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## Misrepresentation and Contract


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Greg Klass

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Contract law provides for the legal enforcement of exchange agreements and certain other voluntary obligations. Laws of deception, in distinction, target misrepresentations, failures to disclose, and other forms of duplicity or deceit.<sup>1</sup> There are significant differences between these areas of law. Most obviously, contract law gives persons the power to undertake new obligations when they wish, whereas laws of deception typically impose duties of candor on persons whether they want them or not. And whereas breach of contract is a strict liability wrong, many laws of deception condition liability on a showing of fault. There are also differences in remedies. Contract law does not penalize breach but restricts parties to compensatory measures, further limited by rules regarding avoidability, foreseeability and the like. Many laws of deception grant the successful plaintiff more generously compensation, and sometimes provide for punitive damages, civil fines, or even criminal punishment.

These and other differences have generated a long-felt need to police the border between the law of contract and the law of deception, and especially the line between actions for breach of contract and actions for the tort of deceit.<sup>2</sup> But the regions also overlap. Although legal duties of candor are typically not chosen, parties can sometimes contract into or out of those duties. The law of warranties provides ways that sellers can become strictly liable for falsehoods. And sophisticated parties can sometimes limit liability for misrepresentations by using a big boy letter or no-reliance clause.<sup>3</sup> Contrariwise, laws of deception can apply, and sometimes target, deceptive acts within contractual relationships, including acts that also qualify as breach. Misrepresentations among contracting parties can both generate defenses against contract actions and give rise to noncontractual forms of liability.

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<sup>1</sup> More specifically, laws of deception are designed to prevent, punish, compensate for, or otherwise address acts or omissions that wrongfully cause false beliefs in another. See Gregory Klass, 'The Law of Deception: A Research Agenda' (2018) 89 U Colo L Rev 707, 711-16.

<sup>2</sup> See William Lloyd Prosser, 'Borderland of Tort and Contract' in *Selected Topics on the Law of Torts* (U Michigan Law School 1953) 380.

<sup>3</sup> See Kevin Davis, 'Licensing Lies: Merger Clauses, the Parol Evidence Rule, and Pre-contractual Misrepresentations' (1999) 33 Val UL Rev 485; Jeffrey M. Lipshaw, 'Of Fine Lines, Blunt Instruments, and Half-Truths: Business Acquisition Agreements and the Right to Lie' (2007) 32 Del J Corp L 431.

This chapter focuses on overlap of the second sort: ways misrepresentations between contracting parties can affect their legal relationship, as distinguished from ways parties can contract to alter the legal effects of their misrepresentations. My thesis is that a successful law of contract must take account of not only promissory obligations, but also obligations of candor. If this is correct, the law of deception should not be viewed as distinct from the law of contract. Contract law incorporates and relies on laws of deception to achieve its goals.

The list of laws and legal rules that address deceptive acts between contracting parties is a long one. It includes in the US the misrepresentation defenses, the law of warranties, equitable estoppel, the torts of deceit and negligent misrepresentation (the “misrepresentation torts”), state unfair and deceptive acts and practices (UDAP) statutes and the Federal Trade Act, criminal fraud, as well as industry specific rules found in employment law, workplace safety regulations, securities law, and elsewhere. Only the first two items on the list—contract defenses and the law of warranties—belong to the law of contract as traditionally conceived. All, however, figure into the legal ecosystem in which contractual transactions take place.

This chapter argues that when applied to contracting parties, laws of deception advance at least three aims of contract law. They ensure that contractual obligations are voluntarily ones. They create incentives with respect to sharing information that advance parties’ interests and expand their options. And they address wrongs constituted in part by the semantic and moral fields contracts generate. Part One discusses the first function and the misrepresentation defenses. Parts Two and Three examine how noncontractual liability for misrepresentation serves the second and third functions. Parts Two and Three focus on the misrepresentation torts, though one might extend their conclusions to other laws of deception.

## I. Misrepresentation and Compromised Choice

Contract law is designed to enforce voluntary obligations, which is to say, obligations that the contracting parties intended to undertake. Familiar means of acquiring a voluntary obligation include promising a performance, agreeing to an exchange, and recording a commitment in a formal document. To say that contractual obligations are voluntary is not to say that contracting parties intend every element of their contract. Default terms attach in the absence of evidence of a contrary intent, and mandatory terms despite evidence of a contrary intent. And a person who undertakes a nonlegal obligation to perform might unwittingly incur a corresponding contractual one, at least in the United States, where contract liability is not conditioned on an intent to be bound.<sup>4</sup> But these points concern the reach of contractual obligations, not their origins. What brings a contractual obligation into existence is one or more voluntary undertaking.

Design follows function. If contract law serves to enforce voluntary obligations, we can expect it to be designed to ensure the voluntariness of

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<sup>4</sup> Restatement (Second) of Contracts § 21 (Am L Inst 1981). See Gregory Klass, ‘Intent to Contract’ (2009) 95 Va L Rev 1437.

undertakings that generate contracts. Joseph Raz makes this point with respect to the role of formalities in power-conferring laws generally. By conditioning legal outcomes on a ceremonial act with no non-legal meaning—like signing a formal document or reciting certain words—the law ensures that the power is not exercised by accident.<sup>5</sup> Also important is the quality of choice. Even if a person knows the normative consequences of their act (Raz’s concern), their choice is compromised if it is made under pressure, if it is not fully informed, or if the actor’s judgment is impaired. In these circumstances the law might deem the undertaking insufficiently voluntary, and therefore limit its legal effect. Hence the procedural defenses of duress, mistake, and incapacity (as distinguished from substantive defenses such as illegality).

