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LICENSING LIES: MERGER CLAUSES, THE PAROL EVIDENCE RULE AND PRE-CONTRACTUAL MISREPRESENTATIONS

Kevin Davis[1]

> Not even in the business world—that one area of social life where the "battle of wits" competitive-game model is most persuasive, and people match the shrewdness of their judgments and the cleverness of their stratagems for getting the better of one another—not even here do rivals voluntarily assume the risk that the other party to an agreement is an outright liar, getting the better of one by plain deceit.[2]

I. INTRODUCTION

Many judges and scholars seem to consider the rules assigning liability for fraud—and sometimes even negligence—in contract formation to be among the few mandatory rules of the contracting game. This belief persists in spite of the fact that virtually every other rule of contract law is treated as a default rule, and therefore, subject to modification by agreement of the parties. Disclaimers of liability for pre-contractual misrepresentations are common features of all kinds of contracts, ranging from the complex agreements of purchase and sale used in connection with the acquisition of businesses, to contracts for the sale or the lease of consumer goods. However, consistent with the view that the rules against fraud and negligence are mandatory rules, a number of courts have refused to give effect to these kinds of disclaimers in cases involving allegations of fraud or negligent misrepresentation, even when they are contained in contracts between relatively sophisticated parties.

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[2] 3 JOEL FEINBERG, THE MORAL LIMITS OF THE CRIMINAL LAW: HARM TO SELF 285 (1984).

The leading case of *Bates v. Southgate* provides a classic demonstration of this belief.[3] Bates, a stock broker, sued the partners of Southgate, another brokerage firm, alleging that one partner had induced him to buy shares of a gypsum company by falsely representing during a telephone conversation that the company had received a large and potentially lucrative order. Bates sought to recover the purchase price of the shares. The defendants admitted that any such representation would have been false, but denied making it. They also resisted the suit on the grounds that Bates was bound by a confirmation slip issued by Southgate which stated "in making this transaction, we make no representation other than to identify the security and state the price." The evidence strongly supported the defendants' contention that the parties' final agreement was embodied in the confirmation slip rather than in their prior oral conversations. The plaintiff testified that, based on his practice with his own customers, he understood that he was entitled to call the deal off until shortly after he received the confirmation slip, but if he failed to do so, the deal would go through on the terms set out in the slip. After he received the slip, he "elected to go through, well knowing that the terms were that Southgate was making no representation with respect to this transaction other than to identify the security and state the price."[4]

The Supreme Judicial Court of Massachusetts dismissed the appeal from a verdict in favor of the plaintiff. Justice Qua, writing for the court held,

> the same public policy that in general sanctions the avoidance of a promise obtained by deceit strikes down all attempts to circumvent that policy by means of contractual devices.... To refuse relief would result in opening the door to a multitude of frauds and in thwarting the general policy of the law.[5]

The main goal of this paper is to attempt to identify the public policy that formed the basis of Justice Qua's decision. There are both practical and theoretical reasons for undertaking this project. The practical reason is that this topic generates a significant amount of litigation but has not recently been the object of much academic

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[3] 31 N.E.2d 551 (Mass. 1941)
[4] *Id.* It is not clear who the court was quoting at this point.
[5] *Id.* at 558.

commentary.[6] This article will serve to identify principles that might eventually be used to clarify the law. This is potentially useful because the relevant legal rules are so fundamental that they affect an extraordinarily wide range of transactions. Even if we focus on relatively sophisticated parties, the legal rules discussed here affect transactions ranging from the modern-day equivalents of the securities trade discussed in *Bates v. Southgate* to sales of agricultural equipment, franchising agreements, and multi-million dollar mergers and acquisitions.

The theoretical reason for addressing this topic is to provide insight into the values that are implicit in the legal doctrines which govern commercial activity. This is one of several areas of the law in which those values appear to be in conflict. Conflicts between values such as respect for individual autonomy, morality, and efficiency are familiar to contract law scholars.[7] However, this article is one of the few that emphasizes that when these conflicts arise in commercial settings the parties have often contracted through agents rather than by bargaining face-to-face.[8] This has both important moral and economic ramifications. In fact, this article's main contribution is to show that once we take into account the fact that most disclaimers of liability are actually disclaimers of vicarious rather than primary liability, it becomes possible to formulate a rule of enforceability which often, though not always, reconciles principles of respect for individual autonomy, morality and efficiency.

The article's more general contribution is to emphasize the lack of congruence between the reality of modern contracting behavior, in which transacting through agents is typical, and legal analyses, both doctrinal and theoretical, which appear to be predicated on the assumption that face-to-face bargaining is the norm. In fact, this article

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[6] For an overview of the topic, see JAMES J. WHITE & ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE, 102-10 (4th ed. 1995). For less current discussions, see Justin Sweet, *Promissory Fraud and the Parol Evidence Rule*, 49 CAL. L. REV. 877 (1961); James L. Hartsfield, Comment, *The "Merger Clause" and the Parol Evidence Rule*, 27 TEX. L. REV. 361 (1949); Comment, *Special Provisions in Contracts to Exclude Contentious Evidence Based on Parol Evidence*, 32 ILL. L. REV. 938 (1937-38).

[7] *See generally* Michael Trebilcock, The Limits of Freedom of Contract (1993).

[8] An exception is IAN R. MACNEIL, THE NEW SOCIAL CONTRACT 78-84 (1980). The implications of delegation to agents in non-contractual settings have recently received more attention. *See* Gary T. Schwartz, *The Hidden And Fundamental Issue of Employer Vicarious Liability*, 69 S. CAL. L. REV. 1739 (1996) and other articles in the same volume (containing a Symposium on Corporate Tort Liability).

can be regarded as a first step towards a more general examination of how the legal rules that govern contracting should be reformulated to distinguish more carefully between parties who have bargained face-to-face and those who have not.

The discussion is organized as follows. Part II provides an overview of the applicable legal doctrines. Part III describes the apparent conflict between the will theory of contract law, which suggests that explicit disclaimers of liability should be enforced, and theories which suggest that contractual enforceability should depend on notions of morality or economic efficiency and weigh against enforcement. Part IV discusses recent attempts to justify enforcement of disclaimers of liability in economic terms as a response to the facts that litigation is costly and can sometimes be effectively replaced by non-legal sanctions.

This rather lengthy introduction to the current state of the literature is designed to set the stage for the analysis in Part V. There I identify the under-appreciated role that enforceable disclaimers of liability for pre-contractual misrepresentations, whether fraudulent or not, might play in minimizing agency costs. I also contend that permitting principals to disclaim vicarious liability for their agents' misrepresentations is compatible with conventional notions of morality. Part VI provides illustrations of how this revised understanding can be used to resolve a variety of archetypal disputes without contravening any of the values that most people think are or should be embodied in contract law. I also suggest that this revised understanding makes it easier to understand the results of a number of decided cases. Part VII summarizes that understanding in terms which should be useful to lawmakers. Part VIII contains a brief conclusion.

II. DOCTRINAL OVERVIEW

Remedies for pre-contractual misrepresentations are provided by the common law as well as under the Uniform Commercial Code ("UCC") and other legislation.[9] First of all, the common law permits a person to avoid or seek the reformation of a contract which was

[9] The discussion that follows does not consider either the circumstances in which a misrepresentation may form the basis of a claim of estoppel or any rules peculiar to circumstances in which a misrepresentation forms the basis of a defense rather than an affirmative claim. In these regards, see WILLIAM L. PROSSER ET AL., PROSSER AND KEETON ON THE LAW OF TORTS 730-35 (5th ed. 1984).

concluded as a result of a misrepresentation.[10] Second, if the transaction in question involves the sale of goods, the UCC permits the buyer to bring an action for damages for breach of warranty.[11] Third, the buyer may bring an action in tort for damages for deceit or, in some jurisdictions, negligent or innocent misrepresentation.[12] Fourth, several statutes, including the securities laws, also create causes of action for misrepresentations.[13] These remedies are all usually available against a person whether they make the misrepresentation personally or it is made on their behalf by an agent.[14]

It is not uncommon for contracting parties to disclaim the right to resort to any of these remedies. The courts commonly distinguish between two types of clauses that might be construed as disclaimers of liability for misrepresentations. The first type is known as an "integration" or "merger" clause. A typical merger clause reads as follows:

> This writing contains the entire agreement between the parties and there are no promises, understandings, or agreements of any kind pertaining to this contract other than stated herein.[15]

Many courts reason that the presence of a merger clause in a written agreement simply indicates that the agreement in question is "integrated". The parol evidence rule bars the use of extrinsic evidence to contradict or even to supplement the terms of an integrated

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[10] RESTATEMENT (SECOND) OF CONTRACTS §§ 164, 166 (1973). Note that on avoidance, the buyer is entitled to restitution. *See* E. ALLAN FARNSWORTH, FARNSWORTH ON CONTRACTS § 4.15 (1990).

[11] U.C.C. § 2-714 (1977). U.C.C. §§ 2-312, 313, 314 and 315 define the express and implied warranties which may form the basis of a claim of breach of warranty.

[12] *See generally* RESTATEMENT (SECOND) OF TORTS §§ 525-557 (1977). PROSSER ET AL., *supra* note 9.

[13] *See* ALA. CODE §§ 6-5-100, 103 (1975); CAL. CIV. CODE § 1709 (West 1998); N.J. STAT. ANN. § 2A: 32-1 (1987). *See also* 15 U.S.C. § 77k (1994).

[14] See RESTATEMENT (SECOND) OF AGENCY §§ 257-259A (1958), providing that in the absence of an exculpatory agreement a principal is liable for all misrepresentations made by an agent so long as the misrepresentation is authorized, apparently authorized, within the scope of the agent's power to act, or, in the case of an agent who has been authorized to enter into negotiations, concerns matters that the principal might reasonably have expected to be the subject of representations. The only exception to these general rules is that a principal is not liable in tort for an agent's unauthorized misrepresentations where the victim should have known that the agent acted without authority (although transactions induced by such misrepresentations may still be rescinded by the victim).

[15] FARNSWORTH, *supra* note 10, at 233.

agreement.[16] Consequently, in the case of an integrated agreement the parol evidence rule precludes the use of evidence of a misrepresentation not contained in the final written agreement as a basis for rescission, reformation, or an action for damages for breach of warranty. However, most courts make an exception to the parol evidence rule to permit evidence of fraud to be used by a party suing on a misrepresentation.[17] Some courts have gone even further and held that the parol evidence rule is merely a rule of contract law that only bars actions that "sound in contract", but cannot bar claims that sound in tort, even if they are based upon nonfraudulent misrepresentations.[18] Other courts arrive at similar results by holding that clauses which attempt to exempt a party from liability for fraudulent misrepresentations are contrary to public policy.[19]

Courts in some jurisdictions distinguish general merger clauses from "specific" disclaimers of reliance upon certain representations and permit the latter type of provision to bar claims for both fraudulent and nonfraudulent misrepresentations.[20] Other courts only permit specific disclaimers to bar claims for nonfraudulent rather than fraudulent misrepresentations.[21] As might be expected, it is often difficult to

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[16] *See* RESTATEMENT (SECOND) CONTRACTS §§ 215, 216(1) (1973). The parol evidence rule is codified in U.C.C. § 2-202 (1977).

[17] *See* FARNSWORTH, *supra* note 10, at 216-19. *But see* One-O-One Enterprises, Inc. v. Caruso, 848 F.2d 1283 (D.C. 1988) (stating "[the exception for fraud] must not be stretched or inflated in a way that would severely undermine the policy of the parol evidence rule, which is grounded in the inherent reliability of a writing as opposed to the memories of contracting parties").

