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Nonmaterial Misrepresentation: Damages, Rescission, and the Possibility of Efficient Fraud

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NONMATERIAL MISREPRESENTATION: DAMAGES, RESCISSION, AND THE POSSIBILITY OF EFFICIENT FRAUD

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Buried in the details of legal doctrine governing misrepresentation is a remedial anomaly that raises some interesting questions about how law should deal with moral wrongs such as fraud.[1] We tend to think of deliberate deception—fraud—as a grave moral wrong. At least, we think of deception as gravely wrong when the deceiver's objective is not to avert harm or spare feelings, but to obtain someone's money or goods. Deception denies the autonomy of the person deceived and undermines the foundation of trust in human interaction.[2] The law, however, does not penalize every instance of fraud. Moreover, the standards governing when fraud is actionable vary according to the remedy sought.

I. TWO RULES

The two principal civil remedies for misrepresentation are tort damages and rescission accompanied by restitution of benefits

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1. The topic for this Article surfaced in the course of research on a larger work-in-progress on deception in law and morality, to be co-authored with Larry Alexander.

2. On the immorality of lying, see generally SISSELA BOK, LYING: MORAL CHOICE IN PUBLIC AND PRIVATE LIFE (1978); Immanuel Kant, *On a Supposed Right to Lie from Altruistic Motives*, *in* IMMANUEL KANT: CRITIQUE OF PRACTICAL REASON AND OTHER WRITINGS IN MORAL PHILOSOPHY (Louis W. Beck, ed. & trans., 1976); Alasdair MacIntyre, *Truthfulness, Lies, and Moral Philosophers: What Can We Learn From Mill and Kant?*, *in* 16 THE TANNER LECTURES ON HUMAN VALUES 309 (Grethe B. Peterson ed., 1995); Christine M. Korsgaard, *The Right to Lie: Kant on Dealing With Evil*, 15 PHIL. & PUB. AFF. 325 (1986).

conferred.[3] Rules governing recovery of damages for misrepresentation are set out in the *Restatement (Second) of Torts*; rules governing rescission appear in the *Restatement (Second) of Contracts* and the *Restatement of Restitution*. For both purposes, misrepresentation is broadly defined to include not only false statements but also misleading conduct, concealment, half-truth, and other behavior designed to instill false beliefs.[4] However, to obtain damages for the tort of deceit, the plaintiff must show that the defendant's misrepresentation was "material."[5] Thus, if the seller of a home tells the buyer that Jewel is thinking of moving nearby, knowing this to be untrue, the buyer cannot later claim damages (unless the seller knew the buyer was unusually motivated by Jewel). In contrast, both the *Restatement (Second) of Contracts* and the *Restatement of Restitution* allow rescission for "either a fraudulent or a material misrepresentation."[6] In other words, if the misrepresentation was deliberate, materiality is not required. The Jewel-obsessed buyer is entitled to rescind.

The apparent source of the rule for rescission—materiality is not required—is Samuel Williston. William Page, discussing rescission in his 1920 treatise on contracts, asserted that "[t]o constitute fraud

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3. *See generally* 2 DAN B. DOBBS, DOBBS LAW OF REMEDIES (2d ed. 1993) [hereinafter DOBBS, REMEDIES] (remedies for misrepresentation); 1 E. ALLAN FARNSWORTH, FARNSWORTH ON CONTRACTS (2d ed. 1998) (rescission and restitution); W. PAGE KEETON ET AL., PROSSER AND KEETON ON THE LAW OF TORTS (5th ed. 1984) [hereinafter PROSSER & KEETON] (remedies for misrepresentation).

4. *See* RESTATEMENT (SECOND) OF CONTRACTS § 159 cmts. a, b (1981) (misrepresentation defined); *id.* § 160 (concealment); RESTATEMENT OF THE LAW OF RESTITUTION § 8 cmt. b (1937) (misrepresentation defined); RESTATEMENT (SECOND) OF TORTS § 525 cmt. b (1977) (misrepresentation defined), *id.* § 527 (ambiguous representation), *id.* § 529 (incomplete statement), *id.* § 550 (concealment). Nondisclosure is sometimes a ground for damages or rescission if the court determines there was a duty to disclose in the circumstances. *See* RESTATEMENT (SECOND) OF CONTRACTS § 161 (referring to good faith and standards of fair dealing); RESTATEMENT OF THE LAW OF RESTITUTION § 8(1)(c) & cmt. b (referring to duty to disclose); RESTATEMENT (SECOND) OF TORTS § 551 (referring to reasonable expectations of disclosure in light of relationship and custom).