The misrepresentation defenses are procedural in nature. The Second Restatement of Contracts identifies several misrepresentation defenses. If a party’s apparent assent was induced by a misrepresentation as to the character or essential terms of a proposed contract, the law deems there to have been no actual assent and therefore no contract.<sup>6</sup> If a party’s assent was justifiably induced by the other’s fraudulent or material misrepresentation of fact, the resulting contract is voidable by the deceived party.<sup>7</sup> If a party’s assent was justifiably induced by a third-party’s fraudulent or material misrepresentation, the contract is again voidable, unless the nondeceived party in good faith and without reason to know of the misrepresentation has already given value or materially relied.<sup>8</sup> Finally, a party’s justified reliance on the other’s misrepresentation as to the contents of an integrated writing can support reformation of that writing, so long as such reformation will not affect the rights of third parties.<sup>9</sup> In each of these cases, a misrepresentation or other deceptive act has rendered the deceived party’s assent imperfect, and so the law holds that there is no contract, that the resulting contract is voidable by the deceived party, or that the contract terms are other than those apparently agreed to.

Just how does misrepresentation compromise the deceived party’s choice? Misrepresentation overlaps with mistake. The deceived party has based their decision to enter an agreement on a false belief, rendering that choice defective. But misrepresentation adds something more. The mistake was caused by another, usually the other party. And if the misrepresentation was fraudulent, the deceiver manipulated the deceived. The deceived party’s choice in such cases is not entirely their own.

One can compare the procedural contract defenses to a function of tort law. Just as tort law serves *inter alia* to allocate the costs of accidents, the procedural defenses—mistake, misrepresentation, duress, lack of capacity—provide rules for allocating the costs of defective contractual undertakings. The cost of a defective undertaking is that one party is bound to a contract they would not otherwise have agreed to and now wish to avoid. When the defense is successful, that cost is avoided by holding the contract void or voidable or by

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<sup>5</sup> Joseph Raz, ‘Voluntary Obligations and Normative Powers (pt. 2)’ (1972) 46 Proceedings Aristotelian S 79, 81 (supp).

<sup>6</sup> Restatement (Second) of Contracts § 163 (Am L Inst 1981).

<sup>7</sup> Restatement (Second) of Contracts § 164(a) (Am L Inst 1981).

<sup>8</sup> Restatement (Second) of Contracts § 164(b) (Am L Inst 1981).

<sup>9</sup> Restatement (Second) of Contracts § 166 (Am L Inst 1981).

reforming it, thereby imposing a new cost on the other side: losing some or all of the benefit of the planned exchange.

This tort analogy suggests dividing the procedural contract defenses into two types: strict and fault based. The infancy defense, for example, is mostly strict.<sup>10</sup> A party that raises the defense must show only that they were under the age of majority, not that the adult party was at fault in the exchange. The contract is voidable even if the adult was reasonably ignorant of the minor's age and took no advantage in the exchange. Duress, in distinction, is a fault-based defense. A party claiming duress must show not only that they had no reasonable alternative, but also that the cause was the other party's wrongful threat. Being over a barrel is no defense; the other party must have tied you to it.

All this is relevant because the misrepresentation defenses are a curious mix of strict and fault based. Consider a basic scenario: A has made a materially false statement of fact, on which B relied when agreeing to transact with A. The defense requires that A's misrepresentation *caused* B's erroneous belief. A is in this sense responsible for the defect in the agreement process. The defense does not, however, require B to show that A was at fault for the defect. A nonfraudulent, nonnegligent material misrepresentation suffices.<sup>11</sup> In this basic scenario, the misrepresentation defense is strict. A party who makes a material misrepresentation on which the other relies bears the costs of the defective agreement, whether they are at fault or not.

But fault is not absent from the misrepresentation defenses. First, some misrepresentation defenses incorporate fault of the deceiver. In the absence of a false statement of fact, the defense might be based on concealment or a failure to disclose. Concealment is an act "intended or known to be likely to prevent another from learning a fact,"<sup>12</sup> and so is by definition fraudulent and wrongful.<sup>13</sup> Nondisclosure gives rise to the defense only if there was breach of a duty to share the information—because of a relationship of trust and confidence, because one party knows that the other has been deceived by their earlier statement, or because a party knew of the other's mistake and failure to correct it violates reasonable standards of fair dealing.<sup>14</sup> Again wrongfulness is built

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<sup>10</sup> 'Mostly strict' because in some U.S. states, the minor who misrepresents their age cannot make use of the defense. For example: 'Infancy is no defense to an action to recover money advanced to an infant on the basis of his misrepresentation of majority reasonably relied upon by the lender.' *Manasquan Sav & Loan Ass'n v Mayer*, 236 A 2d 407, 408 (NJ App Div 1967).

<sup>11</sup> Although section 164 of the Second Restatement provides the misrepresentation must be fraudulent or material, Farnsworth reports that materiality does all the work in case outcomes. '[A]lthough there is no shortage of cases allowing avoidance where the misrepresentation was both material and fraudulent, or material but not fraudulent, it is difficult to find cases that have done so where the misrepresentation was fraudulent but not material.' E. Allan Farnsworth, *Farnsworth on Contracts* (4th edn, 2004) § 4.12. Practically speaking, 'the test for avoidance as distinguished from recovery of damages in tort, is one of the materiality of the misrepresentation without regard to whether it is fraudulent.' *ibid*.