[18] *See, e.g.*, Keller v. A. O. Smith Harvestore Products, 819 P.2d 69 (Colo. 1991); Formento v. Encanto Business Park, 744 P.2d 22 (Ariz. Ct. App. 1987); City Dodge Inc. v. Gardner, 208 S.E.2d 794 (Ga. 1974). *See generally* Elizabeth Cumming, *"Balancing the Buyer's Right to Recover for Precontractual Misstatements and the Seller's Ability to Disclaim Express Warranties,"* 76 MINN. L. REV. 1189 (1992). Some of these courts, however, have gone on to hold that the presence of a merger clause is simply one factor that may be taken into consideration by the finder of fact in determining whether the existence of all the elements of the tort, and in particular the element of justifiable reliance, has been proven.

[19] *See, e.g.*, Pearson & Son v. Dublin Corp. (1907) A.C. 351 at 362 per Lord James of Hereford (holding that "fraud vitiates every contract and every clause in it"); Wilkinson v. Carpenter, 554 P.2d 512 (Or. 1976).

[20] This approach is based upon the decision in Danann Realty Corp. v. Harris, 157 N.E.2d 597 (1959), which held that a party is barred from launching an action for fraudulent misrepresentation if it has disclaimed reliance upon the specific type of representation on which its suit is based.

[21] *See, e.g.*, United States Welding, Inc. v. Burroughs Corp., 640 F. Supp. 350 (D. Colo. 1985).

determine whether a provision ought to be characterized as a specific disclaimer of reliance rather than a general merger clause.[22]

To further complicate matters, some courts have held that a disclaimer clause may exculpate a principal of his vicarious liability in tort for the misrepresentations of an agent but does not prevent the victim of the misrepresentation from rescinding the contract prior to a change in position of the principal. The rationale behind this position is that a principal should not benefit from the fraud of his agent.[23]

This last approach is endorsed by the frequently overlooked section 260 of the Restatement (Second) of Agency. However, that rule is subject to some important qualifications. First of all it is subject to a caveat that a principal may protect himself from even an action for rescission by a "thoroughly understood agreement" made with a third party. The Commentary does not explain how this caveat can be reconciled with the stated rationale for the general rule. Second, both the general rule and the caveat seem to be subject to the principle that only an innocent principal can contract against liability for an agent's misrepresentation. According to the Commentary, an innocent principal is one who has no "knowledge of past frauds or expectation of future frauds by the agent".[24] In fact, the principal must not even "desire" the agent to make fraudulent statements.[25] Furthermore, partners and officers or senior managers of corporations are considered to represent the partnership or the corporation as the case may be for the purposes of this rule and so an exculpatory clause will have no effect upon the liability of the partnership or corporation for the misrepresentations of such an individual.[26] Given all these qualifications of the relatively straightforward general rule, it seems possible to reconcile virtually any result with the Restatement.

This review of the provisions of the Restatement (Second) of Agency brings to light a fact which may otherwise have been obscured by the rather formalistic overview that preceded it: moral considerations have significantly influenced the law in this area. This is clear from the

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[22] *See Keller*, 819 P.2d, at 71 (in which a contract stating "Buyer recognizes that [pre-contractual statements] are not guarantees and he has not relied upon them as such" did not specifically disclaim reliance on pre-contractual statements).
[23] *See* Super-Cold Southwest Co. v. Willis, 219 S.W. 2d 144 (Tex. Civ. App. 1949).
[24] Restatement (Second) of Agency § 260 cmt. a (1958).
[25] Restatement (Second) of Agency § 260 cmt. b (1958).
[26] *Id.*

language of the Restatement of Agency as well as many of the decided cases.[27] Not all theories of the basis of contractual obligation allow room for moral values to play a role in determining the enforceability of a contractual provision. The next section explores this insight in greater detail, showing that this area of the law provides a useful testing ground for competing conceptions of the basis of contractual obligation.

III. CONFLICTING VALUES

Legal scholars generally offer one of three types of justifications for enforcing contractual obligations. First, some claim that contract law is primarily designed to give effect to the will of individuals who choose to make commitments to others.[28] A second view is that contract law reflects a number of diverse values, of which respect for the will of the parties is only one. According to this view, judges sometimes refuse to give effect to the will of the parties to a contract in order to respect other values such as the judges' own notions of justice and fairness in exchange.[29] Finally, a third influential perspective on the basis of contractual obligation emphasizes the economic function of contract law. This view holds that the rules of contract law are designed to facilitate the execution of Pareto-efficient exchanges.[30] The question of whether it is appropriate to enforce disclaimers of liability for pre-contractual misrepresentations looks quite different when examined from each of these perspectives.

A. *Respect for Individual Autonomy*

The will theory of contract law is premised on the notion that contract law serves to increase individuals' freedom by giving them the freedom to make binding commitments. It is also said that failing to enforce a commitment that an individual intended to be legally binding

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[27] White and Summers suggest that merger clauses should not be enforced where the object of the claim has a reputation for "shady dealing". After explaining their discomfort with one court's decision to enforce a merger clause they say, "it helps to know that the Holland Furnace Co. of the 1950's [the object of the claim] was notorious for its questionable sales tactics." *See* WHITE & SUMMERS, *supra* note 6, at 107.

[28] The leading exponent of this view is Charles Fried. *See generally* CHARLES FRIED, CONTRACT AS PROMISE: A THEORY OF CONTRACTUAL OBLIGATION (1981).

[29] *See* Patrick S. Atiyah, *The Modern Role of Contract Law*, *in* ESSAYS ON CONTRACT 1 (1990). *See also* Patrick S. Atiyah, *Contracts, Promises and the Law of Obligations*, *in* ESSAYS ON CONTRACT 10 (1990); Patrick S. Atiyah, *Contract and Fair Exchange*, *in* ESSAYS ON CONTRACT 329 (Rev. ed. 1990).

[30] *See* Anthony Kronman & Richard Posner, *Introduction: Economic Theory and Contract Law*, *in* THE ECONOMICS OF CONTRACT LAW 1-10 (1979).

would imply that we did not respect the individual's ability to make autonomous choices.[31] This implies that courts should enforce disclaimers of liability for misrepresentations according to their terms so long as they are certain that the agreement to disclaim liability was itself an autonomous act. A disclaimer is simply another kind of commitment—a commitment not to seek legal redress under certain circumstances—that must be enforced in accordance with the will of the parties in order to respect their autonomy.[32]

Yet no matter how committed one is to the principle that all autonomous agreements should be enforced, it is difficult to avoid harboring reservations about holding people to commitments that seem to be clearly contrary to their best interests. This may explain why many judges and legal scholars have reservations about enforcing disclaimers of liability for fraudulent or, less commonly, negligent misrepresentations. It is difficult to understand how anyone could ever benefit from entering into such an agreement.[33] Moreover, in many cases it seems appropriate to presume that a misrepresentation that on its face appears to be excluded by a merger clause was actually left out of the final agreement inadvertently or because of the high cost of incorporating it. Consequently, some might defend courts' instinctive reluctance to enforce provisions that appear to relieve one party from liability for a material pre-contractual misrepresentation on the ground that parties rarely enter into such agreements voluntarily. They might claim that prohibiting enforcement of agreements of this sort is prudent in order to avoid the risk of mistakenly enforcing agreements that do not reflect autonomous choices.[34]

This mildly paternalistic reasoning suggests that in the absence of clear language, courts interpreting contracts should presume that the

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[31] *See* FRIED, *supra* note 28, at 20.
[32] *See* FRIED, *supra* note 28, at 38 (stating that "given the consensual basis of contract as promise, the parties should in principle be free to exclude legal enforcement so long as this is not a fraudulent device to trap the unwary"). *See also* SISSELA BOK, LYING: MORAL CHOICE IN PUBLIC AND PRIVATE LIFE 109-10, 138 (1979) (suggesting that even intentional deception is morally acceptable if it has been consented to so long as the consent is informed and voluntary).
[33] *See infra* Part III.
[34] *See* FEINBERG, *supra* note 2, at 124-27 (discussing the appropriateness of this kind of presumption of non-voluntariness). For a stronger defense of paternalism in contract law, see Duncan Kennedy, *Distributive and Paternalistic Motives in Contract and Tort Law with Special Reference to Compulsory Terms and Unequal Bargaining Power*, 41 MARYLAND L. REV. 563 (1982).

parties did not intend to disclaim liability for fraud or negligence. In practice this would probably mean that 'boilerplate' merger clauses would not be construed as disclaimers of liability for fraudulent or negligent pre-contractual misrepresentations. However, an explicit disclaimer of liability would be effective.

B. Morality

No one seems to debate that lying is almost always morally indefensible.[35] This seems to explain why there is also relatively little debate surrounding the proposition that fraud, which most people equate with lying, is morally indefensible. Of course, in law fraud is often defined more broadly than just lying. For instance, lying is generally defined to mean intentional misrepresentation whereas fraud is often defined to include misrepresentations that are made recklessly as opposed to intentionally.[36] Furthermore, the term fraud also encompasses cases in which there has been no affirmative misrepresentation at all, but instead the failure to disclose one or more material facts.[37] The moral status of these forms of deception is less clear than that of lying. Nonetheless, it seems fair to say that fraud is generally considered to be morally reprehensible. This is evidenced by the fact that fraud is not only civilly actionable but also a criminal offence.[38]

Some lawyers believe that contract law does and ought to reflect the influence of a number of societal values, only one of which is the principle of respect for exercises of individual autonomy. For judges this approach opens up the possibility of overriding the will of the parties to impose collective ideals of justice and fairness.[39] Consequently, some judges use it to justify overriding a party's prior expression of intent to bind herself not to seek any remedy for a fraudulent misrepresentation. Their reasoning is that contract law should express society's disapprobation of the immoral, not to mention potentially criminal,

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[35] CHARLES FRIED, RIGHT AND WRONG 54-78 (1978); *see generally* BOK, *supra* note 32. *See also* Anthony Kronman, *Contract Law and Distributive Justice*, 98 YALE L. J. 472, 486 (1980).
[36] *See* McLean v. Alexander, 599 F.2d 1190, 1197 (3d Cir. 1979); Rolf v. Blyth, Eastman, Dillon & Co. Inc., 570 F.2d 38, 44-46 (2d Cir.), *cert. denied*, 439 U.S. 1039 (1978) (scienter requirement under Rule 10b-5 may be satisfied by proof of recklessness).
[37] For a discussion of such cases, see FRIED, *supra* note 28, at 78-85, and TREBILCOCK, *supra* note 7, at 106-118.
[38] *See, e.g.*, 18 U.S.C. §1341 (1994) (mail fraud); 18 U.S.C. §1343 (1994) (wire fraud).
[39] *See, e.g.*, Atiyah, *supra* note 29; PATRICK DEVLIN, THE ENFORCEMENT OF MORALS 43-60 (1965).

behavior of the party seeking to rely upon the disclaimer.[40] The purpose of doing so seems to be either to make a moral statement or else to ensure that contract law joins other branches of the law in attempting to deter fraud. This reasoning clearly justifies allowing the victim of a fraudulent misrepresentation to rescind an ensuing contract, but it may not go so far as to support allowing the victim to maintain an action for deceit.[41]

It is less clear whether taking a moralistic approach to contract law justifies refusing to enforce disclaimers of liability for negligent misrepresentations. The principle that people should be liable for the consequences of their negligent behavior is a collective value that some might argue should not be supplanted in favor of the principle of respect for the individual autonomy, not even the autonomy of the victim of the negligence.[42] However, the amount of moral culpability associated with negligence is debatable.[43] This weighs against allowing victims of a negligent misrepresentation to rescind any ensuing contract simply to make a moral statement. It is even more difficult to justify allowing a person who has voluntarily disclaimed their right to sue on a

[40] *See, e.g.* Bates v. Southgate, 31 N.E.2d 551 (Mass. 1941).