5. RESTATEMENT (SECOND) OF TORTS § 538(1).

6. RESTATEMENT (SECOND) OF CONTRACTS §164(1); RESTATEMENT OF THE LAW OF RESTITUTION § 9 cmt. b. The tentative new *Restatement (Third) of Restitution* continues this rule. *See* RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 13 (Tentative Draft No. 1, 2001).

the representation must be material."[7] Williston, in his contracts treatise of the same year, agreed that "[I]t is laid down" that fraud must be material.[8] But Williston went on to express his own opinion that a fraudulent party should not be allowed to argue that the fraud, although successful, was not material.[9] A deliberate wrongdoer, in other words, should not escape with the goods.

In 1932, the first *Restatement of the Law of Contracts* adopted Williston's view, providing that either "fraud or material misrepresentation" renders a transaction voidable.[10] Comments in that *Restatement* closely tracked the reasoning of Williston's treatise.[11] The 1936 *Restatement of the Law of Restitution* followed the same rule. Writing more recently, Allan Farnsworth observed that cases granting rescission for non-material fraud are "difficult to find."[12] Yet, Farnsworth agreed that rescission should not depend on materiality, and Williston's view has been carried forward as black-letter law in the *Restatement (Second) of Contracts* and the draft *Restatement (Third) of Restitution.*

II. THE MEANING OF MATERIALITY

The precise meaning of materiality is somewhat elusive. The *Restatement (Second) of Torts* provides a black letter definition: a misrepresentation is material if "a reasonable man would attach importance to [it] . . . in determining his course of action"[13] or alternatively, if the defendant knew or had reason to know it had special significance for the plaintiff.[14] Yet, the role of materiality

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7. WILLIAM HERBERT PAGE, THE LAW OF CONTRACTS § 308 (2d ed. 1920).

8. 3 SAMUEL WILLISTON, THE LAW OF CONTRACTS § 1490 (1920).

9. *See id.*

10. RESTATEMENT OF THE LAW OF CONTRACTS § 476(1) (1932).

11. *See id.* cmt. b.

> One who makes an innocent misrepresentation of an unimportant fact has no reason to suppose that his statement will cause action, but fraud is directed to that very end, or is expected to achieve it, and if the result is achieved the fraudulent person cannot be allowed to insist on his bargain.

12. FARNSWORTH, *supra* note 3, § 4.12.

13. RESTATEMENT (SECOND) OF TORTS § 538(2)(a) (1977).

14. *Id.* § 538(2)(b). The *Restatement (Second) of Contracts* incorporates into its definition of fraud a requirement that the defendant must have intended that his assertion would "induce a party to manifest his assent . . . ." RESTATEMENT (SECOND) OF CONTRACTS § 162(1) (1981). Because a

within the overall doctrine of misrepresentation is unclear. All sources agree that to claim either damages or rescission for misrepresentation, the plaintiff must show "justifiable reliance" on the defendant's representation. Materiality is either a separate requirement or a subcategory of justifiable reliance, depending on the source one consults.[15] Prosser and Keeton explain the relationship between justifiable reliance and materiality by saying that, while other elements of justifiable reliance are concerned with representations that should not be *believed* (such as a seller's

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statement that the defendant knows or should know will have significance for the plaintiff counts as material, this aspect of the contracts rule narrows the scope of rescission for non-material fraud. Nevertheless, it is possible that a misrepresenter (for example, the seller who asserts that Jewel is shopping in the neighborhood) may intend—that is, wish—to induce assent, and yet have no realistic hope of doing do. In such a case, the representation is fraudulent but not material.

