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Torts-Negligent Misrepresentation-Abolition of the Privity Requirement

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TORTS—NEGLIGENT MISREPRESENTATION—ABOLITION OF THE PRIVITY REQUIREMENT—Defendants, professional consulting engineers, contracted with the city of Chattanooga to design a sewage system. As part of their performance of the contract they prepared a report of geological conditions which was to be distributed by the city to prospective bidders. Plaintiff, a tunneling subcontractor, had no dealings with the defendants, but did rely on their report in making its bid. Because one of defendant's draftsmen carelessly omitted pertinent geological information from the report, it took plaintiff three weeks longer to complete the work than had been anticipated. Plaintiff sued defendant for damages for misrepresentation; *held*, plaintiff may recover. A person who makes a material and negligent misrepresentation in the course of a business transaction is liable for injuries suffered because of justifiable reliance on the misrepresentation by any member of that class of persons whose reliance was reasonably foreseeable. *Texas Tunneling Co. v. City of Chattanooga*, 204 F. Supp. 821 (E.D. Tenn. 1962).[1]

Misrepresentation is one of the most perplexing areas of modern law. Courts and writers have taken almost every conceivable position,[2] causing confusion in both theory and practice. Many of the difficulties can be traced to Lord Herschell's original formulation of the modern action of deceit. Despite its disarming appearance of clarity, this classic dictum in

1 The name of the case derives from the fact that plaintiff's original suit was against the City of Chattanooga and another engineer as well as the defendants. The action was dismissed as to these other parties. Principal case at 825-26.

2 Some of the most interesting case discussions are found in Cunningham v. C. R. Pease House Furnishing Co., 74 N.H. 435, 69 Atl. 120 (1908); Ultramares Corp. v. Touche, 255 N.Y. 170, 174 N.E. 441 (1931); Derry v. Peek, 14 App. Cas. 337 (1889). Misrepresentation has received much attention from the writers. See, *e.g.*, Bohlen, *Misrepresentation as Deceit, Negligence, or Warranty*, 42 HARV. L. REV. 733 (1929); Bohlen, *Should Negligent Misrepresentation Be Treated as Negligence or Fraud?*, 18 VA. L. REV. 703 (1932); Carpenter, *Responsibility for Intentional, Negligent, and Innocent Misrepresentation*, 24 ILL. L. REV. 749 (1930); Green, *Deceit*, 16 VA. L. REV. 749 (1930); Green, *Innocent Misrepresentations*, 19 VA. L. REV. 242 (1933); Hawkins, *Professional Negligence Liability of Public Accountants*, 12 VAND. L. REV. 797 (1959); Meek, *Liability of the Accountant to Parties Other Than His Employer for Negligent Misrepresentation*, 1942 WIS. L. REV. 371; Seavey, *Mr. Justice Cardozo and the Law of Torts* (pts. 1-3), 52 HARV. L. REV. 372, 48 YALE L.J. 390, 39 COLUM. L. REV. 20 (1939); Smith, *Liability for Negligent Language*, 14 HARV. L. REV. 184 (1900); Williston, *Liability for Honest Misrepresentation*, 24 HARV. L. REV. 415 (1911). The four articles by Professors Bohlen and Green above form an interesting dialogue of competing ideas.

Derry v. Peek[3] states the requirements of a deceit action in highly ambiguous terms. The rule is phrased in terms of "fraud," but, though one would ordinarily think that *scienter* must be shown to establish fraud, the *Derry v. Peek* rule allows recovery for misrepresentations made without belief in their truth, or made recklessly, careless whether they be true or false. Neither of these alternatives requires an intent to deceive. To compound the ambiguity, the rule does not make clear what burden of proof a plaintiff in a deceit action must carry. *Derry v. Peek* requires "proof of fraud," but, as noted in the principal case,[4] this could mean either that "fraud" must be proved, or merely that some proof—some evidence—of "fraud" must be adduced. Although most American courts regard *Derry v. Peek* as controlling authority and purport to demand fraudulent intent,[5] the ambiguous language used by the House of Lords has made it possible for courts to permit recovery in deceit based solely on an inference of fraud drawn from proof of negligence.[6]