[41] The difficulty is that allowing a tort claim to be brought in these circumstances seems incompatible with conventional notions of (corrective) justice that tend to be based upon the notion of respect for individual autonomy. These theories suggest that the defendant should be permitted to raise the defense of consent in these cases. *See generally* Kenneth W. Simons, *Assumption of Risk and Consent in the Law of Torts: A Theory of Full Preference*, 67 B.U. L. REV. 213 (1987). However, it may be possible to formulate a retributive justification for imposing liability in tort in these circumstances. In retributive theory, intentional wrongdoing, like fraud, is viewed as not just causing harm to particular victims but also to society as a whole, because the wrongdoer has challenged the concept of right itself. This is what justifies the use of criminal, state-imposed sanctions against the wrongdoer. It may be possible to explain a rule allowing the victim of fraud to recover damages from the guilty party, regardless of the fact of their consent to being defrauded, as a means by which the state delegates responsibility for exacting retribution to the victim. *See* Bruce Chapman & Michael J. Trebilcock, *Punitive Damages: Divergence in Search of a Rationale*, 40 ALA. L. REV. 741, 786-97 (1989) (suggesting the concept of delegation of the state's retributive functions). Of course this presumes that consent does not negate the criminality of fraud. *See* Mark Kelman, *Interpretive Construction in the Substantive Criminal Law*, 33 STAN. L. REV. 591, 614-16 (1981).

[42] Keller v. A. O. Smith Harvestore Products, 819 P.2d 69, 73 (Colo. 1991) (holding that manufacturers should not be shielded from liability for negligent misrepresentation claims simply because they are not service or information providers).

[43] *Compare* Jerome Hall, *Negligent Behavior Should be Excluded from Penal Liability*, 63 COLUM. L. REV. 632, 635-642 (1963) *with* H.L.A. Hart, *Negligence Mens Rea and Criminal Responsibility*, *in* PUNISHMENT AND RESPONSIBILITY: ESSAYS IN THE PHILOSOPHY OF LAW ch. 6 (1968) *and* George P. Fletcher, *The Theory of Criminal Negligence: A Comparative Analysis*, 119 U. PA. L. REV. 401 (1971).

misrepresentation to nonetheless launch an action based on a negligent misrepresentation.[44] This contradicts not only principles of contract law but also the principle of respect for individual autonomy that forms the basis of the tort law defenses of consent and voluntary assumption of risk.[45] On the other hand, there is less debate about the appropriateness of characterizing someone who has been grossly negligent as blameworthy.[46] This seems to correspond to a certain amount of judicial reluctance to enforce disclaimers of liability for gross negligence.[47]

Finally, we should consider the case in which a disclaimer effectively amounts to a retraction of a prior fraudulent misrepresentation. From one perspective it seems wrong to hold a person responsible for a misrepresentation that they explicitly retracted before anyone had an opportunity to rely on it to their detriment. But, in some cases that person can be compared to a terrorist who plants a bomb in a busy subway station and then calls to warn people to avoid the area. Suppose that someone negligently wanders into the station and is killed when the bomb explodes. It certainly seems appropriate to hold the terrorist responsible for the victim's death, despite his attempt to mitigate the consequences of his wrongful action. On the other hand, if the victim deliberately wandered into the station after being warned, it would be inappropriate to hold the terrorist responsible.[48] On balance, the most satisfying approach seems to be to say that if a misrepresentation has been retracted in the clearest possible language it should not be considered to have induced entry into a subsequent contract.

Some moralists might try to reconcile their position with the notion that, in general, parties' autonomous agreements should be enforced. For example, they might call attention to the fact that a commonly cited reason for giving effect to autonomous contractual decisions is to manifest the intrinsic value that we attach to exercises of individual

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[44] *See supra* note 41, for an explanation of why this is incompatible with the concept of corrective justice. There is no retributive justification for allowing the suit because the wrongdoer has not acted intentionally.
[45] *See* PROSSER ET AL., *supra* note 9, at 112, 482-84.
[46] *See, e.g.*, MODEL PENAL CODE §2.02 (2)(d) (defining culpable negligence as a "gross deviation from the standard of care that a reasonable person would observe in the actor's situation").
[47] *See* PROSSER ET AL., *supra* note 9, at 484.
[48] Then his actions might qualify as a *novus actus interveniens*, sufficient to relieve the terrorist of liability. *See* GEORGE FLETCHER, RETHINKING CRIMINAL LAW 365-66 (1978); *see also generally* H.L.A. HART & ANTHONY HONOR, CAUSATION IN THE LAW (1959).

autonomy in our society.[49] Enforcing agreements that are the product of fraud arguably diminishes the symbolic value of the law's general prohibition on interfering with the exercise of private autonomy through deception. This intuition can be translated into an ontological argument that the use of law as an instrument of fraud is fundamentally incompatible with the notion of law as the embodiment of right. Alternatively, those who prefer a more instrumental mode of reasoning might rely on the currently popular notion that law can and should attempt to influence behavior by shaping attitudes as well as directly sanctioning or rewarding certain behavior. On this view, condoning fraud in any way may give the inappropriate impression that it is somehow acceptable, thus weakening the psychological constraints that operate to keep people from committing fraud (independently of any fear of legal sanctions).[50]

On another tack, some people justify the will theory's respect for exercises of individual autonomy on instrumental grounds, typically because it is likely to facilitate welfare maximization.[51] The moralist might attempt to win these people over by arguing that it makes perfect sense for courts to interfere with autonomous contracting decisions that do not serve their instrumental goals.[52] For instance, they might rely on the economic analysis set out in the following section to prove that agreements of this sort tend not to be mutually beneficial.

C. *Economic Considerations*

The central tenet of the economic approach to contract law is that legal rules ought to be designed to encourage contracting parties to engage in mutually beneficial exchanges. The standard economic analysis of the law of misrepresentation implies that there is little economic justification for enforcing disclaimers of liability for fraudulent

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[49] *See, e.g.*, FRIED, *supra* note 35

[50] For examples of recent scholarship in this vein, see Dan M. Kahan, *Social Influence, Social Meaning and Deterrence*, 83 VA. L. REV. 349 (1997); Cass Sunstein, *On The Expressive Function of Law*, 144 U. PA. L. REV. 2021 (1996); and Richard Pildes, *The Destruction of Social Capital*, 144 U. PA. L. REV. 2055 (1996). The themes discussed in this literature bear considerable resemblance to the views set out by Devlin, *supra* note 39.

[51] *See, e.g.*, Richard Posner, The Economics of Justice 48-115 (1981).

[52] For an example of a forceful critique along these lines, see Robin West, Authority, Autonomy and Choice: The Role of Consent in the Moral and Political Visions of Franz Kafka and Richard Posner, 99 HARV. L. REV. 384 (1985). *See generally* TREBILCOCK, *supra* note 7.

or negligent misrepresentations.[53] This can be illustrated with a simple example.[54] Suppose that Anne offers to sell Barbara a sealed box of candy. Anne tells Barbara that there is no need for her to open the box before she buys it, that Barbara should take her word for the fact that it contains candy. Barbara knows that there is a possibility that Anne is lying and that when she arrives home and opens the box she will discover that the box only contains cat food. Would it ever be mutually beneficial for the parties to let Anne disclaim liability for this kind of intentional misrepresentation?

Leaving aside for a moment the influence of factors such as the litigation costs and non-legal sanctions discussed in the next section, it is difficult to understand how it could ever be particularly beneficial for Anne and Barbara to agree to this disclaimer. If Anne is telling the truth, it should cost her nothing to agree to assume liability for fraudulent misrepresentations.[55] Therefore, if Anne disclaimed liability, Barbara would have to assume that she was lying about the contents of the box (there being no other reason for her to disclaim liability) and reduce the price that she was willing to pay for it accordingly. So long as Barbara reacts to the disclaimer this way, she will not be any worse off than if

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[53] For discussions of the economic justifications for imposing liability for fraud in the first place, see GORDON TULLOCK, THE LOGIC OF THE LAW (1971); RICHARD POSNER, ECONOMIC ANALYSIS OF LAW 122 (5th ed. 1997); Paul G. Mahoney, *Precaution Costs and the Law of Fraud in Impersonal Markets*, 78 VA. L. REV. 623 (1992). For an economic analysis of negligent misrepresentations, see William Bishop, *Negligent Misrepresentation Through Economists' Eyes*, 96 LAW QUARTERLY REV. 360 (1980).

[54] This example is based on one used in RICHARD POSNER, ECONOMIC ANALYSIS OF LAW 99 (3rd ed. 1986).

[55] Economists typically assume that the main cost of avoiding misrepresentation is the cost of verifying one's statements before making them. This in turn implies that so long as *scienter* is an essential element of fraud and is defined as knowledge of the falsity of a statement, it should be costless for a person to avoid making a fraudulent misrepresentation. *See, e.g.*, Mahoney, *supra* note 53, at 647. There are cases, however, in which making an intentional misrepresentation is the only way for a party to avoid disclosing valuable information. This may occur when a person is forced to respond to a direct question or is compelled by law to disclose certain categories of information. Macey and Miller have argued that in these cases it may be appropriate to relieve the party of liability for fraud in order to preserve his incentives to acquire and make use of the information. *See* Jonathan R. Macey & Geoffrey P. Miller, *Good Finance, Bad Economics: An Analysis of the Fraud-on-the-Market Theory*, 42 STAN. L. REV. 1059 (1990). These are situations in which the cost of being honest would appear to be equal to the value of the information that would be lost by disclosure—a positive number. However, this does not seem likely to affect the present analysis. Allowing firms to disclaim liability for fraud usually would not enhance their ability to protect valuable information. A disclaimer would often simply make it clear to all concerned that the party was lying. *See* Ian Ayres, *Back to Basics: Regulating How Corporations Speak to the Market*, 77 VA. L. REV. 945, 963 (1991).

disclaimers of liability were unenforceable (in which case Anne would be deterred from lying in the first place). At the same time though, making the disclaimer enforceable does not seem to make the parties better off in any way.

If this were the only consequence of permitting parties to disclaim liability for fraud, economists would be indifferent about whether courts enforced these kinds of disclaimers. However, once we introduce even a slight possibility that Barbara will (perhaps unreasonably) trust Anne to tell the truth even when she (Anne) is not legally bound to do so, it becomes possible to build a case against enforcing these disclaimers. Under these circumstances, if disclaimers of liability for fraud are enforceable Anne might try to disclaim liability and then lie about the contents of the box hoping that, notwithstanding the disclaimer, her lie will induce Barbara to pay more for the box than she would in the absence of the lie. In this case, the transaction between Anne and Barbara might fail to meet the conditions for Pareto-superiority, because Barbara might be made worse off by the transaction. She might be induced to pay more for the box than she would ever be willing to pay for a box of cat food.[56] Perhaps even more significantly from an economic perspective, this transaction may not simply redistribute wealth from Barbara to Anne. It is quite possible that Anne's gain from the transaction will be less than Barbara's loss, because Anne may incur some costs in order to accomplish her deception. For example, she might buy a label that says "candy" and stick it on the box.[57] Economists view these types of expenditures as being completely unproductive.[58] Therefore, from an economic perspective it would be better if disclaimers

[56] Specifically, it would then fail to satisfy the conditions of Kaldor-Hicks efficiency. For a discussion of different conceptions of efficiency, see JULES J. COLEMAN, MARKETS, MORALS AND THE LAW ch. 4 (1988).

