

Fake It Till You Make It: When Do Optimistic Promises Become Fraud?

The intent of the parties may sometimes be the only difference between a run-of-the-mill breach of contract suit and fraud. As a result, optimistic entrepreneurs and start-up owners may find themselves in the crosshairs of federal prosecutors, or subjected to civil penalties, for over-promising during the early stages of growth. This article will discuss the often-fine line between a simple breach of contract and fraud using a hypothetical start-up.

I. Intent: The Difference Between Breach and Fraud

In cases based on allegedly false promises, the sole difference between a breach of contract suit and fraud may very well be the parties' intent at the time that they entered into the agreement. If one party overpromises with every intention of fulfilling that promise but fails, that is a mere breach of contract. However, if that party overpromises and has no intention of ever fulfilling that obligation, that may constitute fraud. And since there is no such thing as "direct" evidence of intent, whether a judge or a jury will ultimately view such events as a simple breach of contract or fraud will turn on inferences drawn from circumstantial evidence of the parties' intent when they made their promises.

II. Dave's Widgets

To help illustrate the challenge, meet Dave. Dave is an optimistic entrepreneur that first saw success when he began selling widgets to various businesses around town. Dave started Dave's Widgets in 2020, when he was only taking small orders. As his business grew, so did the demand for his widgets. Dave began taking larger orders, sometimes as high as 10,000 widgets per order to be delivered within seven days. As demand grew quickly, Dave's supplier began struggling to keep up. Frequently, Dave's customers would only receive partial delivery of their order, or their order would be a few days late. Dave continued to grow his business by negotiating contracts with new suppliers and hiring new staff to keep up with demand.

One summer, Dave was in the middle of negotiating a new contract with a supplier that would substantially increase his capabilities. Although the deal wasn't finalized yet, Dave was approached by a customer requesting his biggest order yet. "No problem," Dave said. Dave promised to provide the customer with 100,000 widgets by the end of the year, even though he knew his current suppliers would not be able to fulfill such a large order, and that he would not be able to fulfill the order if the deal with the new supplier fell through. Unfortunately, negotiations with the new supplier stalled. Dave attempted to fulfill the customer's large order with the suppliers he already had, but Dave only delivered 50,000 widgets before the deadline. Furious over Dave's failure to deliver on the contract, the customer accused Dave of fraud and reported him to federal prosecutors. Following an investigation, federal prosecutors brought charges against Dave, alleging that he falsely promised to fulfill the order. Is this fraud, or just a breach of contract?

III. Similar Cases

Dave's case may be a hypothetical, but it is not unrealistic. The difference between fraud and a breach of contract is further highlighted in the following examples:

- United States ex. rel O'Donnell v. Countrywide Home Loans, Inc., 822 F.3d 650 (2d. Cir. 2016) – In this case, the Second Circuit Court of Appeals was asked to answer the same question presented by Dave's case: "When can a breach of contract also support a claim of fraud?" 822 F.3d at 652. The federal government intervened in a civil suit brought under the False Claims Act by a former employee of a lending company. *Id.* at 653. After a jury trial, the jury returned a verdict in favor of the government, finding that the lending company was liable for fraud and imposing more than \$1.3 billion in penalties against various parties. *Id.* at 655. However, the Second Circuit reversed the jury's findings on appeal holding that "a contractual promise can only support a claim for fraud upon proof of fraudulent intent not to perform the promise at the time of contract execution. Absent such proof, a subsequent breach of that promise—even where willful and intentional—cannot in itself transform the promise into a fraud." *Id.* at 662.
- Corley v. Rosewood Care Center, Inc. of Peoria, 388 F.3d 990 (7th Cir. 2004) – In this case, a nursing home resident and her son brought an action against a nursing home operator alleging that defendants engaged in a "bait and switch" scheme to defraud residents in violation of the Racketeer Influenced and Corrupt Organizations Act ("RICO"). The Seventh Circuit Court of Appeals upheld the district court's granting of summary judgment against the plaintiffs on their civil RICO action, holding that "[f]raud requires much more than simply not following through on a contractual or other promises. It requires a showing of deception at the time the promise is made. A subsequent breach, although consistent with deceptive intent is not in and of itself evidence of such intent." *Id.* at 1007. The Seventh Circuit held that the district court properly granted summary judgment because the plaintiffs "[could not] show that the defendants intended to deceive him" when the promise was made, a key requirement of establishing liability under a fraud theory. *Id.* at 1108.
- Greyer v. Illinois Department of Corrections, 933 F.3d 871 (7th Cir. 2019) – In this case, a prisoner plaintiff filed a suit against prison officials alleging violations of his constitutional rights. When filling out the paperwork with the court, the plaintiff falsely claimed that he had not brought any other suits related to his incarceration. After learning of his misrepresentations, the district court dismissed the complaint with prejudice as a sanction for committing fraud on the court. *Id.* at 877—78. On appeal, the Seventh Circuit Court of Appeals emphasized that, as is required in other causes of action, "it is essential to distinguish between a negligent, reckless, or even willful act, on one hand, and a fraudulent act, on the other hand." *Id.* at 881. Even if a party intentionally breaches a contract in a "widespread" or "systematic" way, the court explained, that does not necessarily mean the party acted fraudulently. *Id.* "The difference between an intentional breach and a fraudulent 'deception at the time the promise is made,' ... can be the deciding factor between civil and criminal liability." *Id.* (quoting *Corely*, 388 F.3d