Another reason for the confusion is that several different legal theories can properly be applied to the typical factual situations in which misrepresentations arise. Although in *Derry v. Peek* the House of Lords was dealing only with deceit actions, the rule of that case has been taken by many courts to preclude any action for negligent or innocent misrepresentation. In these courts, liability for false representation may be roughly characterized as requiring intentional wrong.[7] The commercial transactions which give rise to claims of misrepresentation, however, often present facts which can be analyzed in terms of estoppel, rescission, warranty, or negligence, as well as in terms of deceit.[8] Consequently, courts which are unwilling to confine misrepresentation to actions in deceit often impose

3 "First, in order to sustain an action of deceit, there must be proof of fraud, and nothing short of that will suffice. Secondly, fraud is proved when it is shown that a false representation has been made (1) knowingly, or (2) without belief in its truth, or (3) recklessly, careless whether it be true or false." Derry v. Peek, 14 App. Cas. 337, 374 (1889).

4 Principal case at 827.

5 *E.g.*, C. W. Denning Co. v. Suncrest Lumber Co., 51 F.2d 945 (4th Cir. 1931); Dundee Land Co. v. Simmons, 204 Ga. 248, 49 S.E.2d 488 (1948); Kountze v. Kennedy, 147 N.Y. 124, 41 N.E. 414 (1895); Newman v. Kendall, 103 Vt. 421, 154 Atl. 662 (1931).

6 Kimber v. Young, 137 Fed. 744 (8th Cir. 1905); Vincent v. Corbett, 94 Miss. 46, 47 So. 641 (1908); State St. Trust Co. v. Ernst, 278 N.Y. 104, 15 N.E.2d 416 (1938); Ultramares Corp. v. Touche, 255 N.Y. 170, 174 N.E. 441 (1931); Shwab v. Walters, 147 Tenn. 638, 251 S.W. 42 (1922).

7 See cases cited in note 5 *supra*. As indicated in the text at note 6 *supra*, stating the rule in terms of fraud does not mean that actual intent to deceive is necessary. Even within its broad limits, however, the rule of *Derry v. Peek* requires more than mere negligence, though at times "gross" negligence may suffice. See, *e.g.*, State St. Trust Co. v. Ernst, *supra* note 6.

8 See Bohlen, *Misrepresentation as Deceit, Negligence, or Warranty*, *supra* note 2; Green, *Deceit*, *supra* note 2; Williston, *supra* note 2; and the interesting hypothetical case propounded in PROSSER, TORTS 531 (2d ed. 1955), where eight different remedies are open to a plaintiff who purchased a horse and a cow.

either strict liability[9] or liability for negligence.[10] The decision in the principal case amounts to an abandonment of deceit as the sole basis of responsibility in favor of permitting an action for negligence.[11] The question of the proper legal basis of responsibility for misrepresentation has been thoroughly and frequently discussed,[12] and further comment here would not be fruitful.

A third reason why courts and writers have failed to forge a consistent body of law for dealing with misrepresentation arises from the difficulty of determining the proper scope of liability. This issue has traditionally been formulated in terms of whether a plaintiff must show that he was in privity with the misrepresenter in order to recover. Treating the problem in those terms,[13] the principal case aligned itself with the American Law Institute[14] by holding that privity is unnecessary and that the one making the misrepresentation is liable for all the foreseeable consequences of his negligence.[15] It must be recognized, however, that when a court decides whether privity is essential in order to recover for negligent misrepresentation, it is actually deciding the more fundamental question of who should bear the business, financial, or economic loss caused by reliance upon a negligent misrepresentation. Imposing a requirement of privity limits the scope of liability to parties who have a contractual relationship with the misrepresenter, and this necessarily means that many persons whose reliance was both justifiable and foreseeable will nonetheless be denied recovery for their loss.

In the principal case the court attempted to show in several ways that there was no reason to be unduly concerned about the greater liability which ensues when privity is abandoned, but it had only one affirmative argument for expanding the liability of the misrepresenter.[16] This argument has been the moving force behind the entire development of negligence law and is embodied in the proposition that, as between an innocent party and a careless one, the party at fault should bear the loss. This is a

9 *E.g.*, Stein v. Treger, 182 F.2d 696 (D.C. Cir. 1950); New England Foundation Co. v. Elliott & Watrous, Inc., 306 Mass. 177, 27 N.E.2d 756 (1940); Moulton v. Norton, 184 Minn. 343, 238 N.W. 686 (1931).