[57] This is not to say that otherwise Anne's gain would necessarily equal Barbara's loss. For example, suppose that Barbara had to decide whether to spend five dollars on traveling to Anne rather than another candy seller, money that will be wasted if the box does not have any candy. In this case, Anne's fraud will cause Barbara to lose not only the difference between the value to her of a box of candy and a box of cat food, but also the five dollars.

[58] The seminal article is Gordon Tullock, *Welfare Costs of Tariffs, Monopolies and Theft*, 5 W. ECON. J. 224 (1967). The view that these activities have no social benefit may be difficult to defend from a utilitarian perspective if the deceiver derives satisfaction from the act of deception itself. Stigler suggests that the utility derived from such activities should not be included in the social welfare function. *See* George J. Stigler, *The Optimum Enforcement of Laws*, 78 J. POL. ECON. 526, 527 (1970). Discussing an analogous challenge to the economic analysis of the law of rape, Landes and Posner suggest that such cases will be rare and so are not worth considering. *See* WILLIAM LANDES & RICHARD POSNER, THE ECONOMIC STRUCTURE OF TORT LAW 157-58 (1987).

of liability for fraud were unenforceable, thus removing Anne's incentive to invest resources in trying to deceive Barbara.

This analysis suggests why it may be desirable to have a legal rule banning the enforcement of disclaimers of liability for fraudulent misrepresentations. Such a rule does not make any contracting parties worse off and at the same time helps to prevent unscrupulous people from taking advantage of the ignorance or vulnerability of others. Such unscrupulous behavior is not only morally reprehensible; it is also undesirable from an economic perspective, because it involves expenditure of resources on unproductive activities. Furthermore, if successful, fraud may result in misallocation of resources (imagine the case where Barbara does not own a cat). Note that this analysis suggests that not only should a victim be able to rescind a contract induced by a fraudulent misrepresentation, they should also be permitted to claim whatever damages are necessary to deter fraud.

A similar but slightly weaker argument can be made against enforcing disclaimers of liability for certain negligent misrepresentations. Suppose that Anne honestly believed that the box contained candy (based on what she was told by the manufacturer) but had not taken any steps to verify her statement to Barbara that it did. Anne's failure to verify her statement would clearly be negligent if the cost of verification was lower than the cost to Barbara of bearing the risk of inaccuracy. It would never make sense for the parties to agree to let Anne disclaim liability for this sort of negligence. By hypothesis, it would always be cheaper for Anne to verify her statements and then assume liability for them than to disclaim liability and then offer to compensate Barbara for bearing the risk of inaccuracy. This suggests that there is no economic justification for enforcing disclaimers of liability for certain sorts of negligent misrepresentations.[59] However, unlike cases involving fraudulent misrepresentations, permitting disclaimers of liability for negligent misrepresentations seems unlikely to create any incentives to

[59] This is not true of all negligent misrepresentations. The conventional definition of negligence in American law merely requires that the cost of precautions be lower than the expected value of the loss to be avoided. *See* U.S. v. Carroll Towing Co., 159 F.2d 169, 173 (2d Cir. 1947). Thus it is possible in law for Anne to be negligent for failing to verify her statement even if Barbara is better placed to bear the risk of loss, because she can simply open the box. This is because the cost of precautions to Anne might still be lower than the expected value of the loss that Barbara will incur if the box turns out to contain cat food. It might actually be mutually beneficial to the parties for Anne to be able to disclaim liability for this sort of negligence. Alternatively, Anne could be excused from liability on the grounds that Barbara was contributionally negligent. I owe this point to Bruce Chapman.

invest in deception (because any investments of this sort would probably make the activity fraudulent rather than merely negligent).

Finally, from an economic perspective it is not clear whether it is essential to allow Anne to escape liability if she retracts a prior fraudulent misrepresentation. Some might argue that this is necessary to give her an incentive to make a retraction. However, she should already have an incentive to do this in order to reduce her potential liability for fraud.

D. *Summary*

There are both moral and economic objections to enforcing disclaimers of liability for either negligent or fraudulent pre-contractual misrepresentations. Furthermore, the economic analysis set out above suggests that even courts that favor the will theory of contract law should hesitate to enforce disclaimers of liability for fraud or negligence, because there is a good chance that they were not agreed to voluntarily. These objections do not seem to apply, however, in cases where a party has effectively retracted a prior misrepresentation.

IV. PRACTICAL CONSIDERATIONS AFFECTING THE ECONOMIC ANALYSIS

In the real world, the legal system does not operate nearly as smoothly as it does in the world represented by economists' simplified models. In actuality, litigation is unpredictable and expensive, and mechanisms that have little do with the formal legal system can sometimes be used to achieve the same goals achieved by that system. Recent law and economics scholarship shows that when these features of commercial reality are taken into account, it becomes easier to find an economic justification for enforcing disclaimers of liability for pre-contractual misrepresentations, including fraudulent and negligent misrepresentations.[60]

A. *The Limitations of the Judicial Process*

Early discussions of the parol evidence rule suggest that the rule was developed to enable courts to avoid the difficult task of determining whether an oral statement has been made.[61] Whatever its merits as an explanation for the historical development of the parol evidence rule,

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[60] *See generally* David Charny, Non-Legal Sanctions in Commercial Relationships, 104 HARV. L. REV. 373 (1990).
[61] *See also* One-O-One Enterprises, Inc. v. Caruso, 848 F.2d 1283 (D.C. Cir. 1988).

this argument fails as a rationalization for the rule's current scope. Evidentiary concerns only seem to explain why the courts enforce disclaimers of liability for oral pre-contractual misrepresentations. These concerns do not lead to the conclusion that the courts should enforce disclaimers of liability for fraudulent and negligent misrepresentations that are reduced to writing, because their existence should not be particularly difficult to prove.[62]

There is a slightly different way of explaining, however, why the inherent characteristics of litigation may make it worthwhile for parties to disclaim liability for misrepresentations. If potential litigants always behaved rationally and always agreed on the likely outcome of litigation, they would rarely bother to take their cases to court. Instead, they would tend to settle and avoid the costs of litigating. This does not reflect reality though. For a variety of reasons, potential litigants often disagree about the likely outcome of litigation. Typically, when this happens both parties are relatively optimistic, meaning that each party gives their own claim a greater chance of success than the other party would give the same claim.[63] This tends to reduce the likelihood of the parties agreeing to settle their disputes before trial and thus avoid the costs of litigation.[64] Of course, the likelihood of settlement will also be low if potential litigants prefer to litigate rather than settle even when settlement makes sense from a purely financial perspective. It is not uncommon for parties to insist on going to trial 'on principle' or because they 'just want to have their day in court'. In either case, parties may find it worthwhile to disclaim liability for even fraudulent misrepresentations, because the benefits of assuming liability are outweighed by the litigation costs that can be expected to accompany the assumption of liability.

An independent reason why parties may find it useful to disclaim liability for misrepresentations is because they might fear that courts are

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[62] *See* FARNSWORTH, *supra* note 10, at 466-69.

[63] *See* Jeffery J. Rachlinski, *Gains, Losses and the Psychology of Litigation*, 70 S. CAL. L. REV. 113 (1997) (attributing this tendency to cognitive biases).

[64] When this happens the amount that a rational defendant is willing to offer to settle the dispute may be lower than the amount that a rational plaintiff is willing to accept as a settlement, even after the parties take into account the costs of going to trial. *See* William M. Landes, *An Economic Analysis of the Courts*, 14 J. L. & ECON. 61 (1971); John P. Gould, *The Economics of Legal Conflicts*, 2 J. LEGAL STUD. 279 (1973); Richard A. Posner, *An Economic Approach to Legal Procedure and Judicial Administration*, 2 J. LEGAL STUD. 399 (1973); Robert D. Cooter & Daniel L. Rubinfeld, *Economic Analysis of Legal Disputes and Their Resolution*, 27 J. ECON. LIT. 1067 (1987).

unable to determine accurately whether parties have behaved negligently or fraudulently. This can be problematic when combined with the fact that punitive damages are often awarded to victims of misrepresentations. This combination of factors makes it possible for significant liability to be imposed upon parties who have not behaved negligently in the economic sense, meaning that they have taken all cost-justified precautions. This, in turn, gives the potentially liable party an incentive to take what both parties would regard as excessive precautions.[65]

In some cases it might be mutually beneficial for parties to disclaim liability for negligent misrepresentations in order to avoid creating incentives to take wasteful precautions.[66] However, it is less likely that they will want to disclaim liability for fraudulent or grossly negligent misrepresentations for this reason. It seems relatively unlikely that a party whom a court considers to have made a grossly negligent or fraudulent misrepresentation will actually have taken adequate precautions against making a misrepresentation. Therefore, it seems unlikely that the threat of this sort of liability will create any significant incentive for anyone to take wasteful precautions, even if we allow for the effects of punitive damages and uncertainty about the precise meanings of fraud or gross negligence.[67]

B. *Non-legal Sanctions*

From an economic perspective, the main benefit associated with imposing legal liability for misrepresentations is that the fear of liability will give parties incentives to ensure the accuracy of their pre-contractual representations. However, any non-legal sanctions that accompany the making of a misrepresentation could have a similar deterrent effect and may serve as a substitute for legal sanctions.[68] This

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[65] *See* Chapman & Trebilcock, *supra* note 41; Richard Craswell & John E. Calfee, *Deterrence and Uncertain Legal Standards*, 2 J. L. ECON. & ORG. 279 (1986); John E. Calfee & Richard Craswell, *Some Effects of Uncertainty on Compliance With Legal Standards*, 70 VA. L. REV. 965 (1984).

[66] *But see* Charny, *supra* note 60, at 407-408 (discussing the opposite situation where legal sanctions give parties insufficient incentives to take precautions).

[67] In a similar vein, see Jason S. Johnston, *Punitive Liability: A New Paradigm of Efficiency in Tort Law*, 87 COLUM. L. REV. 1385 (1987) (suggesting that over-deterrence can be eliminated by making only gross negligence that is proven by clear and convincing evidence subject to punitive damages).

[68] This ignores the fact that liability may also serve to efficiently allocate risk of inaccuracy between the parties. Non-legal sanctions often cannot be used for this purpose because they do not provide compensation to the aggrieved party.

means that rational contracting parties should compare the relative costs and benefits of using non-legal as opposed to legal sanctions when determining whether or not to disclaim legal liability.[69] This comparison will depend in part upon the relative costs associated with enforcing legal and non-legal sanctions, *i.e.*, the expected level of litigation costs if legal liability is assumed versus the costs of using non-legal enforcement mechanisms such as self-help and arbitration.[70] For the reasons discussed above, these costs will depend in part on the predictability of the consequences of resorting to each sanctioning mechanism. The discussion above also explains that the accuracy of each sanctioning mechanism will affect how they compare in another important respect, namely their likelihood of inducing the parties to take excessive precautions. In addition, legal and non-legal sanctions should be compared in terms of the extent to which they require the parties to incur drafting costs. Depending upon the expertise of the person imposing the sanction, it may be necessary to expend considerable resources drafting pre-contractual representations in clear terms before they can be enforced reliably.[71]

Non-legal sanctions for misrepresentations can be a potent substitute for legal sanctions.[72] This is especially likely where the non-legal sanctions consist of one party to a transaction unilaterally altering the terms of its future dealings with the other party (including the case where they refuse to have any future dealings whatsoever).[73] Under

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[69] *See generally*, Charny, *supra* note 60. However, parties' decisions to rely on non-legal sanctions may deprive other members of society of the public goods associated with more formal litigation. These public goods include the development of a set of precedents, public revelation of information about the subject matter of disputes, and the salutary effect of judicial decisions on social norms. *See* David Charny, *Illusions of Spontaneous Order: Norms in Contractual Relationships*, 144 U. PA. L. REV. 1841 at 1852 (1996) (citing Owen M. Fiss, *Against Settlement*, 93 YALE L. J. 1073 (1984)).