<sup>12</sup> Restatement (Second) of Contracts § 160 (Am L Inst 1981).

<sup>13</sup> For more on the ways concealment incorporates fault, see Gregory Klass, 'Meaning, Purpose and Cause in the Law of Deception' (2012) 100 *Geo LJ* 449, 460-66.

<sup>14</sup> See Restatement (Second) of Contracts § 161 (Am L Inst 1981).

into the definition. Both the concealment and the nondisclosure defenses require a finding of fault.

Second, the misrepresentation defenses consider the potential fault of the party raising the defense. Even in the basic scenario, the deceived party's reliance on the misrepresentation must have been justifiable.<sup>15</sup> The Second Restatement provides that one is generally not justified in relying on statements of opinion, puffing, bare statements of intention, and statements of law, and that reliance is unjustified if nondiscovery of the truth "amounts to a failure to act in good faith and in accordance with reasonable standards of fair dealing."<sup>16</sup> The justifiable reliance requirement is comparable to the older contributory negligence doctrine, in which the victim's fault provided a complete defense to a claim of negligence. In this way too fault can figure into determining who will bear the costs of the defective assent.

The appearance of fault in the misrepresentation defenses is not difficult to explain. The party at fault for defective consent should bear the costs of that defect. This simple principle explains, for example, both why a seller who intentionally conceals a material defect is denied the benefit of the bargain, and why a buyer who unreasonably relies on mere sales talk is held to the deal. To be sure, what counts as fault can be difficult to define and has changed over time, as illustrated by the twentieth century expansion of disclosure duties. But line-drawing difficulties aside, there is a simple intuitive appeal to using fault to allocate or reallocate the costs of defective assent.

The strict aspects of the misrepresentation defenses are perhaps more difficult to explain. Consider again the basic scenario: A unintentionally and non-negligently makes a materially false statement on which B justifiably relies when agreeing to the transaction. Although A is not at fault, B has the power to rescind the resulting contract. One might venture an economic explanation of this rule: Having chosen to speak, A is perhaps the least-cost avoider.<sup>17</sup> Or the strictness of the defense might be explained by the moral connection between causation and responsibility. Causing harm to another can generate a duty to correct the harm, even when one is not at fault.<sup>18</sup> Or maybe the explanation is

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<sup>15</sup> The Second Restatement rules generally provide that the reliance must have been 'justifiable.' Mark Gergen has observed that in mid-twentieth-century tort cases, courts began replacing the justifiable reliance requirement with a reasonable reliance one, and that this shifted the focus away from the defendant's bad intent and to the plaintiff's fault, thereby failing to protect especially gullible plaintiffs. Mark P. Gergen, 'A Wrong Turn in the Law of Deceit' (2018) 106 *Geo LJ* 555. Gergen's story begins with the waning of the requirement that a tort defendant intended the plaintiff's reliance. Although I know of no systematic study, I would expect things to be different in the contract defenses, where there is no requirement that the misrepresentation was fraudulent.

<sup>16</sup> Restatement (Second) of Contracts § 172 (Am L Inst 1981).

<sup>17</sup> See Guido Calabresi, *The Cost of Accidents* (Yale UP 1970) 155: '[T]he search for the cheapest avoider of accident costs is the search for that activity which has most readily available a substitute activity that is substantially safer. It is a search for that degree of alteration or reduction in activities which will bring about primary accident cost reduction most cheaply.'

<sup>18</sup> Shelly Kagen, for example, suggests that '[a]ll other things being equal, the person who harms another has a special obligation to correct the harm, by undoing it or

doctrinal: this is where the misrepresentation defenses overlap with unilateral mistake.<sup>19</sup> Or perhaps no explanation is required. Something has gone amiss. One party's undertaking was less than fully voluntary, generating a cost that someone must bear. Shifting it to the party whose words caused the error, even if they are not at fault, is as good a rule as any.

## II. Information and Gains of Trade

The above account of the misrepresentation defenses emphasizes the voluntary nature of contractual obligations. Because contract law gives legal recognition to voluntary undertakings, the conditions of contractual validity are structured to ensure that acts that produce contracts are sufficiently voluntary. Because a preformation misrepresentation can compromise a party's choice to enter a contract, the law limits the legal effects of that choice.

This is not to say that this is all there is to the misrepresentation defenses. Because parties typically want enforcement, withholding the benefits of the bargain from those who make material misrepresentations also encourages precontractual candor, which in the long run benefits everyone.<sup>20</sup> The defenses generate positive incentives. And if the misrepresentation was wrongful, denying enforcement is justified by *ex turpi causa non oritur actio*—from a dishonorable cause no action arises. There is also a moral dimension to the misrepresentation defenses, as befits their origin in equity.

That said, these two functions—creating desirable incentives and addressing wrongful acts—are more directly served by other laws of deception, such as the torts of deceit and negligent misrepresentation. The threat of rescission is a weak one, as compared to damage awards. And tort liability is a common way to signal that a wrong has been committed. This part and the next consider how these misrepresentation torts interact with contract law. This part discusses incentives, the next remedying wrongs.

