No. 20170591-SC

IN THE
SUPREME COURT OF THE STATE OF UTAH

HEALTHBANC INTERNATIONAL, LLC, a New Hampshire limited liability company, BERNARD FELDMAN, an individual,
Plaintiffs,
v.
SYNERGY WORLDWIDE, INC., a Utah corporation, and NATURE'S SUNSHINE PRODUCTS, INCORPORATED, a Utah corporation,
Defendants.

RESPONSIVE BRIEF OF DEFENDANTS / COUNTERCLAIM PLAINTIFF

On certified question of law from the United States District Court for the District of Utah, Honorable Jill N. Parrish, Case No. 2:16-cv-00135

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SUMMARY OF THE ARGUMENT

Synergy Worldwide Inc. and Nature's Sunshine Products, Inc. respectfully urge this Court to find that the economic loss doctrine does not bar a claim for fraud-in-the-inducement of a contract. As discussed in our opening brief, fraud-in-the-inducement is a recognized exception to the economic loss rule because it is an intentional tort that occurs prior to the formation of any contract, which arises from an independent duty – namely, the duty to be honest and to candidly disclose facts basic to the transaction. Numerous Utah federal and state court decisions have recognized fraud as an exception to the economic loss rule, and this Court should adopt their reasoned analysis.

Although Healthbanc International, LLC ("Healthbanc") has correctly outlined the history of the economic loss rule in its opening brief, it errs in its legal analysis of the United States District Court's certified question. In particular, Healthbanc relies primarily upon cases in which a party has alleged only negligence – not intentional misconduct that induced the very formation of the contract in the first instance. Healthbanc also relies upon parol evidence cases, which simply are not applicable to this claim. Accordingly, Healthbanc's collection of cases do not meaningfully assist the Court in analyzing the defendant's duty when fraud-in-the-inducement has been alleged.

Moreover, contract law does not adequately protect parties who have been defrauded into entering into a contractual relationship as Healthbanc contends. Although Healthbanc correctly notes that contract law is designed to allocate risk among consenting parties, it ignores the fact that defrauded parties would have never entered into the contractual relationship in the absence of a defendant's intentional misconduct. Thus, the traditional policies that protect contracting parties are not present in a fraud-in-the-inducement case, as the unknowing party is prevented from understanding the true facts and information needed to fairly negotiate its risk, duties, and protections.

Finally, Healthbanc's application of these legal principles to the underlying case is flawed. Contrary to Healthbanc's assertions, Synergy's alternative claim for fraud-in-the-inducement is not based upon a representation and warranty provision in the parties' contract, but instead, is based upon a series of pre-contractual misrepresentations that were made by both Healthbanc and its principal, Bernard Feldman, prior to the formulation of the contract. The trial court correctly recognized the factual differences between Synergy's claim for fraud-in-the-inducement (which alleges a breach of a common law tort duty) and Healthbanc's claim for "fraud-in-the-performance" (which was based solely upon duties originating in the contract). Accordingly, Healthbanc's attempt to reframe the certified question and its criticisms of the trial court's prior rulings do not contribute to this Court's analysis of the economic loss doctrine.

For these reasons, Synergy and Nature's Sunshine submit that the Court should answer the United States District Court's certified question in the negative, because fraud-in-the-inducement is an intentional tort that arises out of the breach of an independent duty.

ARGUMENT

In its opening brief, Healthbanc makes four arguments: (1) that the economic loss rule prevents any suit in tort when there is a contract pertaining to the "subject matter" of the suit; (2) that exempting misrepresentation claims would "weaken bedrock contract concepts"; (3) that contract law provides an adequate remedy; and (4) that the economic loss doctrine applies equally and protects both parties in the context of this case. See Healthbanc Opening Brief at 12, 18, 21, 22. Each of these arguments is flawed in one or more respects.

I. The Economic Loss Rule Does Not Prevent a Suit for Intentional Misconduct Committed Prior to the Formation of the Contract.