[70] Litigation costs can be defined extremely broadly to include all costs associated with resolving disputes through the courts. These obviously include legal fees and filing fees but may also include the costs associated with the publicity of legal proceedings. *See, e.g.*, Lisa Bernstein, *Opting Out of the Legal System: Extralegal Contractual Relations in the Diamond Industry*, 21 J. LEGAL STUD. 115 (1992).

[71] In other words, failure to do so would lead to unpredictable judicial outcomes that would in turn lead to the consequences identified above.

[72] *See* Jonathan M. Karpoff & John R. Lott, Jr., *The Reputational Penalty Firms Bear from Committing Criminal Fraud* , 36 J. L. & ECON 757, 780-89 (1993) (finding that the market value of the common stock of corporations that were either alleged to have committed fraud or were convicted of fraud fell significantly following announcement of the allegations or conviction and that very little of the fall in value could be attributed to expected legal penalties).

[73] *See* Karpoff & Lott, *supra* note 72, at 763-64; Charny *supra* note 60, at 420-24.

these circumstances, the risk of sanctions being mistakenly imposed on a party who has taken adequate precautions is as low as can be expected; a third party decision-maker would almost certainly have more difficulty evaluating the parties' conduct. For similar reasons, these types of non-legal sanctions may be more predictable than legal sanctions. In addition, having sanctions imposed by one of the parties to the transaction may also economize on drafting costs. Because the parties are likely to be intimately familiar with all aspects of their agreement from their course of dealing, and possibly also from their experience with other similar transactions, their commitments may not have to be explicit in order for them to be mutually intelligible so as to permit self-enforcement. However, the same representations may need to be made much more explicit before they will be sufficiently intelligible for a third party to reliably enforce.[74] Of course, the drawback of relying on unilaterally imposed sanctions is that one party will bear the risk that sanctions will be imposed opportunistically.[75]

To a lesser extent it may make sense for parties to rely upon non-legal sanctions that are imposed by third parties such as arbitrators. The expertise of these parties or the informality of their dispute resolution procedures may permit the parties to avoid the unpredictable and expensive judicial system. In these cases one would expect the parties to explicitly assign responsibility for adjudicating their disputes to the third party in their contract.

Finally, it is possible, but somewhat unlikely, that parties will choose to avoid legal sanctions in order to rely upon non-legal sanctions that can only be imposed by relatively uninformed third parties such as other market participants. For example, an insurance company considering defrauding some of its policy holders may be somewhat deterred by the prospect of being unable to sell its products to other individuals once it gains a reputation for lying. However, it is unlikely that the parties would agree to let the company disclaim legal liability and rely exclusively on fear of loss of reputation to deter fraud. This is because the reputational sanction would be imposed by people—other market participants—with relatively little information about the

[74] This is another way of describing the distinction that economists draw between observable and verifiable information. The implications of observability and verifiability for parties' decisions to seek judicial enforcement are explored in Alan Schwartz, *Relational Contracts in the Courts: An Analysis of Incomplete Agreements and Judicial Strategies*, 21 J. LEGAL STUD. 271 (1992).
[75] *See* Charny *supra* note 60, at 406-07.

circumstances of any alleged fraud. Under these conditions the risk of the sanction being imposed inconsistently or inappropriately is high. This will tend to make these sorts of sanctions less attractive than legal sanctions.

Of course in principle, sanctions imposed by the market may be effective means of ensuring the accuracy of representations when information about a person's misrepresentation can be broadcast quickly and reliably among his potential trading partners. This means that third parties must be able to determine readily that the representation was made in the first place, that it was inaccurate, and that insufficient care was taken to ensure its accuracy. This seems most likely to be possible in situations involving representations that are broadcast widely, such as claims made in advertising or promotional material, and whose falsity can easily be demonstrated to the makers' potential trading partners. Situations like this are quite rare. It seems far more likely that parties will rely upon sanctions inflicted by market participants to complement sanctions imposed by specific independent decision makers, like judges or arbitrators, who have access to superior information about the circumstances of alleged misrepresentations.[76]

C. *Summary*

The economic arguments developed so far suggest that contracting parties may often be able to obtain mutual benefits by disclaiming liability for both fraudulent and negligent pre-contractual misrepresentations in order to avoid potentially costly litigation. Parties are also likely to benefit if courts respect disclaimers of liability for misrepresentations that are neither fraudulent nor grossly negligent, because this allows them to avoid the risk that courts will impose liability in situations where an efficient level of care has been taken to avoid making a misrepresentation. Finally, two scenarios in which parties can rely on non-legal sanctions to deter their trading partners

[76] For example, Karpoff & Lott, *supra* note 72, only found that firms' reputation suffered after the disclosure of information, suggesting that the courts were likely to determine that fraud had taken place. This suggests that potential legal liability may be necessary for the fear of a loss of reputation to act as a deterrent, because the courts can provide credible information about the existence of wrongdoing. Lisa Bernstein's study of the diamond markets illustrates that arbitrator's decisions may also be a source of such information. She found that diamond traders rarely needed to seek legal enforcement of arbitrator's decisions. The decisions were published widely within the community of diamond dealers and so traders had a strong incentive to comply with them in order to avoid exclusion from the market. *See* Bernstein, *supra* note 70.

from making misrepresentations have also been identified. One scenario is where the parties can rely on unilaterally imposed non-legal sanctions, such as the refusal to engage in future dealings. The other situation is where the parties have delegated responsibility for adjudicating their disputes to an independent third party such as an arbitrator. It is relatively unlikely that parties will rely upon non-legal sanctions in other situations, even if they are available, because they are likely to be less predictable and accurate than legal sanctions.

V. MINIMIZING AGENCY COSTS

The arguments developed so far suggest that it may sometimes be justifiable from a purely economic perspective to allow parties to disclaim liability for both fraudulent and negligent misrepresentations. However, none of the economic arguments address the moral objections to enforcing disclaimers of liability for these kinds of misrepresentations (although it may be possible to argue that these are assuaged when parties assign responsibility for adjudicating their disputes to a third party).[77] This section develops an under-emphasized yet intuitive explanation for why it may be both morally defensible and economically desirable to allow commercial parties to routinely disclaim liability for all sorts of pre-contractual misrepresentations, including fraudulent misrepresentations. The argument is simply that enforcing these sorts of disclaimers may permit certain parties to minimize the costs of transacting through agents.

A. *The Moral Ramifications of Enforcing Disclaimers of Vicarious Liability*

The vast majority of commercial transactions in our society involve at least one party that is a corporation, partnership or other form of business association. Those entities, which I will refer to as "enterprises," typically act through agents who are responsible for both negotiating and concluding contracts on behalf of the enterprise. This means that most pre-contractual misrepresentations are made by agents of enterprises. Yet when most lawyers speak of imposing liability for pre-contractual misrepresentations made by agents, they are speaking about imposing vicarious liability upon the agent's principal, the enterprise, rather than just about imposing personal liability upon the

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[77] *See infra* Part VII.

agent.[78] In other words, lawyers often fail to draw a distinction between imposing vicarious and primary liability in this context.

From a moral perspective it is critical to distinguish between the primary responsibility of an agent who has made a false or negligent misrepresentation and the vicarious responsibility of the enterprise on whose behalf he acted. Many scholars question whether the enterprise should be regarded as morally responsible in these situations.[79] Some question whether it is meaningful to speak about the moral responsibility of an abstraction such as a corporation or a partnership, while others question whether the fault of an agent should automatically be attributed to such an entity.[80] Others note, however, that many enterprises can plausibly be viewed as morally responsible agents, because they are capable of formulating and acting upon purposes that are independent of the purposes of any individual member of the enterprise.[81] This analysis provides a logical basis for holding an enterprise morally responsible for some of its agents' actions but does not necessarily imply that the enterprise should be considered to be at fault whenever one of its agents behaves fraudulently or negligently. Rather, the enterprise should be responsible only when a purpose that can truly be attributed to the enterprise, rather than merely its individual agents, can be characterized as blameworthy.[82]

There are situations in which it seems appropriate to hold an enterprise morally responsible for the fraudulent or negligent misrepresentations of its agents. Some of the most prominent recent examples are the cases involving brokerage firms whose brokers were found to have perpetrated widespread frauds on consumers.[83] More generally, any case in which fraud and deception are demonstrated to be entrenched features of corporate culture should qualify. Once those cases are set aside, though, there remain many other cases in which it seems inappropriate to saddle enterprises with moral responsibility for their agents' misrepresentations. In these cases the enterprise's vicarious

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[78] *See* Restatement (Second) of Agency §§257-259A (1958) (stating the doctrinal basis for holding a principal liable for his agent's misrepresentations).

[79] For an overview of this debate, *see* Schwartz, *supra* note 8.

[80] *See, e.g.*, G. R. Sullivan, The Attribution of Culpability to Limited Companies, 55 CAMB. L. J. 515 (1996).

[81] *See generally* Brent Fisse & John Braithwaite, Corporations, Crime and Accountability 24-31 (1993).

[82] *Id.*

[83] *See, e.g.*, In the Matter of PaineWebber Inc., SEC Admin. Proc. File No. 3-8928 (January 17, 1996) *available in* Lexis SEC Release database.

liability probably should be understood as a legal convention that lacks a compelling moral foundation. However, this might be supported by reference to either economic considerations or to social conceptions of responsibility that have nothing to do with conventional morality.[84] In this respect vicarious liability is similar to other forms of strict liability, because it is imposed without regard to moral fault.

So long as the imposition of vicarious liability is not required by moral dictates there should be no moral objection to enforcing agreements under which an enterprise and a third party agree to limit or eliminate the enterprise's vicarious liability, especially if such an agreement is likely to be mutually beneficial for the parties. Enforcing these types of agreements in circumstances where the enterprise itself is morally blameless serves to respect the will of the parties without undermining the law's commitment to expressing disapprobation for fraud and gross negligence. Under these conditions a disclaimer of vicarious, as opposed to primary, liability does not serve to absolve any morally responsible party of liability.

B. Using Disclaimers to Minimize Agency Costs

The standard economic analysis of disclaimers of individual liability for fraudulent or negligent misrepresentations does not apply to disclaimers of vicarious liability for fraudulent and negligent misrepresentations. As mentioned above, economists take the view that disclaimers of individual liability for fraud and negligence are necessarily inefficient, assuming that the courts define both those concepts to mean the failure to take precautions whose costs outweigh their benefits and expected litigation costs are low. This is because the disclaimer removes the threat of liability that would normally give the beneficiary of the disclaimer an incentive to refrain from inefficient behavior. But the fact that an enterprise's agent has acted fraudulently or negligently does not mean that the enterprise itself has failed to take cost-effective precautions. It is quite possible for an agent to make a fraudulent misrepresentation even though the enterprise has taken all reasonable precautions to prevent him from doing so. This suggests that the economic analysis of disclaimers of vicarious liability might be quite

[84] The economic justifications for vicarious liability are canvassed in the next section. For an alternative to the dominant moral conception of responsibility and its emphasis on freely chosen action as the basis of responsibility, see Meir Dan-Cohen, *Responsibility and the Boundaries of the Self*, 105 HARV. L. REV. 959 (1992).

different from the economic analysis of disclaimers of individual liability.