Most contracts govern mutually beneficial exchange agreements. Suppose S agrees to sell their bicycle to B for \$100, and that the parties agree to this exchange because B values the bicycle at \$150, and because S values it at \$75. B stands to gain \$50 in value from the exchange, S \$25. The sum of these individual benefits constitutes the gains of trade, or contractual surplus. At the time of formation each party must determine for themselves whether they stand to benefit from the proposed exchange. To make that determination, a party often needs information about the other's promised performance. B must know something about the bicycle to know its value to B. S, as owner of the bicycle, is likely to possess that information. When this is so, the cheapest way for B to

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otherwise compensating the victim.' Shelly Kagan, 'Causation and Responsibility' (1989) 15 A Philosophy Q 293, 293.

<sup>19</sup> In his 1919 treatise on equity, George L. Clark observes: 'Since equity will rescind for mutual mistake as to an intrinsic fact the plaintiff's case is merely made stronger if it be shown that the defendant innocently caused the plaintiff's mistake.' George L. Clark, *Equity: An Analysis of Modern Equity Problems Designed Primarily for Students* (EW Stephens Publishing 1919) 511-12.

<sup>20</sup> See Richard Craswell, 'Property Rules and Liability Rules in Unconscionability and Related Doctrines' (1993) 60 U Chi L Rev 1, 7.

learn about the bicycle is for S to tell B what S knows about it. Effective communication, however, requires credibility. B must trust S to be truthful. Here noncontractual liability for misrepresentation can play a positive role. By holding S separately liable for any material misrepresentations, the law gives S a new reason to be truthful and gives B a new reason to trust S's statements.

This simple tale is far from the whole story with respect to the incentives legal liability for misrepresentation can provide in contractual settings. But it illustrates a core point: in conditions of mistrust, both parties can benefit from such liability. Just as legal liability for breach can enable mutually beneficial exchanges that might otherwise fail for lack of trust, legal liability for misrepresentation can enable information sharing necessary to make those exchanges happen. Because both parties benefit from the exchange, both benefit from the forms of legal liability that make it possible.

One need not be committed to a welfare-maximizing theory of law to see this as a good thing. Contracts are tools parties can use to engage in shared projects that might otherwise fail for lack of trust. The ability to contract expands party autonomy by enabling them to engage in new and valuable projects together. As the above simple story illustrates, legal duties of candor between contracting parties can do the same. A party's duty of candor is not a voluntary obligation in the strong sense that their duty to perform is. Parties undertake duties to perform, whereas the law imposes on them duties of candor.<sup>21</sup> But duties of candor in contractual relationships are nonetheless autonomy enhancing. Like liability for breach, they enable transactions that might otherwise fail for lack of trust, thereby expanding parties' opportunities to engage in shared projects.

Suppose A, the owner of the bicycle, knows of a hidden defect in it. Should A have a duty to share that information with B? Should the duties of candor that attach at formation include, in addition to the duty not to make false statements, duties to disclose? If more knowledge results in more value-creating transactions, why not require contracting parties to share all material information they have with one another?

A party-centered instrumentalist perspective suggests several reasons.<sup>22</sup> First, communication is not costless, to the speaker or to the hearer. Requiring disclosure forces parties not only to use more words, but to undertake the costs of ensuring that those words do not mislead. And the more information a hearer receives, the costlier it is to process it all and sort out what matters. It is possible for the law to demand too much disclosure.<sup>23</sup> Second, requiring parties to disclose valuable information prevents them from reaping all the benefits of possessing it, thereby reducing their incentives to acquire it. Mandating disclosure of all material information might thereby result in a reduction of

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<sup>21</sup> See David Owens, *Shaping the Normative Landscape* (2012) 3-6 (describing different senses in which an obligation can be said to be voluntary); Gregory Klass, 'Promise, Agreement, Contract' in (H. Dagan and B. Zipursky eds), *Research Handbook on Private Law Theories* (Elgar 2020) 44-45 (applying Owens's categories to contractual obligations).

<sup>22</sup> See Melvin A. Eisenberg, 'Disclosure in Contract Law' (2003) 91 CLR 1645, 1654-55.

<sup>23</sup> See Richard Craswell, 'Taking Information Seriously: Misrepresentation and Nondisclosure in Contract Law and Elsewhere' (2006) 92 Va L Rev 565, 575-80.

information leading to mutually beneficial exchanges.<sup>24</sup> Third are the costs of litigation and erroneous dispute resolutions. Adding additional layers of legal liability can raise the costs of contracting, reducing its benefits to parties.

Not every mandated disclosure reduces the gains of trade. If a party acquires information casually, or at no cost, requiring its disclosure does not disincentivize its production. And sometimes mandating disclosures of a type of information incentivizes the creating of valuable data that would not otherwise exist, such as product safety information. Like elsewhere in the law, getting the right incentives requires finding a happy medium.<sup>25</sup> Worries about too much information are less apposite when one party, having balanced out the nonlegal costs and benefits of sharing information, has chosen to speak. For this and other reasons the instrumentalist case for liability for false statements is easier than the case for liability for nondisclosure.<sup>26</sup>

A particularly salient piece of information is the likelihood that the other side will breach. Because contract remedies often neither fully deter breach nor fully compensate the nonbreaching party, a person deciding whether to enter a transaction usually cares about the probability that the other side will perform, including whether they currently intend to do so. The doctrine of promissory fraud addresses that concern.<sup>27</sup> The doctrine's premise is that a promise or other voluntary undertaking does more than express an intent to undertake an obligation by the very expression of that intent. It also implicitly represents that the promisor currently intends to perform. That implicit representation is part of ordinary language.<sup>28</sup> Its legal recognition in the doctrine of promissory fraud provides parties an important form of assurance that the proposed deal is in their interest. Because most promisors intend to perform, most want to provide that assurance. The implied, or default,

