulent inducement); *Simon-Whelan v. Andy Warhol Found. for the Visual Arts*, 2009 U.S. Dist. LEXIS 44242, at *13–14 (S.D.N.Y. May 26, 2009) (similar); *Great N. Assocs. v. Cont'l Cas. Co.*, 192 A.D.2d 976, 978 (3d Dep't 1993) (sustaining fraud claim despite a general release based on allegations that defendant misrepresented its intent to enter a long-term relationship in order to gain access to plaintiff's confidential information). New York courts have similarly refused to read generic damage limitations clauses as applying to fraudulent inducement. *Sear-Brown Grp. v. Jay Builders, Inc.*, 244 A.D.2d 966, 967 (4th Dep't 1997).

Nor have New York courts empowered contracting parties to do indirectly what they cannot do directly. Just as parties do not have the power to contract out of liability for fraud in the inducement, they lack the power to contract out of the

remedies that attach to such fraudulent conduct. *Air China, Ltd. v. Kopf*, 473 F. App'x 45, 49 (2d Cir. 2012).

Finally, even where a party sues for breach of contract rather than fraud, New York courts have found that evidence of conduct akin to fraudulent inducement prevents the breaching party from enforcing a contractual limitation on damages or liability. For example, in *Deutsche Bank Nat'l Tr. Co. v. Morgan Stanley Mortg. Cap. Holdings*, 289 F. Supp. 3d 484, 499 (S.D.N.Y. 2018), the defendant allegedly entered an agreement to transfer loans into a residential mortgage-backed securities pool knowing that many loans would materially breach representations and warranties. The court denied defendant summary judgment under a sole remedy provision, emphasizing that the allegedly "pervasive[]" breach "ab initio" suggested that the defendant entered the agreement intending to breach, which would render the limitation of liability provision unenforceable. *Id.* at 500–01; *see also Horowitz v. Nat'l Gas & Elec., LLC*, 2018 U.S. Dist. LEXIS 163285, at *23 (S.D.N.Y. Sept. 24, 2018) (denying motion to dismiss notwithstanding a limitation of liability provision where defendant-buyer allegedly agreed to keep a company private when, in fact, it intended to take it public).[4]

[4] New York courts have also held that wrongful conduct *after* contract formation can render a liability or damages limitation clause unenforceable. *See, e.g.*, *Graphic Scanning Corp. v. Citibank, N. A.*, 116 A.D.2d 22, 26 (1st Dep't 1986) (finding that "Citibank's repudiation of the agreement in order to substitute its own system for plaintiff's at a time when it did not have the right to cancel" was "willful

III. THE FACTS OF THIS CASE ILLUSTRATE THE NEED FOR TORT REMEDIES IN CASES OF FRAUD AS A COMPLEMENT TO CONTRACT LAW

The District Court's findings illustrate the incentives that sometimes produce promissory fraud and the role of tort liability in correcting them. The District Court found that during negotiations of the 2015 OA, IBM intended both to displace BMC's software with its own on AT&T's mainframe and to not pay BMC the contractually agreed-upon fee for doing so. ROA.8431, 8473–75. IBM did not communicate this intent to BMC while it was negotiating the 2015 OA with BMC. ROA.8476, 8481. Instead, IBM took steps to hide its plans to displace. When IBM sought to exclude AT&T from the reach of its non-displacement obligation, it added to the request three other accounts "to conceal the importance of AT&T to IBM's overall business goals." ROA.8418–19. Asked why it sought to exclude those accounts, IBM's negotiator did not answer, but "diverted." ROA.8418; *see Laidlaw v. Organ*, 15 U.S. 178, 195 (1817) (Marshall, J.) (where buyer remained silent in

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conduct" rendering unenforceable a limitation of liability clause); *IS Chrystie Mgmt. LLC v. ADP, LLC*, 205 A.D.3d 418, 419 (1st Dep't 2022) (finding that misrepresentations during the course of performance could render damages limitation unenforceable); *Tyrek Heights Erectors, Inc. v. WDF, Inc.*, 178 A.D.3d 631, 631–32 (1st Dep't 2019) (refusing to enforce no-delay damages clause where there was a triable issue of fact as to whether the defendant willfully interfered with plaintiff's timely performance of its subcontracts); *Audthan LLC v. Nick & Duke, LLC*, 211 A.D.3d 419, 421 (1st Dep't 2022) (finding that landlord's alleged refusal to resolve dispute with housing agency could render exculpatory clause unenforceable against tenant who could not build without resolution).

response to seller's question, though there was no duty to disclose, "each party must take care not to say or do any thing tending to impose upon the other").