15. RESTATEMENT (SECOND) OF TORTS § 525, sets out the basic conditions for recovery of damages for misrepresentation, including justifiable reliance:

> One who fraudulently makes a misrepresentation of fact, opinion, intention or law for the purpose of inducing another to act or to refrain from action in reliance upon it, is subject to liability to the other in deceit for pecuniary loss caused to him by his justifiable reliance upon the misrepresentation.

Comments to section 525 refer to a series of later sections as defining when reliance is justifiable. *See* RESTATEMENT (SECOND) OF TORTS § 525 cmt. a. Among these is section 538 on materiality, which states that reliance is "not justifiable unless the matter misrepresented is material." *Id.* § 538(1). Similarly, Prosser and Keeton suggest in the course of a somewhat disjointed discussion that materiality is a branch of the requirement of justifiable reliance. *See* PROSSER & KEETON, *supra* note 3, § 108. Dobbs states that "justifiable reliance may be regarded as encompassing materiality." DAN B. DOBBS, THE LAW OF TORTS § 470 n.1 (2000).

RESTATEMENT (SECOND) OF CONTRACTS § 164 sets out conditions for rescission, treating materiality and justifiable reliance as separate requirements and confining the materiality requirement to non-fraudulent misrepresentation. Comments to section 162, which define materiality, distinguish materiality from justifiable reliance, stating that "[t]he materiality of a misrepresentation is determined from the viewpoint of the maker, while the justification of reliance is determined from the viewpoint of the recipient." RESTATEMENT (SECOND) OF CONTRACTS § 162 cmt. c.

In any event, the reason why the *Restatement (Second) of Contracts* rejects materiality in the context of rescission for fraudulent misrepresentation is not that materiality and justifiable reliance are redundant but that it is undesirable to absolve a deliberately fraudulent defendant from liability on the ground that the fraud was minor. *See id.* § 164 cmt. b (quoted *supra*, text accompanying note 14).

"puffing" or an adverse party's statement of opinion), materiality is concerned with representations that should not be *acted on.*[16]

Prosser and Keeton also imply that both requirements—justifiable reliance and materiality—are best understood as testing the credibility of the claim that fraud induced the plaintiff to act.[17] In other words, the object of both requirements is to screen out pretextual claims put forward after adverse market conditions have rendered a bargain unprofitable.[18] This view, however, makes materiality redundant of causation.[19] If causation is the concern it seems preferable to approach it directly rather than confuse legal doctrine with a materiality requirement.

Perhaps the most straightforward reading of the materiality requirement is that some fraudulent misrepresentations, even if deliberate, believed, believable, and acted on in fact, should not have legal consequences. In other words, materiality is a *de minimus* limitation, marking off a zone in which proven fraud is tolerated by law. In the view of the Restatements, this limitation is applicable to tort damages but not to rescission.

III. REASONS FOR THE DISCREPANCY

The discrepancy in rules governing damages and rescission is puzzling because the reasons, if any, for a materiality requirement are likely to be weightier when the remedy for fraud is rescission than when the remedy is damages. In a tort action, the need to establish damages is a natural obstacle to claims based on nonmaterial fraud.[20] In an action for rescission, there is greater

16. *See* PROSSER & KEETON, *supra* note 3, § 108 (emphasis added).

17. *See id.*

18. *See id.*

19. *See* RESTATEMENT (SECOND) OF TORTS § 525 (reliance in fact), § 537 (misrepresentation must cause loss), § 549 (legal cause) (misrepresentation must cause loss), § 549(1) (legal cause).

20. Damages are for proven pecuniary injury. The most common measure is a "benefit-of-the-bargain" measure, allowing the plaintiff the difference between the value of what he received and the value he would have received if the representation had been true. The alternative is an "out-of-pocket" measure in which the plaintiff receives the difference between what he paid and the value he received. *See* DOBBS, REMEDIES, *supra* note 3, § 9.2(1), at 548–53. There are no nominal damages or presumed damages for the affront of having been deceived. *See id.* at 548.

incentive to press the claim in order to avoid an unwanted transaction.