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<sup>24</sup> Anthony Kronman, 'Mistake, Disclosure Information, and the Law of Contracts' (1978) 7 JLS. 1. The above sentences describe the tip of a large iceberg. See also Saul Levmore, 'Securities and Secrets: Insider Trading and the Law of Contracts' (1982) 68 Va L Rev 117, 137-42 (extending Kronman's analysis to argue that lying in answer to some questions during negotiation should be nonactionable); Robert L. Birmingham, 'The Duty to Disclose and the Prisoner's Dilemma: Laidlaw v. Organ' (1988) 29 Wm & Mary L Rev. 249, 266-75 (distinguishing between socially productive and privately productive information); Robert Cooter and Tom Ulen, *Law and Economics* (6th edn, 2012) 357-59 (distinguishing between productive and redistributive information); Ariel Porat and Omri Yedlin, 'A Welfarist Perspective on Lies' (2016) 91 Ind LJ 618, 624-33 (extending Levmore's analysis of information-protecting lies).

<sup>25</sup> For an example of this balancing approach, adding in considerations of morality, see Eisenberg (n 22).

<sup>26</sup> The other reasons are manifold. For example: 'The liar makes a positive investment in manufacturing and disseminating misinformation. This investment is completely wasted from a social standpoint, so naturally we do not reward him for his lie.' Richard A. Posner, *Economic Analysis of Law* (2003) 111.

<sup>27</sup> For a detailed account and analysis of promissory fraud, see Ian Ayres and Gregory Klass, *Insincere Promises: The Law of Misrepresented Intent* (2005).

<sup>28</sup> See John R. Searle, *Speech Acts: An Essay in the Philosophy of Language* (1969) 54-63 (identifying an intent to perform among the felicity conditions of promising).

representation backed by separate liability in tort again serves parties' contractual interests.<sup>29</sup>

So far I have focused on the value of information before formation, when parties are deciding whether to agree to an exchange. This is not the only time when sharing information can add value. The probability performance, for example, can change, whether due to changed circumstances or to a change of mind. After the parties have entered a contract, new information about one side's performance, including whether there has been a breach, can be crucial to the other's decisions regarding how much more to invest in the transaction, whether to suspend their own performance, and whether to bring an action for breach. If when entering the exchange the parties' goal is to maximize the contractual surplus they will divide amongst themselves, parties should also value the law's help in sharing post-formation information about the probability of performance or breach.

The importance of such information explains the rule for adequate assurances, which provides that if one side's performance becomes doubtful, the other may demand adequate assurances of performance and treat failure to give them as a repudiation.<sup>30</sup> Here tort law can work hand in hand with the contract rule. An express assurance of a continuing intent to perform might be deemed adequate because the speaker thereby exposes themselves to additional liability in tort should it be false.

The adequate assurance rule grants parties the power to sometimes demand a post-formation assurance of performance. Absent such a demand, the law does not impose a general duty to inform the other side of that one has or is likely to breach. Nor does it recognize a post-formation implied representation of a continuing intent to perform. It is an interesting and open question why this is so. In nonlegal contexts there can be such a duty. Suppose I have promised to pick up my friend from the airport and something comes up that will prevent me from doing so. Obligations of friendship require that I tell my friend that I am unlikely to perform. Why does the law not impose a similar duty on contracting parties to share new information about the probability of performance? Similarly, why does it recognize an implied representation of an intent to perform at the time of formation, but not after?<sup>31</sup>

Parties sometimes contract for duties to share information about performance. A construction contract might require a certificate of compliance, or a royalty agreement that the licensee share with the licensor sales data. To provide effective incentives, the remedy for breach of such duties must go beyond compensation in contract. The cost of not learning of a breach is the inability to recover in contract for it. The nonbreaching party's loss, in other

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<sup>29</sup> For an instrumentalist argument for liability in tort for promissory fraud, see Ayres and Klass (n 27) 59-82.

<sup>30</sup> See Restatement (Second) of Contracts § 251 (Am L Inst 1981).

<sup>31</sup> With respect to getting the incentives right, the mitigation rule can do some of the work. Nonrecovery of avoidable losses gives the breaching party a reason to share information about breach. The sooner the nonbreaching party learns of the breach, the sooner they can take steps to avoid losses. This incentive works, however, only if there is a successful action for breach. If the breach is likely to go undetected or be difficult to prove, the breaching party might benefit from remaining silent about their nonperformance.

words, is what they would have recovered for the undisclosed breach. If the only remedy for the informational wrong is compensation, the breaching party risks little or nothing by attempting to hide their breach. Either the deception succeeds, and they avoid paying for the underlying breach, or the deception fails, and they must pay what they would have paid anyway.<sup>32</sup> Liability in tort, with its higher compensatory measures and the availability of punitive damages, can solve this incentive problem.<sup>33</sup>

The advantages of liability in tort for misrepresentations concerning performance illustrates a broader point. The efficient breach theory starts from the observation that both parties gain from each having the option to breach should performance turn out to be inefficient. Parties prefer the expectation measure because it does not prevent efficient breach, whereas penalties or punitive damages would.<sup>34</sup> The theory assumes, however, that every breach is followed by a damages award that forces the breaching party to internalize the costs of breach. Misrepresentations about performance can prevent such awards from happening. The efficient breach theory therefore recommends deterring such misrepresentations. Nor does the theory apply to opportunistic breaches, in which one side takes unbargained-for advantage of the other, as opportunism reduces the gains of trade. Fraudulent pre- and post-contractual misrepresentations are opportunistic in this sense. In short, attaching penalties or punitive damages to misrepresentations does not threaten efficient breach but advances the goals of the efficient breach theory.