Why would IBM misrepresent to BMC its intent not to perform its obligations under the non-displacement provision of the 2015 OA? With hindsight, IBM suggests it would be odd for it to "'fraudulently induce[]' BMC to enter [into a] sweetheart deal" that resulted in hundreds of millions of dollars in liability. IBM Br. 19. But the District Court's findings provide reasons to think IBM made a calculated bet that it could fraudulently induce BMC to enter the 2015 OA and not have to pay the bill when it came due. For example, in an email to IBM's negotiator, an IBM Vice President wrote that "[o]ver the last 5 years, we have had numerous global claims from BMC, Microsoft and others claiming hundreds of millions and have always settled for a small percent of the claim." ROA.8415; *see also* ROA.8416 (IBM negotiator writing that IBM generally expected disputes with firms including BMC to settle for "pennies on the dollar"). And, of course, IBM was ready to excuse its fraudulent conduct with its alternative interpretation of "displace," an interpretation that the District Court held was unambiguously incorrect, and one that was contrary to the meaning that BMC and IBM—in internal communications—assigned to the term. ROA.8387, 8424–28, 8480–81.

That IBM's bet turned out to be wrong is not a reason to excuse IBM from liability in tort for its fraud. In a different world—especially one in which tort

remedies were unavailable—BMC might have been deterred by the cost of prosecuting this lawsuit, the parties might have settled for "pennies on the dollar," or a court might have agreed with IBM's self-serving interpretation of the parties' contracts. In any of those possible worlds, IBM's bet would have paid off. The facts found by the District Court therefore illustrate the broader point: the only way to deter fraud *ex ante* is to provide more than recovery in contract *ex post*.

Accordingly, IBM is confused when it criticizes the "oddity of layering a fraudulent-inducement claim on top of a *successful* breach-of-contract claim." IBM Br. 20 (emphasis in original). It is only because meritorious breach of contract claims are so often unsuccessful or incompletely compensatory that parties engage in promissory fraud. When fraud is discovered, it is essential that the defendant pay more than compensation in contract. Without such a rule, it remains a good bet for the bad actor who enters a contract planning to breach to misrepresent their intent to perform.[5]

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[5] Jonathan Swift recognized something like this dynamic and used it to explain why the Lilliputians punished fraud with death:

> They look upon fraud as a greater crime than theft, and therefore seldom fail to punish it with death; for they allege, that care and vigilance, with a very common understanding, may preserve a man's goods from thieves, but honesty has no defense against superior cunning; and, since it is necessary that there should be a perpetual intercourse of buying and selling, and dealing upon credit, where fraud is permitted and connived at, or has no law to punish it, the honest dealer is always undone, and the knave gets the advantage.

IBM's further contention that the District Court's refusal to enforce the "freely negotiated" liability and damages limitation provisions in Sections 9 and 10 of the MLA was somehow an attack on its freedom of contract again gets things backwards. *Id.* at 25. As New York Courts have recognized, freedom of contract requires that parties *not* have the power to contract out of liability for fraud in the inducement, the remedies that attach to it, or the misrepresentation defense, which together protect party choice. These well-established rules deter misrepresentations during contract formation and protect parties, like BMC, who rely on such misrepresentations by giving them the power to affirm or reject contracts to which they did not originally agree.