Healthbanc broadly argues in its opening brief that the economic loss rule prevents any suit in tort when there is a contract pertaining to the "subject matter" of the suit. See Healthbanc Opening Brief at 12. This argument is incorrect for multiple reasons.

To begin with, Healthbanc's blanket statement proves too much. If the only issue the Court must decide to determine whether the economic loss rule applies is whether a contract relates to the subject matter of the dispute, then there could never be a claim for fraud-in-the-inducement of a contract under Utah law, as procurement of a contract is an element of the claim. In other words, there will always be a contract "covering the subject matter of the dispute" in a case alleging fraud-in-the-inducement because the plaintiff's entire claim is based upon the fraudulent procurement of the contract. Thus, if Healthbanc's general statement is adopted as the rule of law, then this Court would essentially be doing away with the tort. This would require this Court to revisit numerous prior decisions that acknowledge fraud-in-the inducement as a viable claim.[1] Synergy and Nature's Sunshine respectfully submit that this is not the current state of Utah law.

[1] See, e.g., Motter v. Bateman, 423 P.2d 153 (Utah 1967); Giusti v. Sterling Wentworth Corp., 2009 UT 2, ¶¶ 52–63, 201 P.3d 966; Keith v. Mt. Resorts Dev., L.L.C., 2014 UT 32, ¶¶ 40–43, 337 P.3d 213.

More importantly, Healthbanc's brief overstates this Court's prior holdings. Although it is true that "[t]he economic loss rule prevents recovery of economic damages under a theory of nonintentional tort when a contract covers the subject matter of the dispute," this rule does not appear to have been extended to intentional torts as Healthbanc advocates. See Reighard v. Yates, 2012 UT 45, ¶ 20 (emphasis added). To the contrary, this Court has previously recognized that a plaintiff "may recover purely economic losses in cases involving intentional torts such as fraud, business disparagement, and intentional interference with contract." SME Industries v. Thompson, Ventulett, Stainback and Associates, Inc., 2001 UT 54, ¶ 32 n.8, 28 P.3d 669 (citing American Towers Owners Assn's Inc. v. CCI. Mech., Inc., 930 P.2d 1182, 1190 n.11 (Utah 1996)). Likewise, the very case that prompted certification of this matter, Donner v. Nicklaus, noted that "[t]he economic loss doctrine does not affect . . . claims involving intentional misrepresentations." 778 F.3d 857, 876 n.9 (10th Cir. 2015) (citing SME Industries, 2001 UT 54, ¶ 32 n.8).

The primary case that Healthbanc relies on for its proposition, Reighard v. Yates, only alleged claims for negligence, as opposed to fraud or other intentional misconduct. See 2012 UT 45, ¶ 6 (acknowledging that plaintiff's claims were for negligent misrepresentation, negligence, and breach of contract). This same case further recognized that the economic loss rule would not apply to a tort claim that was based upon an independent duty of care, stating:

> The independent duty principle is a means of measuring the reach of the economic loss rule. When a duty exists that does not overlap with those contemplated in a contract, "the economic loss rule does not bar a tort claim

> 'because the claim is based on a recognized independent duty of care and thus does not fall within the scope of the rule.'"

Id. ¶ 21 (quoting Hermansen v. Tasulis, 2002 UT 52, ¶ 17) (quoting Town of Alma v. Azco Constr., Inc., 10 P.3d 1256, 1263 (Colo. 2000)).

In other contexts, this Court has distinguished between intentional and negligent misconduct, and has expressed its willingness to find that an independent duty exists when a defendant commits an intentional act. See B.R. v. West, 2012 UT 11, ¶ 7, 275 P.3d 228. For example, this Court has previously held:

> The long-recognized distinction between acts and omissions—or misfeasance and nonfeasance—makes a critical difference and is perhaps the most fundamental factor courts consider when evaluating duty. Acts of misfeasance or "active misconduct working positive injury to others," typically carry a duty of care. Nonfeasance—"passive inaction, a failure to take positive steps to benefit others, or to protect them from harm not created by any wrongful act of the defendant"—by contrast, generally implicates a duty only in case of special relationship.