10 *E.g.*, Brown v. Sims, 22 Ind. App. 317, 53 N.E. 779 (1899); Weston v. Brown, 82 N.H. 157, 131 Atl. 141 (1925); Houston v. Thornton, 122 N.C. 365, 29 S.E. 827 (1898).

11 Athough the court phrased the question before it in terms of whether an action in *deceit* would lie for negligent misrepresentation, its discussion of contributory negligence as a defense indicates that the true import of the decision is that an action in *negligence* will lie for false representation. Principal case at 835-36. Note, however, the hint that the rule of this case might not extend to all negligent misrepresentations. The court specifically stated that it did not pass upon the question of whether a negligence-based action would lie in cases where the possibilities of liability are almost unlimited. Principal case at 833.

12 The authorities are collected in Hawkins, *supra* note 2, at 812 n.68.

13 Principal case at 832-35.

14 3 RESTATEMENT, TORTS § 552 (1938).

15 Principal case at 832-35.

16 *Ibid.*

persuasive principle, and by its force the holding of the principal case, that privity is unnecessary, must be admitted to be correct unless there are cogent countervailing arguments for affording professional people who supply information and opinions in the course of business transactions a partial immunity for their mistakes.

The most substantial justification advanced in support of the privity requirement is predicated upon a supposed difference between injury to person or property and injury to a financial or business interest.[17] The argument is that differences between these kinds of injury justify different scopes of liability for those who cause them. The court in the principal case felt that no such distinction could validly be made and dismissed the argument summarily,[18] as have many writers.[19] Although various attempts have been made to justify the distinction,[20] only two seem sound enough to support the imposition of different scopes of liability. One rests on the greater difficulty of foreseeing the loss which might result from negligent words, and the other on the disproportionate injury which may be caused by misrepresentations.

Since financial losses due to misrepresentation flow from the effect of words, whereas physical injuries and property damage usually result from physical forces, the chain of cause and effect which will convert a negligent act into personal injury or property damage will generally be more predictable, and hence the time, place, and nature of the loss more foreseeable. Of course, it might be foreseeable that negligent words would at some time and place cause someone injury of some sort, but to be legally foreseeable there must be more than this. The ethereal nature of words and the unseen and devious routes which guide them to their ultimate effect make it more likely that their consequences will not be legally foreseeable. *Ultramares Corp. v. Touche*[21] is the leading authority for requiring privity, and in that case it was partly because Judge Cardozo felt that the effect of words is less foreseeable that he was induced to require privity.[22] This argument, however, is at most a generalization as to the widely different kinds of factual situations that can arise; it is not possible in all instances to say that injuries due to misrepresentation are less foreseeable than

17 Historically, liability has been limited to parties in privity (*e.g.*, Landell v. Lybrand, 264 Pa. 406, 107 Atl. 783 (1919); LeLievre v. Gould, [1893] 1 Q.B. 491) or to known third parties (*e.g.*, Dickle v. Abstract Co., 89 Tenn. 431, 14 S.W. 896 (1890); Glanzer v. Shepard, 233 N.Y. 236, 135 N.E. 275 (1922)), but history alone is not a sufficient justification.

18 Principal case at 830.

19 *E.g.*, Meek, *supra* note 2, at 388; Smith, *supra* note 2, at 193.

20 *E.g.*, Comment, *Liability for Negligent Misstatements*, 78 L.Q. REV. 107 (1962).

21 255 N.Y. 170, 174 N.E. 441 (1931).