IV. APPLYING FAULT-BASED REMEDIES IN FRAUD-BASED CONTRACT DISPUTES IS CONSISTENT WITH THE COMPLEMENTARY ROLES OF CONTRACT AND TORT LAW

In its amicus brief, the Chamber raises concerns about the "tortification" of contract law and argues for a "strong presumption against allowing a plaintiff in a contract dispute to recover in tort." CC Br. 1, 3. Because the Chamber omits any

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Jonathan Swift, GULLIVER'S TRAVELS 48–49 (A. Case ed., 1938) (1726). As with many of Swift's writings, the satirical elements (imposing the death penalty for fraud) are attached to a truth about social reality (the need to punish fraud with more than compensation).

meaningful discussion on the subject of fraud, its brief tells less than half the story with regard to the relationship between tort and contract.

Given the salutary—and limited—role of tort liability in deterring fraudulent inducement and promoting free and efficient markets, "tortification" of contract is in this case a boogeyman. In the 1970s and 1980s, some academics predicted and advocated expanded reliance-based tort liability between contracting parties at the expense of freedom of contract. *See* Grant Gilmore, THE DEATH OF CONTRACT (1st ed. 1974); P.S. Atiyah, PROMISES, MORALS, AND LAW (1981). To my knowledge, no scholar today adopts that position, and I know of no evidence the common law decisions have moved or are moving in that direction.[6] *See* Randy E. Barnett, *The Death of Reliance*, 46 J. LEGAL EDUC. 518, 520–21 (1996) (describing the lack of academic uptake of Gilmore's theory); Alan Schwartz & Robert E. Scott, *Precontractual Liability and Preliminary Agreements*, 120 HARV. L. REV. 661, 673 (2007) (finding based on random sample of 105 judicial decisions involving precontractual reliance no movement toward reliance-based precontractual liability); Paul MacMahon, *Reliance*, *in* RESEARCH HANDBOOK ON THE PHILOSOPHY OF CONTRACT LAW 1 (Mindy Chen-Wishart & Prince Saprai eds., forthcoming 2023),

[6] The only scholarship the Chamber cites for the tortification of contract law is a short talk by a Manhattan Institute fellow given in the early 1990s. CC Br. 8 (quoting Walter Olsen, *Tortification of Contract Law: Displacing Consent and Agreement*, 77 CORNELL L. REV. 1043 (1992)).

available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4361814 (describing the demise of reliance theories of contract).

Moreover, and critically, the District Court here did not impose liability in tort for IBM's breach of contract. It applied tort remedies for the separate wrong of fraudulent inducement. ROA.8451–52.

It is true that were liability in tort, including exemplary damages, commonly imposed for mere breach of contract, it might impede economic activity and threaten freedom of contract. This is why it is so important that tort liability be limited to *fraudulent* misrepresentations at the time of contract formation, such as a promisor's knowing misrepresentation of its intent to perform. Because such fraudulent acts never add value to a deal, the law does not price them but penalizes them. This fault requirement protects parties who innocently or even negligently make a material misrepresentation during negotiations from exemplary damages, while at the same time deterring the more serious wrong of fraudulent inducement.

Rules that turn on fault are not foreign to contract law. Pursuant to a range of established contract law doctrines, courts impose more costly contractual remedies on parties who committed more serious contractual wrongs. Accordingly, the Chamber is wrong to suggest that fault-based remedies have a minimal role in contract law. CC Br. 2–3, 5–6.

Like many contracts professors, I teach my 1Ls on the first day of class that liability in contract is strict whereas liability in tort often requires a showing of fault. This difference explains why the plaintiff in *Sullivan v. O'Connor*, 296 N.E.2d 183, 184 (Mass. 1973), could lose her malpractice claim against a plastic surgeon yet win on her breach of contract claim. *See also Trans Caribbean Airways, Inc. v. Lockheed Aircraft Serv.-Int'l*, 14 A.D.2d 749, 749 (1st Dep't 1961) (nonperformance may be a breach of contract but alone is generally not tortious). But that is only the first day of class. Over the course of the semester, students learn that though fault is not among the elements of breach of contract, it often plays a central role in determining the proper remedies for a contractual wrong. *See generally* Cohen, *Fault Lines*, *supra*; George M. Cohen, *The Fault That Lies Within Our Contract Law*, 107 MICH. L. REV. 1445, 1452–59 (2009).

