CASE STUDY PREPARED FROM ORIGINAL PUBLISHED OPINION

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Ash v. North American Title Company 2/18/14

Foreseeable Contract Damages; Intervening and Superseding Cause

In connection with his sale of commercial real estate, plaintiff realized a taxable gain. He sought to defer the capital gain under section 1031 by purchasing commercial property from defendant Lerner. On October 8, 2018, Lerner agreed to sell the property to Ash, and defendant North American Title Company (NAT) was selected as the escrow company. Escrow was scheduled to close on November 21, 2008. Ash was in the real estate business, and after consultation, selected LandAmerica Exchange Services to receive funds from the sale of his property in order to comply with section 1031. Ash had previously used the company for another transaction.

Under section 1031, in order to defer paying the capital gains tax on the sale of his other property Ash was required to close his transaction with Lerner within 180 days of the sale of Ash's property. Proceeds from the sale of his property were deposited with LandAmerica, using a CitiBank account. Neither Lerner nor NAT had any involvement with the selection of LandAmerica. Escrow was to close on Friday, November 21, 2008, but it did not. On November 24, 2008, LandAmerica froze all of its accounts, and then filed for bankruptcy. Several witnesses later testified that "everybody was shocked" at the bankruptcy, noting there were no concerns with LandAmerica's solvency. Even local LandAmerica employees testified they had no warning.

The Bankruptcy Court refused to allow Ash to have access to his deposited monies. He continued to pay interest on the bank loan he had taken out to purchase Lerner's property without the income from the property to use for loan payments. Without income he was required to borrow money from his mother.

He hired an attorney to attempt to convince the Bankruptcy Court to release his money to complete the transaction. The escrow did not close until March 2010, after the Court released the funds. The closing of escrow was too late for Ash to obtain the section 1031 tax deferral of his capital gain taxes.

As a result of the delayed escrow and the delay in recovering his funds resulting from the bankruptcy, Ash sued Lerner and NAT for damages. He claimed direct damages of $1,033,000 and indirect damages of $1,000,000. Defendants made motions for nonsuit based on a lack of causation and the defense of intervening and superseding cause. The trial court denied the motions and refused to give defendants' proposed instructions on causation and intervening/superseding cause.

The jury returned its verdict finding Lerner breached its contract by delaying timely close of escrow and was liable for $300,000, and that NAT breached its contract to provide timely and proper escrow and title services and was liable for $250,000 in contract damages. The jury also found that NAT was liable for negligence in the amount of $500,000 and breach of fiduciary duty for $250,000. The jury also found $750,000 in punitive damages. The trial court granted NAT's motion for judgment notwithstanding the verdict on the punitive award, but otherwise denied motions for new trial and JNOV. Lerner and NAT appealed.

A. Foreseeability of Contract Damages:

Division Five of the Second District Court of Appeal explained that contract damages are generally limited to those within the contemplation of the parties when the contract was entered into or at least reasonably foreseeable by them at that time; consequential damages beyond the expectations of the parties are not recoverable. In contrast, tort damages are awarded to compensate the victim for the injury suffered. For breach of an obligation not arising from contract, the measure of damages is the amount which will compensate for all the detriment proximately caused thereby, whether it could have been anticipated or not. (Civil Code section 3333)

The California Supreme Court has discussed this principle, pointing out

that California follows the common law rule set forth by an English court in Hadley v Baxendale (1854) 156 Eng.Rep.145. When a shaft broke in Hadley's mill, he contracted with Baxendale to transport the part to an engineer to make a duplicate. Baxendale promised the shaft would be sent the next day, but did not know the mill would be inoperable until the shaft was replaced. Baxendale did not transport the part for five days, causing the mill to be shut down for five extra days. The court held that although a plaintiff is entitled to an amount that will place it in the same position it would have been had the breaching party performed, damages for special circumstances, such as in that case, can be assessed against the breaching party only when they were within the contemplation of both parties as a probable consequence of a breach. Since Baxendale did not know that the mill would be shut down until the new shaft arrived, loss of profits could not fairly or reasonably have been contemplated by both parties without Hadley having communicated the special circumstances to Baxendale. The lost profits award was reversed on appeal. (Lewis Jorge Construction Management, Inc. v Pomona Unified School District (2004) 34 Cal.4th 960)