22 "A force or instrument of harm having been launched with potentialities of danger manifest to the eye of prudence, the one who launches it is under a duty to keep it within bounds. . . . [W]hether the potentialities of danger that will charge with liability are confined to harm to the person, or include injury to property . . . , what is released or set in motion is a physical force. We are now asked to say that a like liability attaches to the circulation of a thought or a release of the explosive power resident in words." Ultramares Corp. v. Touche, 255 N.Y. 170, 181, 174 N.E. 441, 445 (1931).

other losses caused by negligence. For example, the facts of the *Ultramares* case illustrate the validity of the argument, while those of the principal case indicate that it does not always hold true. In *Ultramares* the defendants, public accountants, prepared and certified numerous copies of a corporate balance sheet which they knew would be shown to banks, creditors, stockholders, purchasers, and sellers, but they did not know by whom or for what purposes they would actually be used.[23] In the principal case, however, the report issued by the defendants was for a specific rather than a general purpose. Since it was to be distributed to only one group, defendants, as designers of the sewage system that was to be bid on, could have more easily predicted the kind and extent of possible injuries.

The second justification for limiting the scope of liability for misrepresentation is based on a different distinction between the kinds of negligent injuries. Because personal injury and property damage are usually caused by physical forces, there is often a rough correlation between the magnitude of the force negligently released and the extent of the resulting injury. When words are the cause of tortious injury there is frequently no such correlation. In *Ultramares*, for example, the defendants failed to examine the books of the corporation closely enough or to inquire as fully as they should have. Only on appeal was a judgment against them for over 186,000 dollars reversed.[24] This rationale, like the first, seems therefore to have validity in the context of the *Ultramares* type of fact situation, and it was precisely this fear of disproportionate liability which moved the court of appeals to retain the requirement of privity in *Ultramares*. Judge Cardozo felt that abandoning privity would subject many professional persons to "liability in an indeterminate amount for an indeterminate time to an indeterminate class."[25] The facts of the principal case, however, show that this justification, like the other, is not applicable to all misrepresentations. Defendant, through sheer carelessness, omitted the data which would have properly informed plaintiff of the relevant soil conditions. It does not seem shocking that such negligence caused defendant to sustain a judgment of about 17,000 dollars.[26]

By comparing the facts of the *Ultramares* case with those of the princi-

23 *Ibid.*

24 *Ibid.*

25 *Id.* at 179, 174 N.E. at 444. The court stated further: "Liability for negligence if adjudged in this case will extend to many callings other than an auditor's. Lawyers who certify their opinion as to the validity of municipal or corporate bonds with knowledge that the opinion will be brought to the notice of the public, will become liable to the investors, if they have overlooked a statute or a decision, to the same extent as if the controversy were one between client and adviser. Title companies insuring titles to a tract of land, with knowledge that at an approaching auction the fact that they have insured will be stated to the bidders, will become liable to purchasers who may wish the benefit of a policy without payment of a premium. These illustrations may seem to be extreme, but they go little, if any, farther than we are invited to go now." *Id.* at 188, 174 N.E. at 447.

26 Principal case at 826, 837.

pal case, it appears that, although they reached opposite conclusions on the issue of whether there must be privity, both were correctly decided in view of their particular circumstances. In *Ultramares*, privity operated to prevent a staggering liability for a loss which was foreseeable only in a very general way. In the principal case, however, abolition of the privity requirement resulted in a reasonable recovery for a clearly foreseeable tortious injury. It may be concluded that when the information or opinion is of a broad or general nature, such as a yearly balance sheet, a loss caused by reliance on it is more likely to be both disproportionate to the seriousness of the mistake and less readily foreseeable than when the opinion is specific. Also, when the group of persons which might rely is very large, it will again be more difficult to foresee the consequences, and the injuries are apt to exceed the magnitude of the fault.[27] It must also be concluded that where foreseeability is difficult or the potential liability staggering, the distinction between personal injury or property damage and business or financial loss is a valid one, and that it operates to overcome the otherwise persuasive force of the proposition that he who erred should pay. Being thus left half with privity and half without, the question becomes whether there are other policies which might justify either wholesale acceptance or abandonment of the privity requirement.