From an economic, as well as a moral, perspective, it makes sense to view vicarious liability as a form of strict liability. This is because vicarious liability is imposed without regard to fault in the sense that an economist is likely to define that term, namely the failure to take cost-effective precautions. However, it is easier for an economist to defend strict liability than it is for a moral philosopher. In a contractual setting, imposing strict liability on the party who is able to take precautions against causing harm at the least cost can induce that party to take an optimal level of precautions if the correct level of damages is assessed.[85] Generally speaking, damages should be set at a level equal to the harm caused by the misrepresentation, adjusted only to reflect the possibility that the misrepresentation and its related consequences will not be detected.

At first glance it may seem efficient for an enterprise, rather than its trading partners, to bear liability for all misrepresentations made by the enterprise's agents. This is mainly because, as between the enterprise and its trading partners, the enterprise seems to be able to prevent those misrepresentations from being made at the least cost. The literature on vicarious liability is replete with descriptions of enterprises' ability to deter tortious and criminal acts by monitoring and sanctioning their agents. In fact, the leading economic justifications for vicarious liability are premised on the notion that enterprises are better equipped than courts to prevent agents from misbehaving.[86] However, these discussions should not obscure the fact that there are limits to enterprises' ability to control their agents' behavior.[87] Sometimes, an enterprise may not be in the best position to take precautions that

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[85] The seminal analysis is Steven Shavell, *Strict Liability Versus Negligence*, 9 J. LEG. STUD. 1 (1980).

[86] Some of the most noteworthy contributions to this literature are John C. Coffee, Jr., *"No Soul to Damn No Body to Kick": An Unscandalized Inquiry into the Problem of Corporate Punishment*, 79 MICH. L. REV. 386 (1981); Reinier H. Kraakman, *Corporate Liability Strategies and the Costs of Legal Controls*, 93 YALE L. J. 857 (1984); Alan O. Sykes, *The Boundaries of Vicarious Liability: An Economic Analysis of the Scope of Employment Rule and Related Legal Doctrines*, 101 HARV. L. REV. 563 (1988); Alan O. Sykes, *The Economics of Vicarious Liability*, 93 YALE L. J. 1231 (1984).

[87] This insight is potentially relevant in other contexts. *See* Jennifer Arlen & William Carney, *Vicarious Liability For Fraud On Securities Markets: Theory And Evidence*, U. ILL. L. REV. 691 (1992) (vicarious liability should not be imposed upon corporations whose agents commit fraud on the market because firms have limited ability to identify and sanction responsible agents).

forestall the harm that might be caused by an agent's misrepresentation. In certain circumstances the enterprise's trading partner is in the best position to take such precautions. In these cases the parties may find it mutually advantageous to adjust their potential liability for agents' misrepresentations in a way that gives the trading partner an incentive to take those precautions.[88]

One of the most effective precautions that an enterprise can take to reduce the harm likely to be caused by an agent's misrepresentations is to monitor the agent's representations. This permits the enterprise to verify the representations and to correct, clarify or retract any misrepresentations before they can cause harm. Monitoring also helps the enterprise to deter agents from making misrepresentations by allowing it to sanction those agents whose misrepresentations are detected. Of course the other precautions that can be taken also have their drawbacks. For instance, an enterprise can attempt to screen agents for honesty and carefulness. However, it may be difficult to do this with any degree of reliability. Alternatively, the enterprise could limit the occasions upon which agents are allowed to communicate with third parties, but this might be prohibitively costly. Finally, the enterprise might refrain from monitoring agents' representations prior to contracting but instead attempt to deter agents by sanctioning them for misrepresentations that are detected after the contract is concluded, for example, when a customer sues. This may be the cheapest way of achieving deterrence, because it involves minimal expenditures to detect wrongdoing. But, unlike *ex ante* monitoring, a strategy that relies solely on the investigating and the sanctioning taking place *ex post* does nothing to prevent the agents who inevitably are not deterred from causing harm.

Sometimes it will not be difficult for an enterprise to monitor its agents' representations. In many situations, though, it will be impossible for an enterprise to monitor all of the pre-contractual representations being made by its agents at a reasonable cost. Of course this is most likely to be the case where representations are being made orally, especially when recording is impractical. Imagine how difficult it would be for the board of directors of a large enterprise with a worldwide cast of agents to be confident that they have been informed of all the

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88 The following analysis parallels George Priest's explanation of the efficiency of limiting the scope of consumer product warranties. *See* George L. Priest, *A Theory of the Consumer Product Warranty*, 90 YALE L. J. 1297, 1307-14 (1981).

representations made by the enterprise's agents prior to the signing of a major agreement.

In these types of situations it might be useful to recruit the enterprise's trading partner to assist in the process of monitoring the agent. The trading partner's assistance is valuable, because unlike the enterprise, he is in an excellent position to be aware of all the representations that have been made by the agent and whether they are material. However, under a legal regime in which the enterprise will be liable to the trading partner for losses caused by an agent's misrepresentations whether or not the trading partner assists in monitoring the agent, the trading partner will have little incentive to assist the enterprise by sharing information about representations that the enterprise cannot detect.

The solution to this dilemma is for the parties to agree to a contract that gives the trading partner an incentive to disclose the private information about material representations made by the enterprise's agents that the enterprise may otherwise find difficult to detect.[89] In practice, this is likely to involve the enterprise disclaiming liability for pre-contractual representations not contained in the final agreement between the parties. This gives the trading partner an incentive to inform the enterprise if any material representations have been made which contradict or supplement those contained in the agreement.

The key to the effectiveness of this scheme is the assumption that it is less costly for the trading partner to be responsible for bringing pre-contractual representations to the enterprise's attention than it is for the enterprise to monitor them. There are two independent reasons why this assumption is plausible. The first reason has already been suggested above: some pre-contractual representations are inherently difficult for an enterprise to monitor. But even if the enterprise is readily able to monitor all of its agent's pre-contractual representations, it still may be worthwhile for it to disclaim liability for all but a subset of those representations. That is because the other party to the transaction may

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[89]In some circumstances it may be possible to induce potential buyers to share information regarding agents' representations without resorting to contractual mechanisms. For example, in some telemarketing agencies, after finding a buyer who expresses interest in purchasing the product being offered for sale, the agent is required to patch in her supervisor who concludes the sale by repeating the terms of the transaction and then asking if the agent made any representations inconsistent with those terms. Only sales verified in this fashion are counted in setting the agent's compensation. Of course this type of arrangement might be prohibitively costly to implement.

have better information than the enterprise about which representations are material. Ideally, an enterprise would assume liability for all the representations that it can monitor at a reasonable cost and that it believes are material to its trading partners, and the enterprise can disclaim liability for the rest. The trading partner can then identify and ask the enterprise to assume liability for any other material representations if the enterprise seems to be in a superior position to verify them or bear the risk of their inaccuracy. This way the enterprise is saved the difficulty of monitoring representations that can either be detected more cheaply by the trading partner or that are not material to him.[90] For example, it is likely to be far easier for the board of directors of a large enterprise to monitor the limited set of representations contained in its final written agreements as opposed to all representations made in any format by the enterprise's agents.

VI. ILLUSTRATIONS

A. *Protecting Dishonest Individuals*

There seem to be relatively few cases in which the courts have held that a contractual provision may bar claims of fraud brought against an individual who is alleged to have personally committed the fraud. The leading case is *Danann Realty Corp. v. Harris.*[91] There the claim was that the defendants had induced the plaintiff to buy a lease of a building by making false oral representations about the operating expenses of the building and its overall profitability.[92] The written agreement between the parties stated that the sellers had not made any representations "as to the physical condition, rents, leases, expenses, operation or any other matter or thing affecting or related to the aforesaid premises."[93] The

[90] This point has not been completely overlooked by other scholars. For example, WHITE & SUMMERS, *supra* note 6, point out that merger clauses are useful to protect sellers against the risk posed by unauthorized oral misrepresentations made by an "effusive salesperson." However, they do not explore the economic ramifications of this insight and later hint that they are divided about the appropriateness of allowing merger clauses to bar claims of fraud. *See* WHITE & SUMMERS, *supra* note 6. Dean Clark has also acknowledged the logic of limiting a corporation's vicarious liability when a third party is in the best position to know that one of the corporation's agents has exceeded his authority. *See* ROBERT CHARLES CLARK, CORPORATE LAW 121 (1986). Goldberg makes a similar argument in favor of permitting accounting firms to disclaim liability for the fraud of their employees and partners. *See* Victor P. Goldberg, *Accountable Accountants: Is Third Party Liability Necessary?* 27 J. LEGAL STUD. 295 (1988).

[91] 157 N.E.2d 597 (N.Y. 1959). *See also* Butts v. Groover, 16 S. E. 2d 894 (Ga. Ct. App. 1941).

[92] *Id.* at 598.

[93] *Id.*

agreement went on to state that neither party was "relying upon any statement or representation, not embodied in this contract, made by the other."[94] The majority held that this specific disclaimer of reliance on the very types of representations that constituted the alleged fraud barred the plaintiff from claiming that it had justifiably relied on any fraudulent pre-contractual misrepresentations.[95] Judge Fuld wrote a strong dissent, arguing for the application of the well-established general rule that no contractual provision should bar a claim for fraud.[96]

The *Danann* rule is consistent with the notion that contract law is designed to give effect to the will of the parties and thus they should be free to waive their rights to seek legal redress for fraud. The decision is also defensible in economic terms. From an *ex ante* perspective, the parties may have benefited from a rule that allowed them to avoid the costs of litigating baseless allegations of fraud. However, an important, and perhaps fatal, objection to the *Danann* rule is that it is difficult to reconcile with the notion that the law ought to consistently express both respect for the exercise of individual autonomy and disapprobation of acts of deception that interfere with the exercise of individual autonomy.

Some may defend this position on deontological grounds, but as indicated above, it is also possible to criticize the *Danann* rule from an instrumental perspective. As a number of scholars have observed, legal rules do not only influence behavior by inducing members of society to refrain from illegal behavior out of fear of punishment. People also tend to internalize legal rules and obey them simply because they are legal rules, rather than because breach of the rules is accompanied by sanctions. Therefore, one might argue that the law should manifest a steadfast commitment to honesty because this will tend to encourage members of society to internalize a norm of behaving honestly, even in contexts where they can reasonably expect to avoid being sanctioned if they behave dishonestly.[97] A society in which internalization of norms of honesty is widespread will benefit by having less need to choose between resorting to the legal system to coerce honesty or else incurring the losses that flow from having members of a distrustful society take costly precautions against being victimized. These benefits are virtually

[94] *Id.*
[95] *Id.* at 600.
[96] Danann Realty Corp v. Harris, 157 N.E.2d 597, 600 (N.Y. 1959).
[97] For an interesting analysis along these lines, see Robert Cooter, *Expressive Law and Economics*, 27 J. LEGAL STUD. 585 (1998).

impossible to measure but may be substantial.[98] These factors weigh against adopting any legal rule that allows individuals to escape personal liability for fraud.

Finally, the disclaimer in *Danann* was not sufficiently explicit to qualify as a retraction. Before allowing the sellers to escape liability on the grounds of a retraction, they should have been forced to present evidence that they had specifically brought the previous misrepresentation to the buyer's attention and explained that it was in fact unreliable.

