Michigan Law Review

Volume 32 | Issue 7

1934

CONTRACTS - FRAUD -TESTS OF MATERIALITY IN DECEIT AND ON RESCISSION FOR FRAUD

Follow this and additional works at: https://repository.law.umich.edu/mlr

Part of the Contracts Commons

Recommended Citation

CONTRACTS - FRAUD -TESTS OF MATERIALITY IN DECEIT AND ON RESCISSION FOR FRAUD, 32 MICH. L. REV. 968 (1934).

Available at: https://repository.law.umich.edu/mlr/vol32/iss7/5

This Comment is brought to you for free and open access by the Michigan Law Review at University of Michigan Law School Scholarship Repository. It has been accepted for inclusion in Michigan Law Review by an authorized editor of University of Michigan Law School Scholarship Repository. For more information, please contact mlaw.repository@umich.edu.

COMMENTS

CONTRACTS — FRAUD — TESTS OF MATERIALITY IN DECEIT AND ON RESCISSION FOR FRAUD — Current decisions abundantly show the usefulness and efficiency of remedies based on rescission in contracts induced by fraud, as compared with damage remedies. Modern improvements in the rescission remedies go far to explain their popularity. On the other hand, the tests for "materiality" of misrepresentations that are unavoidably connected with the action of deceit have restricted its utility. Both the advantages of rescission and the disadvantages of damage remedies appear most clearly in a period of rapidly fluctuating and uncertain values. These considerations seem to justify a comparative study of the tests of "materiality" evolved by recent decisions in actions for damages and in actions to rescind for misrepresentation.

I.

Ideally, the remedy of deceit is designed to enable a seller to recover the damages "caused" by misrepresentation. In a majority of the States this result is sought to be achieved by a measure of damages based on a breach of warranty theory; that is, the difference between the ac-

tual value of the thing sold and what it would have been worth if it had been as represented.[1] The federal courts and a minority of the States limit recovery, in conformity with the general rule in tort actions, to the difference between the actual value and the amount paid.[2]

Under both rules the subtrahend of the equation is the same, that is, the actual value, but this term requires further definition, and it is here that difficult causation problems arise. Thus, ordinary principles of tort causation, which are applicable in deceit,[3] require that in determining the actual value, depreciation attributable to some factor other than the falsity of the representations should not be deducted. This consideration makes the damage remedy questionable where the injury traceable to the misrepresentation is little more than nominal, but substantial damage has been suffered. Thus, where the misrepresentation is of intention to perform a promise, it is the breach of the promise which causes the injury; if the promisor chooses to perform, there is no injury.[4] A further illustration is *Seneca Wire and Mfg. Co. v. Leach & Co.*[5] in which the only misrepresentations were that application would be made to the New York Stock Exchange to list the security offered for sale, and, later, that application had been made. The issuing company went into receivership, and the buyer rescinded. The injury resulting from the falsity of the representations was at most a small element in the plantiff's loss, and a damage remedy would clearly have been inadequate.

The fact that the property involved in a transaction giving rise to an action in deceit has, in general, both an intrinsic and a market value, both subject to fluctuation from time to time, raises further difficulties not present in the ordinary tort causation problem. In many fraud cases "actual value" may properly be interpreted as meaning the mar-

[1] 4 SUTHERLAND, DAMAGES, 4th ed., sec. 1163 (1916); BIGELOW, FRAUD, 627 *et seq.* (1888); 57 A.L.R. 1142 at 1143 (1928); Sankey v. United Mercantile Agency, 40 S.D. 444, 167 N.W. 493 (1918); Whitney v. Lynch, 222 Mass. 112, 109 N.E. 826 (1915).

[2] 4 SUTHERLAND, DAMAGES, 4th ed., sec. 1163 (1916); 57 A.L.R. 1142 at 1146-47 (1928); 35 YALE L.J. 757 (1926); 73 UNIV. PA. L. REV. 207 (1925); Stone v. Pounds, 126 Miss. 671, 88 So. 629, 89 So. 652 (1921); Reno v. Bull, 226 N.Y. 546, 124 N.E. 144 (1919); Ebacher v. First State Bank, 188 Minn. 268, 246 N.W. 903 (1933).

[3] Jex v. Straus, 122 N.Y. 293, 25 N.E. 478 (1890); Austin v. Barrows, 41 Conn. 287 (1874); Fottler v. Moseley, 179 Mass. 295, 60 N.E. 788 (1901).