Id. (citing Francis H. Bohlen, The Moral Duty to Aid Others as a Basis of Tort Liability, 56 U. Pa. L. Rev. 217, 219).[2] The Utah legislature has also codified this same distinction with regard to construction contracts, by providing that the presence of a contract does not prevent a person from simultaneously bringing a claim "based on an intentional or willful breach of duty existing in law." See Utah Code Ann. § 78B-4-513.

[2] The West decision identified five factors that courts should consider in determining whether a defendant owes a duty to a plaintiff: "(1) whether the defendant's allegedly tortious conduct consists of an affirmative act or merely an omission . . . ; (2) the legal relationship of the parties . . . ; (3) the foreseeability of injury . . . ; (4) public policy as to which party can best bear the loss occasioned by the injury . . . ; and (5) other general policy considerations." Id. ¶ 5 (internal citations omitted).

The cases cited in Synergy and Nature's Sunshine's opening brief acknowledge this critical distinction and have correctly concluded that the economic loss doctrine does not bar tort claims that are based upon intentional misrepresentations, because the wrongful conduct precedes the formation of the contract and arises out of the breach of an independent duty of care – namely, the duty to be honest in commercial dealings and to truthfully represent facts basic to the transaction.[3] This Court should adopt those reasoned decisions.

II. Healthbanc's Parol Evidence Cases Do Not Meaningfully Assist the Court in Analyzing a Fraud-in-the-Inducement Claim.

In its opening brief, Healthbanc argues that this Court should not recognize an exception for fraud-in-the-inducement claims because doing so would purportedly "weaken bedrock contract concepts." See Healthbanc Opening Brief at 18. In support of this argument, Healthbanc relies upon a group of parol evidence cases which support the proposition that when a contract has been reduced to writing, all prior discussions and agreements merge into the fully-integrated contract. Healthbanc's argument is inapposite.

The fundamental premise underlying the parol evidence rule is that a party should not be permitted to introduce extraneous evidence to contradict the plain language of a fully integrated contract. See, e.g., Tangren Family Trust v. Tangren, 2008 UT 20, ¶¶ 11–

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[3] See, e.g., United Intern Holdings, Inc. v. Wharf (Holdings) Ltd., 210 F.3d 1207, 1227 (10th Cir. 2000); BigPayout, LLC v. Mantex Enterprises, Ltd., No. 2:12-cv-1183-RJS, 2014 U.S. Dist. Lexis 146699, at *12 (D. Utah October 14, 2014); DeMarco v. LaPay, No. 2:09-cv-190-TS, 2012 U.S. Dist. Lexis 117462 (D. Utah Aug. 20, 2012); MP Nexlevel, LLC v. Codale Elec. Supply, Inc., No. 2:08-cv-727-CW, 2010 U.S. Dist. Lexis 40828, at *15 (D. Utah 2010); see also Restatement (Second) Torts § 551.

12. The cases cited by Healthbanc involve situations in which the parties agree that there is a contract, but disagree as to what the terms of the contract are or what certain provisions in their agreement mean. In other words, parol evidence cases analyze situations in which the parties remain in a voluntary, consensual commercial relationship (although they may disagree as to the scope or terms of that relationship).