One view of the matter is that the rule for rescission is simply more enlightened. Tort rules, it might be said, reflect antiquated business ethics and a laissez-faire approach to regulation.[21] Active intervention by treatise writers and the restatements has placed the rules for rescission and restitution on sounder moral footing. Perhaps the rarity of damage claims for nonmaterial fraud has made similar intervention unnecessary in tort law, but in principle the materiality requirement should be dropped.

An alternative view is that materiality serves a useful function—a function intuited by early courts but overlooked by scholars seeking to refine the law of contract and restitution. The function that comes most quickly to mind is protecting the security of transactions.[22] Concern for stability and reliability is frequently cited in support of limits on legal intervention in commercial settings: Potential liability or disruption based on defects in the bargaining process makes the value of formally valid transactions uncertain.[23] A materiality requirement for fraud claims reduces uncertainty by limiting the field of viable claims.

In the context of fraud, however, the stability-of-transactions argument has at best a modest appeal. With or without a materiality requirement, potential defendants concerned about their bargains presumably can avoid uncertainty by avoiding deception. The prospect of damages or rescission based on innocent misrepresentation could indeed cast doubt on transactions. A fraudulent misrepresentation, however, is by definition deliberate—known to be false and intended to deceive. Therefore, a party who has spoken and acted candidly need not be concerned.[24]

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21. *Cf.* PROSSER & KEETON, *supra* note 3, § 108, at 751–53 (noting a change in interpretation of justifiable reliance in response to "a new standard of business ethics," although not challenging the materiality requirement).

22. *See id.* at 753; *cf.* FARNSWORTH, *supra* note 3, § 4.12, at 459 (finding that this rationale provides "feeble support" for a materiality requirement in cases of fraud).

23. *See, e.g.*, FARNSWORTH, *supra* note 3, § 4.15, at 472 (discussing rescission).

24. This may be the idea expressed in comments to section 476 of the first *Restatement of the Law of Contracts*. *See* RESTATEMENT OF THE LAW OF CONTRACTS § 476(1) cmt. b (1932) (quoted *supra*, note 11).

Another possibility, which may be viewed as subversive, is that fraud itself is functional, at least at a low level.[25] Fraud causes deals to be made: when one party believes the bargain is better (for him) than it is, he is more likely to agree. Of course, if the bargain is so bad that the defrauded party will lose value in the agreed exchange, there is no efficiency gain and, therefore, no social interest in promoting or enforcing the transaction.[26] Low-level fraud, however, should not result in markedly inefficient exchanges. Instead, it may help to overcome bargaining impasses that might otherwise prevent a mutually beneficial exchange.

The reason why fraud might sometimes be efficient is this: Most exchanges generate a surplus, which the parties must divide through negotiation before the bargain can be closed. The ultimate distribution of surplus has no efficiency consequences, as long as the exchange itself places the underlying resources in the right hands.[27] Costs incurred in the process of dividing surplus are lost from a social point of view. Meanwhile, if serious differences arise in negotiation over surplus as a result of error or intransigence, the efficient exchange may never occur. At this stage of the transaction, a little deception may help the bargaining process along. If each party can be convinced that he has bested the other, both will be

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25. Several authors have identified efficiencies that may result from legal rules that permit nondisclosure or even affirmative fraud. *See* Anthony T. Kronman, *Mistake, Disclosure, Information, and the Law of Contracts*, 7 J. LEGAL STUD. 1, 9, 13–18 (1978) (explaining that a privilege of nondisclosure creates incentives to gather information); Saul Levmore, *Securities and Secrets: Insider Trading and the Law of Contracts*, 68 VA. L. REV. 117, 140 (1982) (explaining that allowing buyers to withhold information about or even to misrepresent their plans can thwart inefficient strategic behavior by sellers); Christopher T. Wonnell, *The Structure of a General Theory of Nondisclosure*, 41 CASE W. RES. L. REV. 329, 377 (1991) (explaining that privileges of non-disclosure can be efficient in four ways: By facilitating the merger of information and resources, by internalizing the benefits of entrepreneurship and information gathering, by supporting trades that signal price changes, and by minimizing strategic use of disclosed information).

26. *See, e.g.*, RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW § 4.6 (5th ed. 1998) (explaining why fraud is undesirable).