In defense of the stand taken in the principal case, it has been stated several times that unlimited liability need not be feared, because the accountant, engineer, lawyer, or other professional adviser can limit his responsibility by qualifying his report or by limiting its uses.[28] The court in the principal case suggested that, in view of these possibilities, Cardozo was tilting at windmills when he envisioned indeterminate liability.[29] That same court, however, held ineffectual a disclaimer which defendants had attached to their report,[30] on the grounds that the defendants could reasonably have foreseen that bidders would receive and rely upon the report,[31] and that plaintiff had justifiably so relied despite the disclaimer.[32] If this is to be the judicial reception of attempts to qualify and restrict

27 These factors seem to have been contemplated by the authors of the *Restatement*, although their phrasing is somewhat different: "In the majority of situations the identity of the person for whose guidance the information is supplied is of no moment to the person who supplies it, although the *nature and extent of the transaction* for guidance in which the information is to be transmitted is vitally important. This is so since the risk of liability to which the supplier subjects himself by undertaking to supply the information, while not affected by the identity of the person for whose guidance it is given, is vitally affected by the *nature and extent of the transaction* in which it is to be used." 3 RESTATEMENT, TORTS § 552, comment *g* (1938). (Emphasis added.)

28 Meek, *supra* note 2, at 389; Comment, 31 COLUM. L. REV. 858, 869 (1931). See also 3 RESTATEMENT, *op. cit. supra* note 27.

29 Principal case at 833-34.

30 " 'This information is not guaranteed and any bids submitted must be based on the bidder's own investigations and determinations.' " *Id.* at 832.

31 *Ibid.*

32 *Id.* at 835-36.

professional opinions and information, Judge Cardozo's trepidations can scarcely be thought misguided.

It has also been suggested that allowing third parties to sue for negligent misrepresentation would not unduly burden prospective defendants because they can insure against the loss.[33] It should be realized, however, that insurance is not a panacea for problems of risk distribution. Insurance operates most efficiently to soften the shock of losses when the contingencies to be insured against are sufficiently numerous and similar to provide reliable actuarial data.[34] It can be seriously doubted whether there would ever be enough claims based on negligent misrepresentation to provide accurate data, particularly since the risks of accountants are likely to be sufficiently different from those of engineers or attorneys to preclude grouping all such professionals into one risk group.[35] The result of insufficient actuarial data would likely be that insurance companies would either refuse to issue policies or charge exorbitant rates. For example, despite the fact that engineers have been strictly liable under the Securities Act since 1933[36] and have been held liable for personal injury and property damage with fair frequency,[37] only recently has an insurance company made public liability insurance available to them.[38] If such insurance, though offered, proved excessively expensive, the result would be to drive up the fees of insured professionals, perhaps high enough to prevent their services from being as readily available as they are at present. Persons who would otherwise employ such professionals might turn to uninsured professionals of inferior competence, or go without expert advice and assistance. Moreover, there would be a good chance that the policies issued to the professions would not cover all liabilities, and large judgments might still ruin many professional partnerships. A recent study shows that even in the area of medical malpractice, where insurance coverage is well established and data reasonably reliable, present policies are subject to widely different interpretations and do not always protect doctors adequately.[39] Insurance, therefore, will probably not prevent professional advisers from being subjected to staggering liabilities.

Another standard justification for fault liability is that it induces those who control the instruments of harm to be more careful. Although gener-

[33] *E.g.*, Comment, *supra* note 28, at 869.

[34] Illustrative of the amount of data necessary for accurate computation of insurance risks is the fact that 1,084 automobile accident claims are deemed necessary to provide fully credible actuarial data. Morris, *Enterprise Liability and the Actuarial Process—the Insignificance of Foresight*, 70 YALE L.J. 554, 564 (1961).

[35] A recent symposium of ten articles and four comments on professional negligence liability shows dramatically how different the risks of the various professions are. 12 VAND. L. REV. 535-850 (1959).

[36] 48 Stat. 82, § 11(a)(4) (1933), as amended, 15 U.S.C. § 77k a (4) (1958).

[37] Bell, *Professional Negligence of Architects and Engineers*, 12 VAND. L. REV. 711 (1959).

[38] *Ibid.*

[39] Hirsh, *Insuring Against Medical Professional Liability*, 12 VAND. L. REV. 667 (1959).

ally valid, this rationale may be of little weight here. Professional advisers and specialists almost always work by special contract. Their ability to demand and receive high fees depends upon the quality of their past performance and their reputation. Thus, whether they are held liable for their negligent misstatements or not, these persons have a great incentive to minimize errors.