The High Court added that "Hadley did not expressly distinguish between general and special damages. But such a distinction flows naturally from that case; hence the rule that a party assumes the risk of special damages liability for unusual losses arising from special harm which might result from breach. It is not deemed to have assumed such additional risk, however, simply by entering into the contract. "(Lewis Jorge, at p. 969) The Hadley rule has long been applied by California courts, which view it as having been incorporated into Civil Code section 3300's definition of the damages available for breach of contract. Contract damages, unlike tort (section 3333) do not permit recovery for unanticipated injury.

Parties may voluntarily assume the risk of liability for unusual losses, but to do so they must be told, at the time the contract is made, of any special harm likely to result from a breach. Alternatively, the nature of the contract or the circumstances in which it is made may compel the inference that the defendant should have contemplated the fact that such a loss would be "the probable result" of the defendant's breach. Not recoverable as special damages are those beyond the expectations of the parties. Special damages for breach of contract are

limited to losses that were either actually foreseen or were reasonably foreseeable when the contract was formed. (*Erlich v Menezes* (1999) 21 Cal.4th 543; *California Press Mfg. Co. v Stafford Packing Co.* (1923) 192 Cal.479) Foreseeability is to be determined as of the time of the making of the contract. The loss need only have been foreseeable as a probable, as opposed to a necessary or certain, result of the breach. (Farnsworth on Contracts (3d ed. 2004)

The DCA majority stated that the subject case is governed by *Hadley v Baxendale.* To the extent any part of the $250,000 of damages for the breaches of contract by Lerner and NAT is attributable to expenses incurred in connection with the bankruptcy and the loss of the deferral of the capital gains tax, such damages are not general damages from the breach (section 3300) and which flow directly and necessarily from a breach of contract. Rather, they are secondary or derivative (special) losses arising from circumstances that are particular to the contract or to the parties. These special damages are recoverable if the special circumstances from which they arise were actually communicated to or known by the breaching party (subjective test) or were matters of which the breaching party should have been aware at the time of contracting (objective test).

The foreseeability of the bankruptcy must be derived from the testimony of the witnesses. The Justices decided there was no evidence in the record that Lerner or NAT knew or should have known of this risk at the time of contracting or anytime. Not even the plaintiff was aware of the impending bankruptcy. There is no evidence Ash knew, much less that he communicated any such risk to Lerner or NAT. None of the real estate professionals involved in the transaction were able to foresee the risk of bankruptcy. Thus, defendants did not contemplate the LandAmerica bankruptcy or the consequences thereof. This is consistent with the general view that bankruptcies are normally not within the contemplation of the parties at the time of a contract. (*Fiduciary Trust Co. v Bingham Dana & Gould & Others* (2003) 789 N.E.2d 171)

Unless financial ruin is a consequence arising naturally from a breach of contract, damages sought by the non-breaching party for financial ruin are not recoverable unless a risk of insolvency was within the actual contemplation of the parties at the time the contract was made. Here, there was no evidence the parties considered the bankruptcy of LandAmerica to be a foreseeable

consequence of any delay. Nor is there evidence the defendants at the time of the contracts had knowledge that Ash would incur expenses related to the bankruptcy. As stated in Williston on Contracts, "If the contract is silent with respect to the risks the defendant has assumed, the court will determine what risks were foreseen or foreseeable when the contract was made by viewing the matter in the light of common sense; and the courts will consider the nature and purpose of the contract, and the surrounding circumstances known by the parties to exist at that time, as well as what the breaching party may reasonably be supposed to have assumed consciously. (24 Williston on Contracts (4th ed. 2013)

Accordingly, the Appellate Court finds the trial court should reduce the contract damages judgment against Lerner and NAT by amounts attributable to the bankruptcy and the bankruptcy court's delay in releasing the funds.

