Legal Hypothetical: Fraudulent and Negligent Misrepresentation

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Kramer invented a liquid metal cleaner that he hoped to sell for household and industrial applications. While the product was undergoing a series of tests for safety and effectiveness, Kramer met with executives at Costco to discuss terms of an agreement under which Costco would market the cleaner. During the meeting one executive said, "If everything checks out, it looks like we have a deal."

Excited about his future prospects, Kramer rushed over to his neighbor's house and said, "Jerry, Jerry . . . I just got out of a meeting with the brass at Costco. They're going to pick up my metal cleaner. The only thing I need now is some working capital in order to set up production. This thing is going to be big for sure, Jerry."

Jerry wrinkled his nose and said incredulously, "Are you talking about that gray muck you've been mixing up in your sink? Costco wants it? Are you sure? Has it been tested?"

Kramer responded, "Of course it's been tested. These Costco people know what they're doing. Don't dismiss this, Jerry. You're very quick to dismiss."

Jerry was finally convinced when Kramer provided him with the name of his company (Kramerica Enterprises—formed for the sole purpose of marketing the metal cleaner), the pending patent number, and other information necessary for Jerry to research the venture on his own. Jerry never actually did any research, but he was impressed by Kramer's forthrightness.

Jerry's investment in Kramerica Enterprises was used to set up production equipment in Kramer's apartment. Meaning to keep the equipment clean and in good running order, Kramer frequently applied his product to the equipment during the first couple of days of production. On the morning of day three, Jerry discovered Kramer passed out in his living room next to the equipment, which was pitted and corroded beyond use.

It turned out the metal cleaner was both toxic to breath and corrosive to metal. Fortunately for Costco, the information came out in time to break off negotiations and avoid entering into a contract with Kramer. Unfortunately for Jerry, his money is spent and the equipment can't be sold for anything other than scrap. His investment is a total loss.

What result in Jerry's suit against Kramer alleging 1) fraudulent misrepresentation, and 2) negligent misrepresentation?

The first issue is whether there was an actual misrepresentation. For either claim to prevail, Jerry must first show Kramer made statements that were false. Here Jerry understood Kramer's statements to mean Kramer had entered into a binding agreement with Costco and that the only thing standing in the way of profits was the lack of startup capital. Jerry will argue the statement "They're going to pick up my metal cleaner" in the context of "I just got out of a meeting with

the brass at Costco" and "This thing is going to be big for sure" indicates a contractual relationship. If that is in fact Kramer's representation, it is false for two reasons: 1) Kramer had not yet entered into any legally binding agreement with Costco, and 2) the deal was contingent upon positive test results (startup capital was not the *only* obstacle). Since Kramer did not actually state in so many words that he had a contract with Costco, he will move to dismiss both claims on the grounds of no misrepresentation. He will point out the phrase "they are going to" indicated a future event that had not yet occurred, which was not false. Also, the term "pick up," even in this context, makes no literal mention of a contractual agreement.

Lord Fitzgerald, opining in the seminal 19th century English case *Derry v. Peek*, 14 App. Cas. 337, draws attention to the possible disparity between a statement as understood in its "popular or business sense" and the same statement as understood when scrutinized for a particular point of law. In Fitzgerald's view, greater weight should be given to the popular or business interpretation because that indicates whether a statement is "morally true." *Id*. To overcome this motion to dismiss, Jerry will have to convince the court 1) that it should adopt Fitzgerald's view in interpreting Kramer's statements and 2) that those statements, thusly understood, do represent the existence of a contract and are, therefore, false.

The argument that "pick up" can be construed to represent a contractual obligation may not alone be sufficient to defeat Kramer's motion to dismiss. However, Jerry's chances of success are greatly enhanced by the fact he expressly asked Kramer whether the product had been *tested* (past tense), and Kramer answered in the affirmative. Kramer may argue that because the product was currently undergoing testing, to some extent at least, it had been tested, albeit not to its final conclusion. This argument appears specious in light of Fitzgerald's "popular or business" criteria. A better approach would be for Kramer to challenge the

materiality of the statement, arguing the product's having been tested was not important in Jerry's decision to invest: "To be actionable, a misrepresentation of fact must be one of a fact that is of importance in determining the recipient's course of action at the time the representation is made." Restatement of Torts §525 (comment e). However, Jerry asked about the testing after having already been solicited to invest, which would suggest the answer factored in his decision-making process. Also, one would suppose Costco's testing would have revealed the defective nature of the product. Had Jerry known tests were being conducted, it is likely he would have waited for the results and, thus, avoided the loss.