The above discussion can be summarized as follows. Most contractual relationships involve a mix of trust and mistrust. By creating a remedy for breach, contract law can address mistrust about whether performance will happen. But parties often care about more than performance *vel non*. Sharing information before and after formation can be essential both to determining whether a proposed exchange will be mutually beneficial and to maximizing the value it creates. Mistrust can also prevent such information sharing. If the goals of contract law include enabling people to engage in joint value-creating projects that would otherwise fail for lack of trust, tort liability for pre- and post-formation misrepresentations can be as important to its success as is legal liability for breach. In fact, it would be difficult to imagine a contract law without it.

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<sup>32</sup> See Gregory Klass, 'Contracting for Cooperation in Recovery' (2007) 117 Yale LJ 2.

<sup>33</sup> U.S. courts are divided on whether breach of a contractual duty to share information about performance can support recovery in tort. See Jean Braucher, 'Deception, Economic Loss and Mass-Market Consumers: Consumer Protection Statutes as Persuasive Authority in the Common Law of Fraud' (2006) 48 Ariz L Rev 829; Catherine Paskoff Chang, Note, 'Two Wrongs Can Make Two Rights: Why Courts Should Allow Tortious Recovery for Intentional Concealment of Contract Breach' (2005) 39 Colum JL & Soc Probs 47; R. Joseph Barton, Note, 'Drowning in a Sea of Contract: Application of the Economic Loss Rule to Fraud and Negligent Misrepresentation Claims' (2000) 41 Wm & Mary L Rev 1789; Steven C. Tourek and Thomas H. Byrd and Charles J. Schoenwetter, 'Bucking the "Trend": The Uniform Commercial Code, the Economic Loss Doctrine, and Common Law Causes of Action for Fraud and Misrepresentation' (1999) 84 Iowa L Rev 875.

<sup>34</sup> For an overview of the history and limits of the efficient breach theory, see Gregory Klass, 'Efficient Breach' in G. Klass and G. Letsas and P. Saprai (eds), *Philosophical Foundations of Contract Law* (OUP 2014) 362.

### III. Tortious wrongs in contractual contexts

Not all parties enter contracts from a place of mistrust. Repeat play, reputation, and character can, individually or together, provide all the assurances parties need to engage in joint endeavors. But such trust is sometimes misplaced, as can be trust in legal incentives. When one party defects from an agreement, contract law serves also to clean up the mess. In addition to providing useful incentives *ex ante*, remedies for breach do justice *ex post* by conferring on nonbreaching parties the legal power to demand compensation for losses incurred. The same is true of the misrepresentation torts. They not only deter wrongful behavior, creating conditions of trust, but also provide compensation to those who suffer losses when trust is misplaced. The principal difference between this remedial aspect of contract and the misrepresentation torts lies in the nature of the wrong remedied by each: defection versus deception.

With respect to this remedial function, tort liability for misrepresentations between contracting parties is arguably nothing special. A lie between parties to a contract is wrongful for many of the same reasons a lie in other contexts is. The successful liar exploits and abuses another's trust. The liar treats the target of their deception as a means, not an end. The liar cannot universalize the maxim of their action. Lies erode valuable social practices of candor and trust. And so forth. All this is as true of lies in contractual exchanges as it is of lies elsewhere. The torts of deceit and negligent misrepresentation applied in the contractual context address the same types of wrongs they do elsewhere.

The doctrine of promissory estoppel illustrates. I argued above that at the time of formation, many parties want the assurances provided by an implied representation of an intent to perform backed by liability in tort. But we should not lose sight of the fact that the lying promise is a wrong of a different order than mere breach. The promisor who breaches because they have changed their mind disappoints the other side's expectations. The lying promisor has manipulated the other side, tricking them into entering a transaction that was not in their interest. That distinctive wrong also explains the separate, higher damage measures promissory fraud can trigger.

If the contractual context does not alter the remedial function of the misrepresentation torts, it can make a difference in determining whether there has been a wrong calling for a remedy. Contract law operates together with extralegal norms and practices to set the terms on which parties interact, sometimes referred to as the "morality of the marketplace." Those terms interact with laws of deception in three ways. First, the contractual context can systematically affect the meaning of what parties say and do, and so can be critical to identifying whether there was a misrepresentation. Second, contracts can shift parties' duties of candor in ways relevant to assessing whether a misrepresentation was wrongful. Third, laws of deception themselves help shape markets, and should therefore be crafted to promote socially desirable marketplace norms and contractual relationships.

The contractual context can affect the meaning of parties' words and actions. Consider once more time the doctrine of promissory estoppel. The Second Restatement of Torts suggests that "a promise necessarily carries with

it the implied assertion of an intention to perform.”<sup>35</sup> But this is an overstatement.<sup>36</sup> A contractual agreement that includes a nonrefundable deposit might, depending on context, represent only an intent to perform or forfeit the payment. And there are markets in which a contractual undertaking to perform is generally understood to be compatible with an intent, in a range of circumstances to, breach and pay damages.<sup>37</sup> The contractual context is highly relevant to interpreting what a voluntary undertaking implicitly represented, and therefore whether it misrepresented a party’s intent.