B. Controlling Overly Enthusiastic Agents

The paradigmatic case in which it might make sense to enforce a disclaimer of liability for pre-contractual representations is in the context of an agreement of purchase and sale where the seller's agent is a) primarily responsible for providing information to the buyer prior to contracting and b) has strong incentives to see that the transaction is concluded. Agents placed in these situations will often have strong incentives to make either fraudulent or negligent misrepresentations. This is obviously most likely to be the case where the agent's compensation is tied directly to his or her success in concluding sales on behalf of the seller.

A classic example of how a disclaimer clause can be used to mitigate the consequences of this undesirable set of incentives is provided by the facts of *Northwestern Rug Mfg. Co. v. Leftwich Hardware & Furniture Co.*[99] In that case, Northwestern's salesman told Leftwich that he had not sold and would not sell any of his goods to any other merchant in Leftwich's town. In other words, he promised Leftwich an exclusive agency. Leftwich proved at trial that the salesman had sold the same goods to two other merchants in the town on the same day, both before and after the sale to Leftwich took place. The appellate court upheld a jury verdict against Northwestern despite the fact that the parties were both merchants and their agreement made no mention of the exclusive agency. Rather the contract stated, "Any special terms or agreements with the salesman will not be binding unless specified above."[100] The

[98] *See* James S. Coleman, *Social Capital in the Creation of Human Capital*, 94 AM. J. OF SOC. 95 (1988). *See generally* FRANCIS FUKAYAMA, TRUST: THE SOCIAL VIRTUES AND THE CREATION OF PROSPERITY (1995).
[99] 2 S.W.2d 1109 (Ark. 1928).
[100] *Id.* at 1110.

court ignored the fact that as between Northwestern's owners and Leftwich, Leftwich was in a far better position to protect himself against the mendacious traveling salesman. If the exclusive agency agreement was important to Leftwich, he should have asked the salesman to add it to their written agreement. The salesman would probably have been reluctant to put his promise in writing, because this would have made it easy for his head office to detect his (presumably) unauthorized representation. He would have been particularly reluctant if the contract was of a type that would not be effective until it was approved by his head office.[101]

Another classic example of a case in which an enforceable disclaimer could have helped the parties minimize agency costs is *Bates v. Southgate*.[102] To recap, in that case a stock broker sued the two partners of a brokerage firm, alleging that one partner had induced him to buy the shares of gypsum company by falsely representing that the company had received a large and potentially lucrative order. The confirmation slip issued by the defendants' firm stated "in making this transaction, we make no representation other than to identify the security and state the price."[103] The court held that the slip could not bar a claim based in fraud for policy reasons.[104]

Justice Qua suggested that this case could be distinguished from other cases in which misrepresentations were made through an agent, because "the parties dealt directly with each other."[105] It is not clear how this conclusion can be supported insofar as it concerns the partners who were not accused of making any false representations. Those innocent partners' liability was purely vicarious. From an economic perspective the implications of permitting people to disclaim vicarious liability for their partner's misrepresentations are the same as the implications of permitting them to disclaim vicarious liability for an employee's misrepresentations. Enforcing the disclaimer would allow the innocent partners to focus their monitoring efforts exclusively on the confirmation slips rather than having each of them keep an ear cocked throughout the day to eavesdrop on their partners' telephone conversations. It should

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[101] *Compare* Cannon v. Burrell, 79 N.E. 780 (Mass. 1907) *with* Colonial Dev. Corp. v. Bragdon, 106 N.E. 633 (Mass 1914).
[102] 31 N.E.2d 551 (Mass. 1941).
[103] *Id.* at 552.
[104] *Id.* at 558.
[105] *Id.* at 558-59.

not be difficult to imagine circumstances in which this might be desirable.

It is important to emphasize that the claim being made here is that economic considerations weigh in favor of giving parties the *option* of disclaiming vicarious liability for certain pre-contractual misrepresentations. It is not being claimed that parties will necessarily find it beneficial to exercise that option. For instance, some or all of Southgate's customers might well have decided that virtually everything their brokers told them was material. Those customers might have found it prohibitively costly to attempt to incorporate all the relevant representations and warranties into a formal written document. Therefore, they would probably refuse to allow Southgate to disclaim liability for pre-contractual misrepresentations. By doing so, they would effectively decline to be responsible for helping the members of the partnership monitor one another. Under circumstances like this, the members of the partnership would fall back on alternative methods of deterring or preventing their partners from making misrepresentations. These might include more careful screening of prospective partners and more intense monitoring of existing partners.

An alternative scenario is that certain firms might find it less necessary to monitor agents because they screen their partners more carefully. In fact, such firms' partners might not only refrain from getting their customers involved in monitoring their fellow partners, but they could also avoid using internal mechanisms to monitor one another either. Those firms would attempt to capitalize on their relatively low monitoring costs by offering to assume liability for all pre-contractual misrepresentations at a relatively low premium. In effect, the partners of those firms would capitalize on their collective honesty and trustworthiness by offering to put the assets of every partner behind the word of each individual partner.

Each of the two scenarios described above, or some combination of them both, seems plausible. One or the other might even describe the norm in many industries. However, it also seems plausible that there will be scenarios in which customers do not wish to pay a premium to have a firm subject its partners to searching scrutiny. Those customers may be willing to bear the responsibility for ensuring that all material representations are included in an easily monitored final agreement. This may either be because they don't find it costly to draft an agreement that incorporates all material representations, or else because they are willing to abandon recourse against the assets of the partnership and rely solely upon the assets of the individual with whom they are dealing. Those customers will benefit from having the option of dealing with a firm that is able to disclaim liability for its partners' pre-contractual misrepresentations.

It is difficult to understand how anyone could complain on moral grounds had the decisions in either *Northwestern* or *Bates* had gone the other way. Anyone who favors the will theory of contract law should accept the propriety of a decision to enforce a disclaimer clause once they are satisfied that, at the time of contracting, both parties understood its effect and were not coerced. These pre-conditions to voluntary agreement were probably present in both cases. Both Leftwich and Bates apparently were experienced merchants and there was no suggestion of coercion in the cases. Bates especially seems to have understood that the ordinary effect of the confirmation slip would be to bar any action based on a pre-contractual misrepresentation. It seems unlikely that either would have been surprised to discover that the clause barred an action for a non-fraudulent misrepresentation. The fact that we can easily show why it may have been mutually beneficial for the parties to enter into an agreement containing this sort of disclaimer should go a long way towards alleviating any nagging doubts about whether the agreement was voluntary.

It also is difficult to see how allowing the disclaimer clauses at issue in these two cases to bar the imposition of vicarious liability would undermine the law's general prohibition of fraud. I am not suggesting that either the salesman in *Northwestern* or the stockbroker in *Bates* should have been relieved of liability for their fraud. They both seem to be morally culpable, and so it is arguably inappropriate to allow them to escape liability. The same cannot be said, however, of the salesman's employer or the broker's partners. They effectively gave notice to their customers that they would not be monitoring their agents' pre-contractual representations and so would not necessarily be able to prevent their agents from committing fraud. The customers agreed to contract on those terms. It is difficult to formulate a theory that would ascribe moral responsibility for the agents' fraud to the employer or the brokerage firm under these circumstances. The employers and the brokerage firm seem to be just as innocent as their customers. There should be no moral objection to enforcing a contract by which two innocent parties attempt to allocate the risk of losses caused by a third party's malfeasance. Therefore, there should be no objection to enforcing contracts under which parties like the employer in *Northwestern* and the brokerage firm in *Bates* agree with their respective customers to allocate the risk of losses caused by agents' pre-contractual misrepresentations to the customers.

This analysis is consistent with the recent cases in which the courts have enforced disclaimers of liability for even fraudulent misrepresentations contained in contracts between sophisticated parties. For instance, despite the teachings of *Bates*, a number of circuits have dismissed claims of fraud brought by customers of brokerage firms on the grounds that any fraudulent misrepresentation made prior to the impugned transaction were refuted by information contained in the prospectus. In the typical case, the plaintiffs allege that the firm's representatives misrepresented the risks associated with the investment to them in both oral and written material. The defendants then point to a lengthy prospectus that invariably makes full, true, and plain disclosure of all the risks associated with the scheme. The prospectus also typically states, "no person has been authorized to give any information or to make any representations, other than those contained in this prospectus, and if given or made, such information or representations must not be relied upon."

More often than not courts presented with these facts conclude that the plaintiff's reliance upon the misrepresentations was unjustifiable, whether or not the plaintiff read the prospectus.[106] Because justifiable reliance is an essential element of the 10b-5 claims that are brought by most of these plaintiffs, a finding of unjustifiable reliance serves to destroy their claim.[107] From an economic perspective this result is appropriate in cases involving sophisticated parties, because it permits brokerage firms to focus on monitoring the representations made in one document—the prospectus—without fear of being held liable for their agents' extrinsic oral or written representations. This seems to be the most cost-effective way of monitoring agents.[108]

One aspect of these decisions is troubling. In all of these cases, the finding of unjustifiable reliance serves to bar claims against the individual broker as well as the broker's firm. This sends the wrong

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[106] *See, e.g.*, Zobrist v. Coal-X Inc. 708 F.2d 1511 (10th Cir. 1983); Brown v. The E.F. Hutton Group, 735 F. Supp. 1196 (S.D.N.Y. 1990), *aff'd*, 991 F.2d 1020 (2d Cir. 1993). See further cases cited in Margaret V. Sachs, *Freedom of Contract: The Trojan Horse of Rule 10B-5*, 51 WASH & LEE L. REV. 879, 883 (1994).
[107] The situation may be different in actions brought under section 12(2). *See* MidAmerica Federal S & L v. Shearson/American Express, 886 F.2d 1249 (10th Cir. 1989).
[108] Some courts have explicitly mentioned this argument in their reasons. *See* Acme Propane, Inc. v. Tenexco Inc., 844 F. 2d 1317, 1321-22 (7th Cir. 1988).

message to brokers. For the broker, the lesson to be learned from this line of cases is not that fraud is reprehensible, but rather that fraud is an acceptable part of a sales pitch so long as at the end of the day one goes through the formality of sending the prospective customer a prospectus. This is inappropriate for the same reasons that it is inappropriate for the courts to permit individuals to disclaim liability for their frauds. Brokers receiving these kinds of lessons from the courts are far less likely to internalize a norm of honesty than brokers who face legal sanctions for their misrepresentations. This argument applies even if most brokers have insufficient assets to make it worthwhile for investors to sue them. An unequivocal judicial pronouncement that fraud is clearly unlawful might be sufficient to induce meaningful changes in brokers' behavior even if it is not backed by any significant threat of liability.[109]

VII. PROTECTING CULPABLE ORGANIZATIONS

So far this article has established that enterprises should generally be allowed to disclaim vicarious liability for the misrepresentations of their agents. It has also argued that this position is compatible with the notion that morally blameworthy individuals should not be permitted to use contractual provisions to shield themselves from liability. This begs an important question: should morally blameworthy enterprises be permitted to disclaim liability for fraud or negligence?

Take, for example, an enterprise whose agents are found to have engaged in numerous acts of deception for over two years. Assume that in some cases the agents intentionally attempted to deceive their customers, but that in other cases their misrepresentations can be attributed to the fact that they were provided with erroneous or incomplete information about their products. A large number of people within the enterprise can be blamed for failing to ensure that the agents received accurate information. All of the customers of the enterprise are sophisticated and sign agreements that include disclaimers of liability for agents' pre-contractual misrepresentations. Should the disclaimers be enforced?