at 1007). Because the district court made no finding that plaintiff's omissions were intentional, the sanctions order was vacated. *Id.* at 882.

- *Greenberger v. GEICO General Ins. Co.*, 631 F.3d 392 (7th Cir. 2011) – In this case, the plaintiff alleged that the defendant had violated the Consumer Fraud Act “by falsely promising to restore its insureds’ vehicles to their preloss condition and failing to disclose to policyholders that it would not keep that promise.” *Id.* at 399. In upholding the district court’s dismissal of this claim, the Seventh Circuit noted that claims of consumer fraud brought pursuant to a contract require that the plaintiff “prove that the defendant engaged in deceptive acts or practices distinct from any underlying breach of contract.” *Id.* Even allegations of “widespread” or “systematic” breaches of contract do not suffice to establish a claim of fraud. *Id.* at 400.

It is clear based on these examples that, while fraud does require something more than just a simple breach of contract (i.e. an intent to defraud at the time the contract was entered into), the same problem remains—proving (or disproving) a fraudulent mindset. In the example of Dave’s widgets, federal prosecutors must prove fraudulent intent at the time Dave entered into the contract with the customer. In other words, fraud requires the government to prove that Dave *never* intended to fulfill the customer’s order, not merely that he failed to perform. Whether Dave can establish his lack of fraudulent intent, therefore, may come down to whether he can show that he genuinely believed that he would reach a deal with the new supplier or not.

IV. How to Protect Your Company Against Fraud Accusations

The sort of “fake it until you make it” business model that Dave used while growing his business is commonplace in start-ups all over the United States. Businesses and entrepreneurs regularly make promises that they know they cannot currently fulfill, with every intention of putting themselves in a position to fulfill their promises during the term of the contract. But those same businesses may find themselves on the wrong side of a federal indictment if they cannot convince federal prosecutors that they actually intended to perform, despite their failure to do so.

There are numerous ways for business owners and entrepreneurs to protect themselves against the risk of liability for fraud while growing their businesses. First, and perhaps the most important, companies can take steps to ensure that potential customers are fully informed about the business’s current abilities and the fact that the contract contemplates growth in the capabilities of the business. For example, Dave could, when negotiating contracts with his customers, inform his customers that his ability to fulfill the order is dependent on his ability to secure a new supplier. Further, Dave could also incorporate provisions into his contracts that provide that his ability to fulfill the order within the specified timeframe could change depending on the availability and capability of his suppliers. Such disclosures can help insulate a business owner from liability for fraud because it will make it harder for the customer, and potentially the government, to later claim that the capabilities of the business were concealed from the promisee.

Sometimes, disclosing details about the current state of the business or ongoing negotiations with third parties may not be desirable, especially for companies looking to protect proprietary information related to their growth strategies. In those instances, it is advisable to keep diligent records of efforts to comply with all contractual terms and promises. In the above hypothetical, Dave should keep diligent records of efforts to identify and secure potential new suppliers. Those records could be used to rebut any accusation that he never intended to fulfill the promises he made to the customer.

It is not uncommon for growing businesses to employ this “fake it until you make it” strategy to bring in new business that they are not yet able to fulfill. But the line between a simple breach of contract and fraud can sometimes be blurry. To an honest entrepreneur, that kind of overpromising may seem like a great way to grow their business and play “catch up” later. But to an angry, unsatisfied customer or an overzealous federal prosecutor, that same strategy may seem like a “get rich quick” scheme that was never intended to be legitimate. To protect themselves from such accusations, growing businesses should be careful, lest their best intentions are later portrayed as fraud.