[4] This difficulty is not usually noticed. See, for example, Swift v. Rounds, 19 R.I. 527, 35 Atl. 45, 33 L.R.A. 561, 61 Am. St. Rep. 791 (1896), allowing recovery; Dawe v. Morris, 149 Mass. 188, 21 N.E. 313, 14 Am. St. Rep. 404 (1889), denying relief.

[5] 247 N.Y. 1, 159 N.E. 700 (1928); see also Gunderson v. Havana-Clyde Min. Co., 22 N.D. 329, 133 N.W. 554 (1911).

ket price because, since it is the value which others have acted on, it is more reliable than some hypothetical "intrinsic" value, and because, practically, the proof is less difficult. On the other hand, particularly where a sale of corporate securities is involved, the market price may be influenced by the same representations on which the plaintiff relied, and therefore would not reflect the loss which the plaintiff had suffered. Several courts have consequently held that in such cases it is the intrinsic value which governs.[6] A determination of the intrinsic value, particularly of corporate securities or realty, always raises a difficult problem of proof, however, and it has been held that the market price is competent evidence of the real value, and may be, at least in the absence of other proof, controlling.[7] The advantage to the plaintiff in being permitted to recover on the basis of the intrinsic value may consequently be more apparent than real.

The difficulties inherent in the damage remedy are increased by the necessity for choice of a date as of which value is to be determined. One court has taken the value at the time the fraud was discovered as controlling,[8] but this view has been criticised on the ground that it permits recovery for a depreciation in no way traceable to the falsity of the representations.[9] A second possibility is the time of suit, but this is subject to the same objection, and in addition permits the plaintiff to speculate on further changes in value. A vast majority of the courts have, therefore, in order to limit the damages to those caused by the fraud, fixed the date at the time of the fraudulent transaction.[10] In many cases this limitation may be immaterial, since the injury will be complete at the time, but the time factor may become paramount where a sale of land, stock or bonds is involved. In these cases the purchaser frequently intends to hold the property for a considerable period, and may suffer a heavy loss through a subsequent decline, at least a portion of which may be traceable to the misrepresentation. In *Moore v. Beak-*

[6] Peek v. Derry, 37 Ch. D. 541 (1887); Whitney v. Lynch, 222 Mass. 112, 109 N.E. 826 (1915); Whiting v. Price, 172 Mass. 240, 51 N.E. 1084, 70 Am. St. Rep. 262 (1898); Morrow v. Franklin, 289 Mo. 549, 233 S.W. 224 (1921).

[7] Warner v. Benjamin, 89 Wis. 290, 62 N.W. 179 (1895); Hazelton v. Carolus, 132 Ill. App. 512 (1907); Johnson v. Niles Invisible Door Check Co., 222 Ill. App. 65 (1921); Redding v. Godwin, 44 Minn. 355, 46 N.W. 563 (1890).

See the discussion as to the difficulty of measuring damages in sales of corporate securities by Shulman, 43 YALE L.J. 227 (1933).

[8] Danielson v. Skidmore, 125 Ark. 572, 189 S.W. 57 (1916); Fort Smith Lumber Co. v. Baker, 123 Ark. 275, 185 S.W. 277 (1916).

[9] Hotaling v. Leach & Co., 247 N.Y. 84, 159 N.E. 870 (1928).

[10] 57 A.L.R. 1142 at 1150-51 (1928); Rochester Bridge Co. v. McNeill, 188 Ind. 432, 122 N.E. 662 (1919); Ebacher v. First State Bank; 188 Minn. 268, 246 N.W. 903 (1933); Whitney v. Lynch, 222 Mass. 112, 109 N.E. 826 (1915).

ley[11] the plaintiff had purchased bonds for $1,300, and brought an action for deceit when they turned out to be worthless. It was admitted that at the time of the sale the market value was equal to the amount paid, and recovery was denied on the ground that the defendant could not be held for any depreciation which occurred subsequently. A more recent illustration is *Ebacher v. First State Bank.*[12] There plaintiff had purchased a bond which, according to uncontroverted evidence, was worth 20 to 25 cents on the dollar at the time of the sale, although it was admittedly worthless at the time of the suit. The jury fixed the damages at the amount paid. A new trial was ordered unless the plaintiff consented to a reduction of the verdict, and the court said:[13] "The damages must be fixed as of the date of the transaction. This is not an action for rescission. All sorts of securities whose value was unquestionably above par in December, 1928, have since fallen below par." This strict view may often make the remedy in deceit practically worthless, and some courts have adopted a more liberal attitude, permitting subsequent developments to be shown for the purpose of determining the value as of the time of the sale.[14] They do not, however, depart from the fundamental principle.[15] Losses not traceable to some defect inherent in the property sold at the time of the sale cannot be shown, and hence the interpretation does not aid a party whose injury was caused by some intervening factor, such as a general decline in values. In the New York case of *Hotaling v. Leach & Co.*[16] an exception

[11] (Tex. Civ. App. 1916) 183 S.W. 380. The court said at p. 383: "In order to ascertain the loss the injury should be confined to the time of the trade. If the bonds were worth $1,300 when they were delivered to plaintiffs, as they admit they were, the defendant cannot be held to have guaranteed they would never decrease in value." Reversed above, the court finding that the evidence did not show the admission.