Assuming Jerry overcomes the motion to dismiss for no misrepresentation, we turn attention to the claim of fraudulent misrepresentation. According to Restatement 2nd of Torts §526, a misrepresentation is fraudulent if the maker (a) knows or believes that the matter is not as he represents it to be, (b) does not have the confidence in the accuracy of his representation that he states or implies, or (c) knows that he does not have the basis for his representation that he states or implies. Jerry must, therefore, show Kramer had scienter.

With respect to the representation of a binding agreement with Costco, the facts here are similar to those in *Derry*, where directors of Plymouth, Devonport and District Tramways Company solicited investors by claiming to have an absolute right to use steam/mechanical power in constructing a tramway when in fact that right was subject to approval from the Board of Trade. The majority in *Derry* found defendants did not have the scienter required to raise the misrepresentation to the level of fraud in spite of several factors suggesting intent, factors which are not present in Kramer's situation. First, the defendants acted as a group of directors of a large company, whereas Kramer is the sole proprietor of a business that never actually got off the ground. It is less likely a group of sophisticated businessmen would make the honest mistake of

misinterpreting their company's rights than it is that one owner, excited about his first deal, would. Also, the directors had time to look over the special legislative Act authorizing their company's services, formulate the rhetoric to be used in attracting investors, and reduce that rhetoric to writing. By contrast, Kramer received only a verbal assurance by a Costco executive, little time had elapsed before he made his statements to Jerry, and his statements were made orally without the extra consideration one takes in committing words to paper. Therefore, if the court gives weight to the holding in *Derry*, it is unlikely Jerry will prevail on fraudulent misrepresentation. His best hope is to prove his claim of negligent misrepresentation and argue the lack of reasonable grounds for believing the veracity of statements made indicates Kramer did have scienter. Even courts that do not recognize negligent misrepresentation as grounds for recovery recognize it as a factor in showing fraudulent misrepresentation. *Derry*, at 342; *Ultramares Corp. v. Touche*, 255 NY 186 (1931). With this in mind, we turn to Jerry's claim of negligent misrepresentation.

In *US v. Neustadt*, 366 US 696 (1961), the US Supreme Court relied on the definition of negligent misrepresentation contained in §552 of the Restatement of Torts, the revised version of which states:

> (1) One who, in the course of his business, profession or employment, or in any other transaction in which he has a pecuniary interest, supplies false information for the guidance of others in their business transactions, is subject to liability for pecuniary loss caused to them by their justifiable reliance upon the information, if he fails to exercise reasonable care or competence in obtaining or communicating the information.

In the same opinion, the Supreme Court cites *Glanzer v. Shepard*, 233 N.Y. 236 (1922), as epitomizing negligent misrepresentation. *Neustadt*, 366 US at 706. In *Glanzer*, the defendants were public weighers who misrepresented the weight of several hundred bags of beans, which resulted in the buyer being overcharged. Judge Cardozo awarded damages to the buyer on the

theory defendants have a duty to not act carelessly in representations that they know will be used and acted upon: "Constantly the bounds of duty are enlarged by knowledge of a prospective use." *Glanzer*, 233 N.Y. at 240 (citing *MacPherson v. Buick Motor Co.*, 217 N.Y. 393(1916)). Cardozo further espouses viewing the representations in context, which includes consideration of "usage and fair dealing." *Id.* at 241.

Applying the standard established in the Restatement and *Glanzer* to the present facts, it would seem difficult for Kramer to escape liability. First, as the owner of Kramerica enterprises, statements he makes concerning the metal cleaner are made "in the course of his business." Also, since he was trying to convince Jerry to invest in his company, the false information he supplied was "in the guidance of others in their business transactions" and contrary to the notion of fair dealing. Kramer can argue he had reasonable grounds on which to base his belief in the statements by pointing to the assurance he received from the Costco executive. However, the executive specifically indicated positive test results as a contingency of the deal, which directly contradicts the reasonableness of believing either that a binding agreement existed or that the product had already been tested.

The best argument Kramer can make is that Jerry did not justifiably rely on the statements. After all, Jerry was given the information necessary to research the matter himself but failed to act on it. However, at least one scholar notes courts have not intimated plaintiffs may be barred from recovery for failure to confirm accuracy, even when there are ready means to do so, because a doctrine of contributory negligence would be troublesome to apply in negligent misrepresentation cases. Francis H. Bohlen, *Misrepresentation as Deceit, Negligence, or Warranty*, 42 Harvard Law Review 733 (1929). Kramer may also try to distinguish the facts here from *Glanzer* by pointing out the defendants in *Glanzer* were negligent not only in their words but also in their acts, the

service of weighing commercial goods. This distinction, however, will also come up short since Cardozo is careful to note liability attaches to either negligent words *or* negligent acts; the combination is not required. *Glanzer*, 233 N.Y. at 241.

Bibliography

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