Fraudulent inducement claims, however, are quite different. In a fraudulent inducement case, the plaintiff is alleging that there should have never been a contract in the first instance, and that the relationship was only procured by the defendant's fraud. Thus, when fraud-in-the-inducement has occurred, the plaintiff has not voluntarily entered into the relationship based upon good faith negotiations, but instead, was deceived into entering into the contract through intentional misconduct. In these types of cases, the plaintiff is not seeking to "modify," "amend," or "supplement" the contract through extraneous evidence; rather, it is seeking relief from an agreement it would not have entered into absent fraud.[4]

[4] In Energy Claims Ltd. v. Catalyst Inv. Group Ltd., 2014 UT 13, 325 P.3d 70, this Court held that an allegation that a contract was entered into fraudulently is sufficient to render the forum selection clause unenforceable. Otherwise, this Court reasoned, "the district court must accept as valid a provision in a contract despite the plaintiff's contention that the entire contract was induced by fraud." Id. ¶ 52. In other words, one provision (the forum selection clause) cannot mysteriously survive a global claim for fraud: The entire contract, when fraudulently induced, is vitiated. See Swanson v. Sims, 51 Utah 485, 499–500 (Utah 1917) ("It has been considered an elementary proposition that fraud vitiated all contracts when established, and that any one induced to make a contract by false representations could be relieved from the burden thereof by a court of equity.").

The parol evidence cases cited by Healthbanc do not involve claims for fraud-in-the-inducement of a contract and do not meaningfully assist the Court in analyzing the issue at hand. The primary case relied upon by Healthbanc to support this argument, KeyBank National Association v. Systems West Computer Resources, Inc., 2011 UT App 441, 265 P.3d 107, does not even involve an intentional tort, but instead, affirmed the dismissal of a claim for negligent misrepresentation based upon inadequate briefing. Id. ¶ 30. The other case discussed by Healthbanc, Wardley Corporation v. Meredith Corporation, 93 Fed. App'x. 183 (10th Cir. 2004), does not meaningfully discuss the economic loss rule, but instead, summarily dismissed a negligent misrepresentation and fraud claim due to the plaintiff's failure to establish reasonable reliance. Id. at *186–87. Neither case contributes to this Court's analysis of the underlying legal principles at issue in this case.

In any event, even if the Court were to find Healthbanc's parol evidence theory persuasive, it would not dispose of the issues in this case. Utah law recognizes that "parol evidence is always admissible to show fraud, even though it has the effect of varying the terms of written contract." Mawhinney v. Jensen, 120 Utah 142, 153 (Utah 1951) (emphasis added) (citing Riverside Rancho Corp. v. Cowen, 88 Cal. App. 2d 197 (Cal. Ct. App. 1948); Lufty v. R. D. Roper & Sons Motor Co., 57 Ariz. 495 (Ariz. 1941)).[5]

[5] See also Tangren Family Trust v. Tangren, 2008 UT 20, ¶ 15 (extrinsic evidence is admissible to support the argument that an integrated contract is void due to fraud; a written contract may purport to be the complete understanding of the parties but still be invalid due to fraud.)

Accordingly, parties are permitted to seek reformation or rescission of a contract that is procured by fraud, and to introduce parol evidence to support those claims. Healthbanc offers no law or analysis that would reconcile this body of case law with its proposed rule of law.

III. Contract Law Does Not Adequately Protect the Parties in a Case of Fraud-in-the-Inducement.

Healthbanc has also argued that fraudulent inducement claims should be subject to the economic loss doctrine because contract law provides for adequate remedies and protections. See Opening Brief at 21. This argument is incorrect for multiple reasons.

First, contract law does not adequately protect parties who have been defrauded into entering into a contractual relationship as Healthbanc contends. Although Healthbanc correctly notes that contract law is designed to allocate risk among consenting parties, it ignores the fact that a defrauded party would have never entered into the contractual relationship on the same terms – if at all – but for the defendant's intentional misconduct. Thus, the traditional policies that protect contracting parties are not present in a fraud-in-the-inducement case, as an unknowing party is prevented from understanding the true facts and information needed to fairly negotiate its risk, duties, and protections. See Preventive Energy Solutions, No. 2:16-cv-809-PMW, 2017 U.S. Dist. Lexis 4195 (D. Utah Jan. 10, 2017), at *19–20 (fraud-in-the-inducement lies outside the scope of the economic loss doctrine because the plaintiff is "brought to the bargaining table under false pretenses" which prevents the plaintiff from intelligently negotiating or allocating its risks) (citing West v. InterFinancial, Inc., 2006 UT App 222, ¶ 10).[6]