Particular legal rules can also affect what contracting parties’ words and actions mean. Judicial interpretation of the False Claims Act (FCA) provides an example. Under the FCA, a contractor with the federal government that submits “a false record or statement” material to a claim for payment is liable for treble damages and fines.<sup>38</sup> Since the 1990s, courts have held that the mere act of requesting payment from the government implicitly represents performance.<sup>39</sup> This implied certification doctrine has changed the meaning of asking for payment on these contracts. Sophisticated government contractors today know that by requesting payment they implicitly represent no breach. A similar phenomenon can be seen in common law disclosure duties. Judicial rulings that the seller of a residential property has a duty to disclose termites have, in effect, attached a new implied representation to selling a home: that it is termite free. The fact that the parties are in a contract is often essential to determining what, from a legal point of view, they are saying, and so also whether they have said something false.

The contractual context is also relevant to assessing the parties’ duties of candor, and so whether the law should treat misrepresentation or nondisclosure as wrongful. In some contexts, some deceptions are permissible. Although an ace up the sleeve is cheating, no one blames a poker player for bluffing. Similarly, few markets require full transparency, and many accept some types or degrees of misrepresentation.

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<sup>35</sup> Restatement (Second) of Torts § 530 cmt c (Am L Inst 1976). The Second Restatement of Contracts provides a more nuanced rule: “[i]f it is reasonable to do so, the promisee may properly interpret a promise as an assertion that the promisor intends to perform the promise.” Restatement (Second) of Contracts § 171(2) (Am L Inst 1981).

<sup>36</sup> See Ayres and Iltis (n 22) 108-12; Gregory Klass, ‘A Conditional Intent to Perform’ (2009) 15 LEG 107.

<sup>37</sup> Some proponents of the efficient breach theory have argued that contractual undertakings between sophisticated parties should always be understood not as commitments to perform, but as Holmesian commitments to perform or pay damages. Daniel Markovits and Alan Schwartz, ‘The Myth of Efficient Breach: New Defenses of the Expectation Interest’ (2011) 97 Va L Rev 1939, 1973-77. If that is right, an intent to perform or pay damages would not be fraudulent. To my knowledge, no court has recognized the efficient breach theory as a defense to promissory fraud.

<sup>38</sup> 31 USC §§ 3729-3733 (2006 & Supp III 2009).

<sup>39</sup> *Ab-Tech Const, Inc v United States*, 31 Fed Cl 429 (1994), aff’d sub nom *Ab-Tech Const v United States*, 57 F 3d 1084 (Fed Cir 1995) (introducing the implied-certification doctrine); *Universal Health Servs, Inc v United States*, 579 US 176 (2016) (recognizing that implied certification can be the basis for FCA liability in some circumstances); Michael Holt and Gregory Klass, ‘Implied Certification under the False Claims Act’ (2011) 41 Pub Cont LJ 1.

The misrepresentation torts do not, for example, typically prohibit a negotiator from lying about their reservation price. Nor do they punish puffery or sales talk.<sup>40</sup> The law reaches these outcomes by requiring that the plaintiff's reliance on the misrepresentation be justifiable or reasonable.<sup>41</sup> Market participants are expected to understand the norms of the market, including privileges to sometimes deceive. How much deception a given market tolerates is an empirical question.<sup>42</sup> Steven Gelber reports that in the nineteenth century market for horses, lies were not only tolerated but expected. "The morality—or more precisely, immorality—of horse trading derived from the way it operated as a game. . . . Horse traders expected to be judged by the ethics of the game."<sup>43</sup> Changes in the market and changes in the law have since changed that reasonable expectation. The line between permissible and impermissible deception has shifted.

Some have advanced deontological arguments for generic duties of candor between contracting parties, especially with respect to disclosure. Kim Lane Scheppele deploys a Rawlsian approach to argue that justice demands equality in bargaining relationships, from which it follows that there is a duty to disclose "deep secrets," whose possible existence the other side is fully ignorant of, as distinguished from "shallow secrets," whose existence the other party might suspect.<sup>44</sup> Alan Strudler takes as his explanandum the privilege not to disclose, and maintains that it protects "the advantages bargainers deserve for bringing valuable information to the bargaining table."<sup>45</sup> Marc Ramsay maintains that entering negotiations allows for a degree of self-interested behavior not permissible elsewhere, but that there is a contract-specific duty not to engage in unfair advantage taking and that each party is responsible for correcting reasonable, but mistaken, beliefs about the goods [the other] brings to the bargaining table.<sup>46</sup>

I am skeptical of such general accounts of contractual duties of candor. As Deborah DeMott observes with respect to mistake, "[common] scenarios implicate more than one policy objective or expression of moral intuition, all of

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<sup>40</sup> Stefanie Jung argues that German law takes adopts, at least as a matter of black-letter law, a much less forgiving attitude towards such misrepresentations than does the common law. Stefanie Jung, 'Bluffing in Business-to-Business Contract Negotiations' (2019) 92 S Cal L Rev 973, 983-1000.

<sup>41</sup> See Restatement (Second) of Torts § 537 (Am L Inst 1979) (requiring that the plaintiff's reliance was justifiable). But this is not all there is to these requirements. See Gergen (n. 15): The law also tolerates non-material misrepresentations. For an efficiency-based explanation of that rule, see Emily Sherwin, 'Nonmaterial Misrepresentation: Damages, Rescission, and the Possibility of Efficient Fraud' (2003) 36 Loy LA L Rev 1017.