In the principal case the court noted that, in the thirty years since the *Ultramares* decision, the growing complexity and specialization in our economy has necessitated increased reliance upon the representations of specialists.[40] This matter of judicial notice is treated as an additional reason for imposing liability for negligent misrepresentations, the thought being that an enterprise should pay for the risks it creates. Again, this argument is persuasive, but only so long as the professions can bear the burden. In view of the substantial possibility that liability for negligent misrepresentations, unbounded by the requirement of privity, might ruin many specialists and unreasonably raise the prices of others, a different conclusion seems warranted. Indeed, the fact that professional advisers have become essential to many businesses militates against such an extension of the scope of their liability; it might be better social policy to assure the availability of professional advice even though the result is to rest the burden of negligent misrepresentations upon parties who rely on such advice for their own ends without paying for it.

The requirement of privity as set out by Cardozo in *Ultramares* has been roundly criticized.[41] If its principal justification is that it prevents the imposition of staggering or unforeseeable liability, it must be admitted that it is a rather crude device. There seems no logical reason why the existence or non-existence of contractual relations with the misrepresenter should provide the basis for distinguishing instances where liability is justifiable from those where it is not. Rather, the better approach would be twofold, relying upon both the legislative and judicial processes. The legislature is the best equipped organ of government for making the kind of exhaustive study necessary in order to determine which of the various advisory professions are generally most apt to be subjected to dangerously burdensome liability. The legislature is also the proper organ of government to weigh the social utility of the professions and determine which are so important to society that it is more desirable to insure the easy availability of their services, by granting them partial immunity from liability for their negligence, than to make them pay for all the injuries they cause. However, since the problem of foreseeability is one that necessarily depends upon the facts of specific instances, the judicial process is better suited to making the individual evaluations necessary to insure that

40 Principal case at 833.

41 See, *e.g.*, Hawkins, *supra* note 2; Meek, *supra* note 2; Comment, *supra* note 28. The illogic, overlap, and inconsistency of legal ideas in the area of misrepresentation has, on the other hand, been thought beneficial and desirable. Green, *Deceit, supra* note 2.

professional persons are held liable only for those injuries they could have reasonably predicted. Whether this determination is made by the judge or the jury, the trier of fact should be apprised of the special problems inherent in attributing losses to the effects of negligent words rather than negligent acts. Although the *legal* standard of foreseeability should be the same, an appreciation of the qualitatively different circumstances in which most representations are made would ordinarily mean that injuries due to words would less often be found foreseeable than injuries for which physical forces are the instruments of harm. Just as foreseeability presents different problems in product liability cases than in attractive nuisance or automobile collision cases, so too are the problems different in misrepresentation cases.

The legislatures of some states have abolished the privity requirement for certain professions while retaining it for others.[42] Perhaps because the legislature failed to act on the problem, the Supreme Court of California recently announced a flexible judicial rule designed to apply the privity requirement only when warranted by both broad policy and specific circumstances.[43] Other courts are likely to follow this lead. These trends indicate that the law of misrepresentation is in flux on the question of the scope of liability, and although the approach here suggested might be better in the long run, for some years hence there is likely to be great diversity among the states. Some states will continue to accept the rule of the *Ultramares* case and require privity in all instances, while others, like the court in the principal case, will abolish it entirely. Hopefully more will move to the wiser middle ground.

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42 See Arnold & Co. v. Barner, 91 Kan. 768, 139 Pac. 404 (1914); Gate City Abstract Co. v. Post, 55 Neb. 742, 76 N.W. 471 (1898); Sackett v. Rose, 55 Okla. 398, 154 Pac. 1177 (1916).

43 "The determination whether in a specific case the defendant will be held liable to a third person not in privity is a matter of policy and involves the balancing of various factors, among which are the extent to which the transaction was intended to affect the plaintiff, the foreseeability of harm to him, the degree of certainty that the plaintiff suffered injury, the closeness of the connection between the defendant's conduct and the injury suffered, the moral blame attached to the defendant's conduct and the policy of preventing future harm." Biakanja v. Irving, 49 Cal. 2d 647, 648, 320 P.2d 16 (1958). See also Lucas v. Ham, 56 Cal. 2d 583, 15 Cal. Rptr. 2d 583, 364 P.2d 685 (1961), *cert. denied*, 368 U.S. 987 (1962).