Second, tort law affords additional remedies to the parties that would not be available in contract, including the possibility of punitive damages, should a jury determine that exemplary damages are justified. In this case, tort law also affords the only remedy that Synergy has against Bernard Feldman, Healthbanc's principal, who made each of the false statements but did not sign the parties' contract. Healthbanc's reasoning would not only deprive potential fraud victims of their avenues for full recovery, but would also reward the tortfeasor by allowing him to limit his liability through a contract procured by its own fraud.

Third, Healthbanc ignores the high burden of proof that is applicable to a fraud-in-the-inducement claim. As the Court is aware, Utah law requires the plaintiff to prove fraud by clear and convincing evidence, which suggests that the claim is only likely to succeed in cases where there is credible evidence supporting the fraud. This Court's acknowledgement that a prospective plaintiff may be permitted to proceed on a fraud-in-the-inducement claim without running afoul of the economic loss rule would not alter the standard of proof in any manner, nor would it affect the defendant's right to defend against

[6] See also Associated Diving & Marine Contrs. v. Granite Constr. Co, No. 2:01CV330 DB, 2003 U.S. Dist. Lexis 21560, at *21 (D. Utah July 11, 2003) ("A claim for fraud in the inducement cannot be barred by the economic loss doctrine" because it is committed before the contract is entered into and "the doctrine only applies to bar tort claims that fall within the bargained-for duties and liabilities of a contract.") (internal quotation marks omitted).

the claim. Indeed, a defendant may very well wish to introduce the contract as evidence to rebut a fraud claim, whether it be to challenge the materiality of representation, a plaintiff's lack of reliance, or other elements of the claim. There is nothing unfair about allowing a plaintiff who meets its heavy burden of proving a fraud claim to obtain its full recovery.

Finally, allowing for tort recovery does not automatically equate to a windfall as Healthbanc suggests. Although a party may be able to proceed simultaneously on both fraud and contract theories in certain circumstances, that does not mean that the law will allow for double recovery. Rather, the trial court would still be obligated to structure its special verdict form appropriately, as well as to reduce and / or offset any damages awarded by a jury to eliminate duplicate recovery.

In short, recognizing an exception for fraudulent inducement claims will not unfairly penalize a tortfeasor, as the law provides adequate protection by requiring a high standard of proof and reasonable limits on recovery. The tortfeasor should not, however, be permitted to contract away his liability for intentional misconduct by bringing a party to the bargaining table under false pretenses.

IV. The Trial Court Correctly Applied the Economic Loss Doctrine in the Context of this Case.

Finally, Healthbanc has argued that the economic loss rule should be applied to Synergy's counterclaim for fraud-in-the-inducement because the trial court previously dismissed Healthbanc's fraud claim under this doctrine. See Healthbanc Opening Brief at 22-23. Healthbanc's reasoning is misguided.

Synergy and Nature's Sunshine acknowledge that it may be somewhat difficult for this Court to evaluate this particular argument since the Court only receives limited facts in conjunction with its review of a certified question. However, when placed in context, it is clear that the trial court not only appreciated the significant factual differences between Synergy and Healthbanc's respective fraud claims, but also correctly applied the economic loss doctrine in analyzing the two competing claims.