B. Intervening and Superseding Cause Instructions:

Defendants also appealed the trial court's refusal of their jury instructions on intervening and superseding cause. The two Justices in the majority noted that a principle in tort law is that when "subsequent to the defendant's negligent act, an independent intervening force actively operates to produce the injury, the chain of causation may be broken. It is usually said that if the risk of injury might have been reasonably foreseen, the defendant is liable, but that if the independent intervening act is highly unusual or extraordinary, not reasonably likely to happen and hence not foreseeable, it is a superseding cause, and the defendant is not liable." (6 Witkin, Summary of Cal. Law(10th ed 2005) Torts)

The Restatement of Torts, section 440, provides that "a superseding cause is an act of a third person or other force which by its intervention prevents the actor from being liable for harm to another which his antecedent negligence is a substantial factor in bringing about. Section 441(1) states: "An intervening force is one which actively operates in producing harm to another after the actor's negligent act or omission has been committed." If the intervening act is itself unforeseeable then it may become a superseding cause. A superseding cause relieves a defendant from tort liability for a plaintiff's injuries, if both the intervening act and the results of the act are not foreseeable. What is required to be foreseeable is the general character of the event or harm … not its precise

nature or manner of occurrence. (*Bigbee v Pacific Tel. & Tel. Co.* (1983) 34 Cal.3d 49)

Although the defense of intervening and superseding cause applies in tort cases, it does not absolve the defendant of liability in contract cases. Here, Lerner cannot invoke the defense of intervening and superseding cause applicable to torts because no tort claims were asserted against him. Ash contends his claims against NAT include an intentional tort, and therefore the intervening and superseding act doctrine does not apply, as it applies only to NAT's negligence. Ash asserts that as long as the intentional tort of breach of fiduciary duty was a substantial factor in causing harm, NAT cannot escape liability even if there was an intervening and superseding cause. (*United States Fid. & Guar. Co. v American Employer's Ins. Co.* (1984) 159 Cal.App.3d 277)

The majority opinion authored by Justice Mosk notes that the breach of fiduciary duty can be based upon either negligence or fraud depending on the circumstances. It has been referred to as a species of tort distinct from causes of action for professional negligence. (*Salahutdin v Valley of California, Inc.* (1994) 24 Cal.App.4th 555) The trial court did not instruct the jury that it was required to find the breach of fiduciary duty to be intentional, and it refused to instruct the jury on constructive fraud. The Justices stated that the breach of fiduciary duty might have arisen from negligence here, and the intervening and superseding act doctrine could have been applicable. They declined to decide whether an intervening or superseding act can be a defense to an intentional tort because here the trial court did not instruct the jury that to find a breach of fiduciary duty it had to find that NAT intentionally breached its fiduciary duty.

The intervening and superseding act itself need not necessarily be a negligent or intentional tort. For example, the culpability of the third person committing the intervening or superseding act is just one factor in determining if an intervening force is a new and independent superseding cause. A tort is a legal cause of injury only when it is a substantial factor in producing the injury. (*Soule v General Motors Corp.* (1994) 8 Cal.4th 548) This principle is distinct from the defense of "superseding cause" which absolves a tortfeasor, even though his conduct was a substantial contributing factor, when an independent event intervenes in the chain of causation, producing harm of a kind and degree so far

beyond the risk the original tortfeasor should have foreseen that the law deems it unfair to hold him responsible.