[12] 188 Minn. 268, 246 N.W. 903 (1933).

[13] 188 Minn. 268 at 270 (1933).

[14] Peek v. Derry, 37 Ch. D. 541 (1887); Whiting v. Price, 172 Mass. 240, 51 N.E. 1084; 70 Am. St. Rep. 262 (1898); Morrow v. Franklin, 289 Mo. 549, 233 S.W. 224 (1921).

[15] Morrow v. Franklin, 289 Mo. 549 at 571, 233 S.W. 224 at 230 (1921): "It is urged that the value of the stock at the date of the purchase is the value to be considered in determining the damages in deceit cases. This is true, but it does not follow from this that the subsequent history of the corporation may not throw some light upon the value at the time of the purchase, and it is upon this theory that such evidence is competent."

[16] 247 N. Y. 84, 159 N. E. 870 (1928). In January 1920, plaintiff had purchased a bond for $980, for investment. The bond was one of a $5,000,000 issue of first lien bonds of the National Oil Co. of New Jersey, secured by a trust indenture on its property. The company encountered financial difficulties in January 1922, and in May a receiver was appointed. The trust indenture was foreclosed, and the property sold at forced sale to a bondholder's committee for $50,000. Plaintiff received $5.84 for his bond. See also Smith v. Duffy, 57 N.J.L. 679, 32 Atl. 371 (1895).

was recognized on its peculiar facts, and recovery was permitted for "the loss which the plaintiff sustained through the purchase and continued ownership of the bond" of an oil company, a loss occasioned both by concealed weakness in the corporation's financial situation and by a general disintegration of the oil industry. The dangers in so liberal a rule of damages, and conversely the justification for the time limitation usually enforced, must be apparent, particularly in jurisdictions allowing damages in deceit to include the value which the subject matter was represented to have.[17] A purchaser, even though influenced by misrepresentations, must be held to have assumed the ordinary risks attending an investment. The flotation of corporate securities would be too severely handicapped if, because of what might be a comparatively minor misrepresentation, the seller could be required to make good in damages every subsequent loss, regardless of its cause. Even if tort theories of causation and the special requirements in the fraud field for justifiable reliance[18] should restrict the total of recoverable damages, it would be undesirable to impose on the representor a guaranty against subsequent alterations in conditions represented at the time to exist.

2.

The strict limitations applied in deceit contrast sharply with the very liberal attitude shown by many courts in actions for rescission, relief being allowed in many cases on a showing that the contract was "induced" by the fraud. The plaintiff in *Stillwell v. Rankin*[19] had been induced to purchase stock by a false representation that it was treasury stock. The court pointed out that a person might be willing to purchase treasury stock to supply working capital and protect his investment, but unwilling to increase his investment by purchase of issued stock, and held that this constituted a sufficient injury to warrant rescission, even though no pecuniary damage was shown. An ac-

[17] The result would not be so extreme in one of the minority jurisdictions, since the maximum recovery, even where the thing sold became worthless, would be the amount paid.

[18] In Gunderson v. Havana-Clyde Min. Co., 22 N.D. 329, 133 N.W. 554 (1911), plaintiff had invested in mining stock. Misrepresentations had been made that there was a large quantity of ore already mined valuable enough to justify the erection of an extracting mill; that the stock was worth par, although offered at 15 per cent of par, and that 1000 shares would make the plaintiff independent for life. The mine turned out to be valueless, but the court denied recovery in deceit, holding that the insufficiency of the evidence made an estimation of damages resulting from the first misrepresentation too speculative and that plaintiff had no right to rely on the others.