As discussed previously, Synergy's counterclaim asserted an alternative claim for fraud-in-the-inducement, which alleged that Healthbanc and its principal made certain untrue, pre-contractual statements regarding Healthbanc's: (i) alleged ownership of the Greens formula; (ii) exclusive rights to the formula; (iii) intellectual property rights that purportedly accompanied the formula; and (iv) scientific backing that purportedly validated various health benefits associated with the product. (R. 327–29). Synergy alleges that these pre-contractual statements were false, and that it would not have entered into the Royalty Agreement on the same terms, if at all, but for Healthbanc's misrepresentations. Id. Synergy has asked the Court to award damages to compensate it for the excess royalties that were paid as a result of Synergy's misrepresentations, which have been calculated by an expert witness whose opinion will be disclosed in accordance with applicable discovery deadlines. Alternatively, Synergy has also sought rescission of the parties' agreement and a refund of the amounts it paid based upon the misrepresented facts. (R. 330). The trial court accepted Synergy's allegations as true – as it is required to do when evaluating a motion to dismiss – but certified the present question to this Court to obtain clarification as to whether the economic loss rule would bar a fraud-in-the-inducement claim in light of the parties' subsequent contract.

Healthbanc's fraud claim was a completely different animal. Unlike Synergy's claim (which alleged pre-contractual misrepresentations), Healthbanc's fraud claim alleged that the defendants committed fraud after the contract was formed by failing to make certain payments and failing to disclose certain accounting information related to those payments. (R. 215). In other words, Healthbanc's fraud claim was framed as a "fraud-in-the-performance" of the agreement since it accused the defendants of intentionally and willfully breaching their duties to provide information that was purportedly required to be provided under the parties' contract. (R. at 212–15)

Critically, Healthbanc never cited any common law duty or statute that required Synergy to provide the information that Healthbanc claimed the defendants had improperly withheld. Rather, Healthbanc was looking to the Royalty Agreement as the sole source of the defendants' duty. Under these circumstances, the trial court correctly dismissed Healthbanc's fraud claim because Healthbanc could not identify any independent duty to report royalty calculations or pay royalties beyond those set forth in the contract. (R. at 303)

The trial court's ruling represents the correct application of the economic loss doctrine and is consistent with the Utah authorities discussed in the parties' briefing. As both parties acknowledge, Utah law has traditionally required the trial court to look to the "source of the parties' duty" when evaluating the economic loss doctrine, allowing tort claims to proceed only when they arise from an independent duty of care. See Hermansen

v. Tasulis, 2002 UT 52, ¶ 16. Here, Synergy's fraud-in-the-inducement claim arises from the breach of a common law duty – namely, the duty to be honest and to candidly represent facts basic to the transaction in commercial dealings, as recognized by Section 551 of the Restatement. Healthbanc's fraud-in-the-performance claim, in contrast, was never based upon any duty imposed by society, but rather, arose strictly out of the parties' contract. The economic loss doctrine bars tort claims that are based solely upon the breach of contract; it does not, however, bar a claim that is based upon an intentional and pre-contractual breach of a common law duty of care.

CONCLUSION

For the reasons expressed herein, Synergy and Nature's Sunshine respectfully submit that the Court should answer the United States District Court's certified question as follows:

> Does the economic loss rule bar a cause of action for fraudulent inducement that is based on pre-contract misrepresentations that induce another party into entering into a contract?
>
> ANSWER: No. The economic loss rule does not bar a cause of action for fraudulent inducement because the tort is committed prior to the formation of a contract and there is an independent duty of care to refrain from making fraudulent misrepresentations in commercial dealings.

DATED this 16th day of March, 2018.

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Certificate of Compliance With Rule 24(f)(1)

I hereby certify that:

1. This brief complies with the type-volume limitation of Utah R. App. P. 24(f)(1) because, excluding the parts of the document exempted by Utah R. App. P. 24(f)(1), this document contains 4,389 words.

2. This brief complies with the typeface requirements of Utah R. App. P. 27(b) because this document has been prepared in a proportionally spaced typeface using Microsoft Word 2016 in 13 point Times New Roman Font.

DATED this 16th day of March, 2018.

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CERTIFICATE OF SERVICE

I hereby certify that on March 16, 2018, I hereby served Responsive Brief of Defendants/Counterclaim Plaintiff via hand-delivery and e-mail to the following:

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