The trial court refused a proposed jury instruction on intervening and superseding cause (CACI No. 432) which instruction was based on North American Title's defense theory. NAT claimed at trial the bankruptcy and subsequent refusal to release funds occurred after NAT's conduct caused Ash his damage and was highly unusual. NAT claimed it had no reason to expect such occurrences, and the resulting harm was different than that which could be expected from NAT's conduct. The Appellate majority found that there was sufficient evidence that the bankruptcy constituted an independent event intervening in the chain of causation, producing harm of a kind and degree so far beyond the risk that NAT should have foreseen, that the jury should have been given the intervening and superseding cause instruction. The failure to give that instruction constituted error.

More so, the error was prejudicial. The Justices are bound to review the evidence most favorable to the applicability of the requested instruction, as a party is entitled to that instruction if that evidence could establish the elements of the theory presented. (*Scott v Rayhrer* (2010) 185 Cal.App.4th 1535) Beyond the $250,000 in contract damages, the jury found NAT liable for $750,000 in tort damages for negligence and breach of fiduciary duty. As the jury was not given an instruction on the defense of intervening and superseding cause, it could not properly consider whether NAT should be responsible for a tort or tort damages. Had the jury been given instructions on intervening and superseding cause, it is reasonably probable it would have come to a different result, because damages were caused by the bankruptcy proceedings, an independent event that caused a harm that could not be foreseen by NAT.

The general instruction on causation dealt with the defense of superseding cause by negative implication only, and the jury may well have overlooked that defense in untangling the issues and arriving at its verdict. In addition, as the contract damages for the bankruptcy were not foreseeable, those damages should not be invoked to render the instructional error harmless.

The judgment is affirmed as to the liability of Lerner and NAT for breach of

contract. It is reversed and remanded as to contract damages as to Lerner and NAT and tort liability as to NAT. Each party is to bear their own costs on appeal.

C. Dissent:

Justice Kriegler filed a dissent, disagreeing that the jury's finding lacked evidence the damages sustained by plaintiff were foreseeable. He pointed out that damages awarded to an injured party for breach of contract seek to approximate the agreed-upon performance. The goal is to put the plaintiff in as good a position as he or she would have occupied if the defendant had not breached the contract. In other words, the plaintiff is entitled to damages that are equivalent to the benefit of the plaintiff's contractual bargain.

There are two types of contractual damages, general and special, sometimes referred to as direct and consequential. General damages, as a natural consequence of the breach, are said to be within the contemplation of the parties. Special damages are secondary or derivative losses arising from circumstances that are particular to the contract or to the parties. They are recoverable if the circumstances from which they arise were actually communicated to or known by the breaching party or were matters of which the breaching party should have been aware at the time of contracting. To be recoverable, special damages must be actually foreseen or were reasonably foreseeable when the contract was formed.

Justice Kriegler then reviewed the state of the financial and investment community in the United States in 2008, during the financial crisis. He noted that Ash and Lerner entered into their transaction in October 2008, in the midst of the crisis. Given the economic crisis, he argued the jury was entitled to interpret the evidence in light of common human experience and matters of common knowledge. (*Gottloeb v Melrose Health Baths* (1957) 148 Cal.App.2d 313) The economic conditions created a foreseeable risk of bankruptcy to financial institutions throughout the country, including LandAmerica. As a foreseeable risk, Ash's damages from the delay in closing escrow were general, not special damages. It was sufficiently predictable at the time that the parties entered into their agreement that if NAT failed to obtain Ash's funds and left them with the intermediary, it might fail, as many larger institutions had already done. It was

certainly predictable to Lerner that if escrow failed to close on time Ash would lose income from his property and might have to arrange a new loan. Whether the bankruptcy was foreseeable to the parties at the time of contracting was a factual issue for the jury to determine.

Justice Kriegler agreed the superseding cause instruction was warranted in connection with the tort claims against NAT. In the trial, though, NAT argued that the bankruptcy was unforeseeable and caused Ash's damages. The jury not only awarded Ash's damages, but awarded the entire amount claimed plus punitive damages. He concludes it is not reasonably probable that the jury would have reached a different result had they been given a superseding cause instruction as to a few of Ash's claims.

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