27. Rules that affect the distribution of surplus may cause parties to act strategically to position themselves in advance for an advantageous distribution. *See* DOUGLAS G. BAIRD ET AL., GAME THEORY AND THE LAW 219–20 (1994) (discussing pre-bargaining incentives). But in such a case it is the behavior, not the distribution itself, that produces inefficiency.

eager to close. In this way, the deal-making capacity of fraud becomes useful.

Fraud may seem an odd prescription for bargaining problems. Yet, it is worth noting that minor fraud is a widespread, even customary, practice. Few people follow unqualified rules of truth and candor in commercial relations. Instead, we seem to internalize a sense of allowable and prohibited deception.[28] We consider it wrong to falsify a resume but not to dress deceptively well for an interview, and we happily understate the maximum we will pay for something we are negotiating to buy. It may be that customs of minor deception exist because there is no reasonable way to stop minor deception. But customary deception may also reflect a common-sense intuition that this sort of deception can be beneficial.[29]

If in fact deception can facilitate bargaining over surplus, the materiality standard can be seen as a rough means of protecting efficient fraud. The definition of materiality set forth in the *Restatement (Second) of Torts* does not map perfectly onto the threshold of mutually beneficial exchange, beyond which the parties are simply bargaining over division of surplus. Some matters may be important to a reasonable person, and yet not essential to the efficiency of a particular exchange; and some exchanges are efficient precisely because one party privately values the goods for a reason many would consider unimportant. Yet, most matters that, if falsified, would produce seriously inefficient outcomes are likely to qualify as material. And, at least if courts are loose in their application of the *Restatement* definitions, materiality provides them with a doctrinal means for sorting intuitively between matters that undermine the efficiency of exchange and matters that do not.

Thus, it is at least possible that the materiality standard has practical value, either because it protects the stability of transactions or because it tolerates efficiency-enhancing, low-level fraud. Yet, these rationales do not explain why the law has adopted a materiality

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28. I am setting aside personal relations where our understanding of allowable deception is much more generous.

29. On the benefits of custom, see generally Richard A. Epstein, *Customary Practices and the Law of Torts*, *in* NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW 579 (Peter Newman ed., 1998), arguing that custom represents cumulative wisdom, which is likely to produce efficient results when developed among repeat players in consensual settings.

standard for deceit but not for rescission. In fact, they seem equally applicable, if not more significant, in the context of rescission.[30] Why, then, has materiality been preserved in one case but not in the other?

The distinction among remedies may reflect a tendency to differentiate morally between damages and restitution. The arguments suggested above in favor of a materiality standard are practical ones. Meanwhile, fraud remains an affront to autonomy and trust, widely felt to be a moral wrong. Rescission is a remedy with origins in Chancery, and restitution is based on "unjust enrichment," a term that naturally evokes considerations of justice and ethics. Therefore, scholars who state the rules for rescission and restitution—if not the courts that apply those rules—may prefer to sacrifice practical benefits for moral rectitude in dealing with these remedies. Rules for rescission take the high ground, while the damages remedy accommodates practical concerns.

IV. CONCLUSION

I have criticized in previous writing this tendency to elevate restitution to a higher moral plane.[31] In my view, there is no good reason why moral considerations should carry more weight in the context of restitution than they do in the context of tort law and compensatory remedies. Either materiality has sufficient practical value to justify it as a limit on legal liability for fraud, in which case it should apply equally to damage remedies and to rescission; or deliberate fraud is an evil the law should not tolerate in commercial relations, in which case materiality should be irrelevant to any remedy.

30. If tort claims for deceit extended to emotional and dignitary complaints, concerns about the volume of claims might support a materiality rule for deceit, but this is not the case. Recovery for deceit is limited to pecuniary injury. *See* RESTATEMENT (SECOND) OF TORTS §§ 525, 549 (1977); DOBBS, REMEDIES, *supra* note 3, at 548.

31. *See* Emily Sherwin, *Restitution and Equity: An Analysis of the Principle of Unjust Enrichment*, 79 TEX. L. REV. 2083, 2104–08 (2001).