[19] 55 Mont. 130, 174 Pac. 186 (1918); but see Mason v. Madson, 90 Mont. 489, 4 Pac. (2d) 475 (1931).

tion of deceit would clearly have failed in this case under either the majority or minority rule, since treasury stock and issued stock would have the same value in the hands of a purchaser. The principle of *Stillwell v. Rankin* was also applied in *Brett v. Cooney*,[20] in which the plaintiff was induced to convey property by a misrepresentation as to the identity of the intended remote grantee. It was suggested that since the grantor would not have conveyed if the ultimate grantee's identity had been known, the transaction was "induced" by fraud and could be set aside in equity. This test was extended in *Seneca Wire & Mfg. Co. v. Leach & Co.* to an action "at law" under the New York Code to secure the restitution of the purchase money paid for stock,[21] and numerous other decisions announce a similar rule, either in defensive rescission at law or affirmative action for rescission and restitution in equity.[22]

The liberality of these decisions is to be explained partly by the comparative simplicity of rescission remedies. In their normal operation they aim merely to restore the original situation on both sides of the transaction. Some problems of valuation will remain where specific restitution on either side is impossible,[23] and an intervening destruction or deterioration of the subject matter may be embarrassing.[24] The survival of special damages, even after rescission and restitution have been accomplished, may require some stretching of legal doctrines in exceptional cases.[25] But rescission avoids many difficult problems in the assessment of damages, particularly under the majority view which attempts to measure, in money terms, the purely hypothetical value that the subject matter would have had if it had been as represented. It is not surprising that legislation has adopted rescission in preference to the damage remedy in similar situations.[26]

[20] 75 Conn. 338, 53 Atl. 729, 1124 (1902). *Contra*, Stewart v. Monad Engineering Co., 26 Del. (3 Boyce) 165, 84 Atl. 209 (1912).

[21] 247 N.Y. 1, 159 N.E. 700 (1928).

[22] Brown v. Search, 131 Wis. 109, 111 N.W. 210 (1907); Higbee v. Trumbauer, 112 Iowa 74, 83 N.W. 812 (1900); Barnes v. Central Savings Bank, 149 Iowa 367, 128 N.W. 541 (1910); Vaiden v. Rudolph, (N.Y. Sup. 1913) 145 N.Y. S. 55; Everson v. J. L. Owens Mfg. Co., 145 Minn. 199, 176 N.W. 505 (1920); MacLaren v. Cochran, 44 Minn. 255, 46 N.W. 408 (1890); Williams v. Kerr, 152 Pa. 560, 25 Atl. 618 (1893).

[23] Gray v. Trick, 243 Mich. 388, 220 N.W. 741 (1928); 42 HARV. L. REV. 438 (1929); 31 MICH. L. REV. 436 (1933); Basye v. Paola Refining Co., 79 Kan. 755, 101 Pac. 658 (1909).

[24] 32 MICH. L. REV. 550 (1933).

[25] See 32 MICH. L. REV. 113 (1933).

[26] Mich. Comp. Laws (1929), sec. 9788; Mo. Rev. Stat. (1929), sec. 7747; Ill. Rev. Stat. (Cahill 1933), c. 32, sec. 290; and especially secs. 11 and 12 of the Securities Act of 1933, 48 Stat. 74, U.S.C.A. tit. 15, secs. 77k, 77l (1933 Cum. Supp.)

A broader notion is reflected in some of the cases, the notion that the choice of a party to a legal transaction should not be influenced by false information supplied by the opposite party. If motivation is to be protected against this type of influence, the sole inquiry will be whether the transaction would have been entered into if some fact had not been misrepresented. The representor's knowledge or innocence would, from this point of view, be immaterial.[27] Numerous cases employ such a test. For the representee it has obvious advantages, since it dispenses with proof of pecuniary injury and guarantees him against serious loss if the transaction proves to be disadvantageous. But it is at least doubtful whether legal relief, even in the limited form of rescission and restitution, should be available to protect a representee against unsubstantial defects in performance, and allow him to gamble, without serious risk, on major shifts in economic conditions.

Some further limitation of the power to rescind seems desirable. Many cases do impose the further requirement that pecuniary damage must be shown. Whether it exists is determined by the same rules that govern in deceit.[28] As stated by Pomeroy,[29] this view requires a showing of some pecuniary injury, although the amount, if at all appreciable, is immaterial, and the exact sum need not be shown.

If the jurisdiction is one following the majority rule in deceit, that the measure of damages is the difference between the actual value and the value as represented, an application of the same principles in rescission may not embarrass the plaintiff. In the leading case of *Spreckels v. Gorrill*[30] the plaintiff had been induced to purchase stock by a false representation that the company owned a valuable patent. The court quoted Pomeroy with approval, but allowed rescission even though there was no showing that the stock was worth less than the amount paid, pointing out that the stock would certainly have been more valuable if the company had had the patent, and consequently "damage" existed.