<sup>42</sup> See Edward J. Balleisen, *Fraud: An American History from Barnum to Madoff* (2017) 50-54, 97-99 (discussing the historically contingent nature of what constitutes fraud).

<sup>43</sup> Steven M. Gelber, *Horse Trading in the Age of Cars: Men in the Marketplace* (2008) 15.

<sup>44</sup> Kim Lane Scheppele, *Legal Secrets: Equality and Efficiency in the Common Law* (1988) 77-79.

<sup>45</sup> Alan Strudler, 'Moral Complexity in the Law of Nondisclosure' (1997) 45 UCLA L Rev 337, 340.

<sup>46</sup> Marc Ramsay, 'The Buyer/Seller Asymmetry: Corrective Justice and Material Non-Disclosure' (2006) 56 UTLJ 115, 144.

them justifiable, many of them conflicting.”<sup>47</sup> If, as DeMott further suggests, “parties who deal at arm’s length are free to take a sporting view of their relationship with each other,”<sup>48</sup> the proper focus should be on the rules of the game they are playing, rather than on generic deontological arguments.

This is not to say that the law should not protect those who are ignorant of the rules of the game, punish those who attempt to exploit them, or attend to individual cases of injustice. Nor are all games of equal social value. This brings me to my last point. Laws of deception do more than recognize market norms. They also help shape them. For all their virtues, markets can be sites of exploitation, discrimination, and alienation, not to mention sources of enduring economic, social, and political inequality. Nor are market transactions hermetically sealed from other forms of sociability. Market norms might affect how people think about their responsibilities to one another generally. In short, not all markets are created equal. Some markets and market norms are more socially desirable than others.<sup>49</sup> Although courts should attend to local rules of the game regarding candor, they should not always defer to them. Laws of deception can also be deployed to make markets better.

## 1. Conclusion

Although this chapter has treated the misrepresentation defenses and the misrepresentation torts separately, the doctrines support one another. As noted in Part Two, the defenses serve not only allocate the costs of defective consent, but also to deter precontractual lies and prevent deceivers from benefiting from their wrongs. Similarly, the deterrence provided by the misrepresentation torts further ensures that contractual transactions are voluntary ones. And among the reasons precontractual lies are wrongs deserving remedies is that they subvert contract law’s goal of enforcing only voluntary undertakings.

The distinct aspects of the misrepresentation torts identified in Parts Two and Three—the positive incentives they create and their role in remedying wrongs—are also interwoven. Part Two emphasized ways information-sharing can help parties identify value-creating exchanges and maximize the gains of trade those exchanges produce. The marketplace norms discussed in Part Three should be evaluated in part on how well they serve those interests. But only in part. Contract law should seek to do more than help parties maximize gains of trade. As Hanoch Dagan and Michael Heller emphasize,<sup>50</sup> for example, the default and mandatory rules that attach to specific contract types—employment agreements, franchise relationships, consumer transactions, and so forth—also serve to guide parties toward culturally meaningful forms of engagement that promote autonomy in yet other ways. Those forms of engagement are likely to

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<sup>47</sup> Deborah A. DeMott, ‘Do You Have the Right to Remain Silent?: Duties of Disclosure in Business Transactions’ (1994) 19 Del J Corp L 65, 66.

<sup>48</sup> *ibid* 65.

<sup>49</sup> For an argument along these lines concerning the social value of a practice of efficient breach. Gregory Klass, ‘The Rules of the Game and the Morality of Efficient Breach’ (2017) 29 Yale JL. & Human 71, 97-109.

<sup>50</sup> Hanoch Dagan and Michael Heller, *The Choice Theory of Contracts* (2017).

include duties of candor, compliance with which the misrepresentation torts incentivize.

This chapter has discussed only three of the ways laws of deception advance the goals of contract law: by ensuring that contractual agreements are sufficiently voluntary; by creating incentives that enable parties to act together in ways that benefit both, thereby promoting party autonomy; and by giving deceived parties the power to recover from those who have wronged them, thereby recognizing and defining market norms. There is more to say about the connection between contract law and the law of deception. Regulators have sought to use mandatory disclosure, for example, to address disparities in bargaining power and to prevent contract law being used to systematically disadvantage groups such as consumers and employees.<sup>51</sup> And there is empirical evidence that contract terms themselves can be tools of deception, as ordinary people tend to assume unfair terms are enforceable even when they are not.<sup>52</sup> Nor has this chapter had much to say about how other laws of deception, such as false advertising law or securities law, interact with the law of contract. I hope it has said enough, however, to convince that duties of candor are as integral to contract law as are duties to perform.

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<sup>51</sup> The success of these efforts is open for debate. See Omri Ben-Shahar and Carl E. Schneider, 'The Failure of Mandated Disclosure' (2011) 159 U Pa L Rev 647 (arguing the thesis in the title); Richard Craswell, 'Static Versus Dynamic Disclosures, and How Not to Judge Their Success or Failure' (2013) 88 Wash L Rev 333 (critically assessing Ben-Shahar and Schneider's argument).

<sup>52</sup> Tess Wilkinson-Ryan, 'The Perverse Consequences of Disclosing Standard Terms' (2017) 103 Cornell L Rev 117; Meirav Furth-Matzkin and Roseanna Sommers, 'Consumer Psychology and the Problem of Fine-Print Fraud' (2020) 72 Stan L Rev 503.