Examples are manifold. In *Jacob & Youngs, Inc. v. Kent*, 230 N.Y. 239, 243 (1921), then-Judge Cardozo held that to determine whether a breach is material, thereby discharging the non-breaching party's duty to perform, a court should look, *inter alia*, to the breaching party's "excuse for deviation from the letter" of the agreement. *See also* Restatement (Second) of Contracts § 241(e) (materiality of breach depends on "standards of good faith and fair dealing"). Under this rule, a party's willful breach might discharge the non-breaching party's duty to perform where an unintentional breach might not, even though the costs of their

nonperformance to the breaching party might be disproportionate to the losses caused by the breach. *See, e.g.*, *Bullinger v. Interboro Brewing Co.*, 194 A.D. 205, 209–10 (2d Dep't 1920) (small purchases of third-party beer in violation of exclusive purchase agreement were material breach where breach was intentional).

Similarly, many courts have treated the willfulness of defective performance as reason to award the cost to repair a breach, rather than the diminution in value caused by the performance, though the former is again often out of proportion to the latter. *See, e.g.*, *Groves v. John Wunder Co.*, 286 N.W. 235, 236 (Minn. 1939), *approved by Am. Standard, Inc. v. Schectman*, 80 A.D.2d 318, 323–25 (4th Dep't 1981).

Other contract doctrines in which fault plays a role include unilateral mistake (the defense exists if the non-mistaken party was at fault for the mistake, *Barclay Arms, Inc. v. Barclay Arms Assocs.*, 74 N.Y.2d 644, 646 (1989)), the public policy defense (restitution might be available if the parties were not *in pari delicto*, *Smith v. Pope*, 422 N.Y.S.2d 192, 193 (4th Dep't 1979)), and the rules for reformation of overly broad non-compete clauses (where overreach is willful, the clause will be deleted to deter future bad actors, *Data Mgmt. v. Green*, 757 P.2d 62, 64–65 (Alaska 1988); *Long Island Minimally Invasive Surgery, P.C. v. St. John's Episcopal Hosp.*, 164 A.D.3d 575, 578 (2d Dep't 2018); Restatement (Second) of Contracts § 184(2)).

In all these examples, courts vary contractual remedies based on fault. Doing so removes a sword of Damocles from above the heads of parties who act honestly and in good faith. A party who does not seek to exploit the other side faces only limited legal liability for breach or other contractual missteps. Fault requirements isolate those contractual wrongs that should be deterred *tout court* and those parties who will be sensitive to such deterrence. The very same logic explains why tort liability for misrepresentations during contract formation exists and is appropriate when those misrepresentations constitute *fraudulent* inducement.

CONCLUSION

For the foregoing reasons, the Court should affirm the judgment of the District Court.

Dated: April 17, 2023

Respectfully Submitted

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CERTIFICATE OF SERVICE

I hereby certify that on April 17, 2023, I served the foregoing Brief of Amicus Curiae Gregory Klass in Support of Plaintiff-Appellee on counsel of record and transmitted it to the Clerk of Court *via* the CM/ECF system.

Dated: April 17, 2023

/s/ Gregory Klass
Gregory Klass

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CERTIFICATE OF COMPLIANCE

This Brief of Amicus Curiae Gregory Klass in Support of Plaintiff-Appellee complies with:

1. The type-volume limitations of Fed. R. App. P. 29(a)(5) because, excluding those portions exempted by Fed. R. App. P. 32(f) and Cir. R. 32.2, it contains 6,453 words; and

2. The typeface requirements of Fed. R. App. P. 32(a)(5) and the type-style requirements of Fed. R. App. P. 32(a)(6) because it has been prepared in a proportionally-spaced 14-point Times New Roman typeface.

Dated: April 17, 2023

/s/ Gregory Klass
Gregory Klass

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CERTIFICATE OF CONFERENCE

I hereby certify that I conferred with counsel for the parties and that the parties consent to the filing of the foregoing Brief of Amicus Curiae Gregory Klass in Support of Plaintiff-Appellee.

Dated: April 17, 2023

/s/ Gregory Klass
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