[27] It is familiar doctrine that, in equity at least, knowledge of falsity is not required in rescission for misrepresentation. See 37 YALE L.J. 1141 (1928). It should perhaps be pointed out that the absence of this requirement constitutes a very great practical advantage in the rescission remedy.

[28] Aron v. De Castro, (N.Y. Sup. 1891) 13 N.Y.S. 372.

[29] 2 POMEROY, EQUITY JURISPRUDENCE, 4th. ed., sec. 898, p. 1864 (1918): "The party must suffer some pecuniary loss or injury as the natural consequence of the conduct induced by the misrepresentation. . . . Fraud without resulting pecuniary damage is not a ground for the exercise of remedial jurisdiction, equitable or legal. . . . If any pecuniary loss is shown to have resulted, the court will not inquire into the extent of the injury; it is sufficient if the party misled has been very slightly prejudiced, if the amount is at all appreciable."

[30] 152 Cal. 383, 92 Pac. 1011 (1907). See also Wainscott v. Occidental Bldg. and Loan Ass'n, 98 Cal. 253, 33 Pac. 88 (1893).

The Texas court, which follows the minority rule for measuring damages in deceit, has likewise adopted the requirement of pecuniary loss in rescission. In *Russell v. Industrial Transportation Co.*[31] agents of the defendant misrepresented that the stock sold would be up 25 per cent in fifteen days, and that it would pay 8 per cent. The jury in the rescission action found that the reasonable value at the time of the purchase was unknown. The court denied relief because of the impossibility of determining the pecuniary loss. Although the same result would probably have been reached even though the court followed the majority view in deceit, the decision has been severely criticized on the ground that a liberal rule in rescission is particularly desirable where the narrow rule of damages prevails if the defrauded party is to obtain adequate redress.[32]

Even where a showing of pecuniary injury is necessary, rescission may be the more adequate remedy, since the second branch of Pomeroy's rule, that the extent of the injury will not be inquired into if it is at all appreciable, is not to be ignored. Thus, in *Dubovy v. Woolf*,[33] a contract for the sale of a tenement building was rescinded even though the only defects shown could have been repaired for little more than $50, and the purchase price was $7750. But that this consideration is no cure-all is indicated by *Ziegler v. Stinson*[34] in which it had been represented that a note was secured by mortgage on the realty involved, but not on the personalty, when in fact it was secured by mortgages on both. It was held that the resulting inability to dispose of the personalty occasioned only nominal damage, insufficient to justify a rescission.

Another possible limitation is suggested by *Labar v. Lindstrom*,[35] in which it was held, where the misrepresentation was innocent, that its "materiality" could be determined objectively and rescission denied if the discrepancy was relatively unimportant and readily measureable in money. This result is supported by the analogous cases of rescission for breach of contract, where courts of equity have usually claimed a wide discretion in the grant or refusal of rescission.[36]

If it is conceded that every contract induced by fraud should not

[31] 113 Tex. 441, 251 S.W. 1034 (1923), rehearing 258 S.W. 462 (1924). See also Kanaman v. Hubbard, (Tex. Civ. App. 1913) 160 S.W. 304; aff'd 110 Tex. 560, 222 S.W. 151 (1920).

[32] 2 TEX. L. REV. 524 (1924); 4 TEX. L. REV. 510 (1926).

[33] 127 Me. 269, 143 Atl. 58 (1928).

[34] 111 Ore. 243, 224 Pac. 641 (1924).

[35] 158 Minn. 453, 197 N.W. 756 (1924). See the argument in favor of this restriction on rescission remedies in 28 YALE L. J. 178 (1918).

[36] Baughan v. Mortgage and Contract Co., 263 Mich. 249, 248 N.W. 611 (1933); 27 R.C.L. 646 (1920).

be rescindable, the limitation suggested by Pomeroy seems inadequate.[37] It is based on rules devised for the entirely different problems involved in the measurement of damages for deceit, and is essentially arbitrary, since the presence or absence of pecuniary damage may be merely a single element in a complex economic problem. Moreover, since a substantial amount of damage need not be shown, the limitation does not wholly exclude relief in those cases in which the injury is trivial. The rule of *Labar v. Lindstrom* is not subject to these objections, although it has the disadvantages of any rule that is so phrased as to introduce a wider judicial discretion. It provides no clear-cut solution but enables the courts to take account of additional factors in determining which party should be made to bear the loss caused by extrinsic factors, such as unforeseen and catastrophic changes in economic conditions.

R. J. S.

---

[37] The rule is criticized in 1 BLACK, RESCISSION AND CANCELLATION, 2d ed., sec. 112 (1929), and 1 PAGE, CONTRACTS, 2d ed., sec. 335 (1920).