To some, enforcement under these circumstances will seem morally objectionable. The most plausible basis for this objection is that enforcement will tend to undermine respect for the general principle of honesty. However, this argument is only tenable if it can be shown that

[109] Brokers are still likely to face administrative penalties in these circumstances. *See* In re Foster, Exchange Act Release No. 3-8423, 1994 SEC Lexis 2107, at *6 (July 20, 1994).

the enterprise is worthy of blame. Otherwise, the law's failure to provide redress for harm caused by the enterprise's agents will not be perceived as an instance of toleration of moral failing, but rather as an unremarkable case in which the law fails to provide compensation to those who have suffered bad luck.

The argument that enterprises can be blameworthy rests on the notion that they are capable of both formulating policies to guide their actions and changing those policies in response to moral strictures. In the hypothetical presented here, the enterprise's policies clearly create a substantial risk that misrepresentations will be made to its customers. Even if the enterprise reasonably expects its customers to participate in the monitoring of the enterprise's agents by insisting that all material representations be put in writing, it seems clear that the enterprise has failed to take adequate precautions against deception. To some, this is sufficient to support the conclusion that the enterprise is morally culpable.[110] Skeptics should note that this type of reasoning about the moral status of organizations is now embodied in the rules used to determine the culpability of enterprises for sentencing purposes in the criminal context,[111] suggesting that it reflects a fairly broad social consensus.

The next step is to see whether economic analysis sheds any light on the question of how the courts should resolve the question posed in the hypothetical. It might seem that economic considerations justify enforcing the disclaimer clause regardless of the enterprise's overall lack of due diligence. On this basis some might conclude that it is appropriate to enforce the disclaimer clauses. However, a closer review of the economic argument in favor of enforcement reveals that it does not require the courts to enforce disclaimers in these circumstances.

The economic logic behind enforcing disclaimers of vicarious liability is to minimize the cost of the precautions taken by enterprises and their trading partners to guard against agents' misrepresentations. As indicated above, disclaimers can be used to give enterprises and their trading partners incentives to allocate responsibility for taking precautions in an efficient manner. Notice that the argument only

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[110] Attributing responsibility to the enterprise as well as its individual agents also seems appropriate given the difficulty of identifying all culpable individuals in these circumstances.

[111] *See generally* United States Sentencing Commission, Federal Sentencing Guidelines Manual 1-11 (1998-99 ed. 1997).

supports enforcing disclaimers to the extent necessary to induce enterprises and their trading partners to take an efficient level of precautions.

But what if both the enterprise and its trading partner fail to take adequate precautions? Is there anything wrong with refusing to enforce the disclaimer then? This can only enhance the enterprise's incentive to take adequate precautions. Therefore, the only possible source of concern is that refusing to enforce disclaimers in these circumstances will dilute the trading partner's incentive to take precautions. However, this does not seem like a basis for significant concern, because the trading partner should expect the enterprise to take adequate precautions. Therefore, in principle, there should be little objection on economic grounds to a rule that states that disclaimers of vicarious liability are unenforceable where the enterprise has failed to take adequate precautions against making misrepresentations.[112] I should note, however, that this only holds if the failure to take adequate precautions is defined in economic terms and thus means the failure to take all precautions that are cost-effective. It is also important to remember that it may not be cost-effective for the enterprise to take certain precautions when its trading partner can readily monitor agents' representations.

The proposition that courts are unwilling to allow morally culpable or, for those who prefer more legalistic terminology, grossly negligent enterprises to escape being held liable for their agents' misrepresentations seems to explain the results of a number of decided cases and is consistent with leading commentators' assessment of the state of the law in this area.[113] For example, the most notorious and recent instance of a court refusing to give effect to a disclaimer of liability for pre-contractual misrepresentations involved a claim brought against A. O. Smith Harvestore Products, Inc. ("AOSHPI").[114] AOSHPI is a silo manufacturer that was sued by dozens of customers after misrepresenting the ability of its silos to keep oxygen from coming into contact with the feed stored in them. Feed exposed to oxygen becomes moldy or spoils and is harmful to livestock. AOSHPI was found to have

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[112] This result can be expressed in terms more familiar to law and economics scholars. The text contends that two parties, A and B, in a contractual relationship can be induced to take efficient levels of precautions by a legal rule that provides that A is strictly liable subject to a defense of contributory negligence, even if the defense is not permitted when A is negligent.

[113] *See supra* note 6.

[114] *See* Keller v. A. O. Smith Harvestore Products, Inc. 819 P.2d 69 (Colo. 1991).

repeatedly misrepresented the capability of its silos to eliminate oxygen, well after the company's own engineering studies, tests, and patent documentation, as well as complaints from farmers should have made it aware that grain stored in Harvestore silos was subject to excessive spoilage.[115] Given this factual setting it should not be surprising that the Colorado Supreme Court ruled that AOSHPI could not shield itself from liability for negligent misrepresentations by relying upon an extremely explicit disclaimer of liability contained in sales agreements signed by the plaintiffs.[116] Similar factors may explain the results in cases involving franchisees and sellers of home equipment.[117]

VIII. EXPLOITING VULNERABLE CONSUMERS

The preceding analysis is primarily intended to support the enforcement of disclaimers of liability for fraudulent pre-contractual

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[115] *See* Korf v. A. O. Smith Harvestore Prod. Inc., 917 F.2d 480, 485 (10th Cir. 1990). *See generally* Richard Meryhew, *$4.2 Million Award Against Silo Maker Upheld*, STAR TRIBUNE Aug. 12, 1992 at 2B *available in* LEXIS NEWS LIBRARY; *Jury: A. O. Smith Corp. Violated Racketeering Act*, WISCONSIN STATE JOURNAL, May 23, 1996 at 3F *available in* LEXIS NEWS LIBRARY.

[116] *See* Keller v. A. O. Smith Harvestore Products, Inc., 819 P.2d 69, 71 (Colo. 1991) in which the purchase orders signed by the plaintiffs contained the following provisions:

> This order form is the entire and only agreement between the Seller and Buyer; and no oral statements or agreements not confirmed herein, or by a subsequent written agreement, shall be binding on either the Seller or Buyer....
>
> Buyer understands the conditions of use of the products and is not relying on the skill or judgment of the Manufacturer or Seller in selecting them because Buyer acknowledges that farming and livestock feeding results are very much the product of individual effort, combined [**4] with various climatic, soil, water, growing and feeding conditions which are beyond the control of the Manufacturer and Seller. Buyer recognizes that any advertisements, brochures, and other written statements which he may have read...are not guarantees and he has not relied upon them as such....Buyer understands that the sole warranty, express or implied, which is provided by [AOSHPI]...is as follows....
>
> I [BUYER] HAVE READ AND UNDERSTOOD THE TERMS AND CONDITIONS OF THIS PURCHASE ORDER INCLUDING THE WARRANTIES, DISCLAIMERS AND TERMS AND CONDITIONS HEREIN GIVEN TO ME, EITHER BY THE MANUFACTURER OR THE SELLER. I RELY ON NO OTHER PROMISES OR CONDITIONS AND REGARD THAT AS REASONABLE BECAUSE THESE ARE FULLY ACCEPTABLE TO ME.

Id. at 71.

[117] *See* Moffatt Enters., Inc. v. Borden, Inc., 807 F.2d 1169 (3d Cir. 1986); Holland Furnace Co. v. Williams, 295 P.2d 672 (Kan. 1956).

misrepresentations in transactions involving reasonably sophisticated commercial parties. Nothing said so far justifies enforcing those disclaimers against parties who failed to appreciate the consequences of agreeing to the disclaimer.[118] Nor can we justify enforcing a disclaimer against a party for whom it would have been prohibitively costly to modify a contract containing a disclaimer to reflect pre-contractual statements upon which they planned to rely.[119] Both the will theory of contract law and economic theories of contract law suggest that courts should interpret disclaimer clauses narrowly under these circumstances.[120] These considerations suggest that courts should be reluctant to enforce disclaimers against consumers in transactions involving goods or services with a fairly low value, particularly when the disclaimer in question is so vaguely worded that its effect is likely to be misunderstood.

In principle, the concern about ensuring that parties appreciate the consequences of agreeing to a disclaimer also suggests that it is inappropriate to enforce a disclaimer against any parties who tend to over-estimate the accuracy of pre-contractual representations for which liability has been disclaimed. In other words, it may be inappropriate to enforce disclaimers of liability for pre-contractual misrepresentations against people who systematically invest an undue amount of trust in their trading partners. At first glance one might think that although this concern might arise in isolated cases, it should not affect the general conclusion that most disclaimers of vicarious liability of misrepresentations should be enforced. There would seem to be no reason to believe that people will routinely be overly trusting in their

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[118] This point is most frequently discussed in connection with disclaimers of liability for defective products. For a survey of the extensive literature, see Steven P. Croley & Jon P. Hanson, *Rescuing the Revolution: The Revived Case for Enterprise Liability*, 91 MICH. L. REV. 683 (1993).

[119] *See* Eric A. Posner, Essay, *The Parol Evidence Rule, The Plain Meaning Rule, and the Principles of Contractual Interpretation*, 146 U. PENN. L. REV. 533 (1998). This seems most likely to be relevant where there are numerous pre-contractual representations or where the value of the transaction is so low that it is not cost-effective for the recipient of the pre-contractual representations even to read the final written agreement.

[120] Under these circumstances it becomes difficult to argue that the terms of the written agreement represent the will of the parties. From an economic perspective, the concern is that a person who underestimates the risk associated with agreeing to let an enterprise disclaim liability for pre-contractual misrepresentations will not make efficient decisions about whether to agree to such disclaimers. A slightly different concern is that uninformed people who agree to disclaimers will, because of their lack of information, underestimate the expected cost of an inaccurate pre-contractual misrepresentation and so fail to take adequate precautions against the harm that may result from inaccuracy.

commercial dealings. However, in an important recent article Professor Langevoort seems to suggest that experienced salespeople can and do systematically cultivate inordinate levels of trust among their customers.[121]

Much of Professor Langevoort's article is concerned with showing that both individual investors and professional investment agents are prone to take significant risks when motivated by greed or faced with either the prospect of a loss or a risk that is not salient and has a low probability of materializing. He also mentions that both types of investors are likely to be persistently overconfident, meaning that they overestimate their ability to perceive risk and learn slowly from their mistakes. He then suggests that brokers have both the motive and the opportunity to take advantage of these cognitive illusions to induce their customers to purchase risky securities.

Professor Langevoort suggests that factors similar to those which distort customers' valuation of securities also distort their perceptions of the trustworthiness of brokers.[122] He claims that even professional investors can be overwhelmed by greed, the fear of experiencing loss, and the fear of appearing ignorant; under these circumstances people naturally tend to be more willing to trust even total strangers.[123] He also seems to believe that investors overestimate the extent to which fear of loss of reputation will constrain their brokers.[124] If true these claims present a significant objection to the central thesis of this paper, namely that people ought to be permitted to agree to contracts that contain disclaimers of liability for pre-contractual misrepresentations. In essence, Langevoort suggests that people can frequently be induced to make bad decisions about whether to trust their trading partners as

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[121] Donald C. Langevoort, *Selling Hope, Selling Risk: Some Lessons for Law from Behavioral Economics About Stockbrokers and Sophisticated Customers*, 84 CAL. L. REV. 627 (1996).

[122] Professor Langevoort's analysis, *supra* note 121, raises the possibility that brokers are able to persuade their customers to assume excessive risk even if they do not misrepresent the riskiness of their products. This implies that it might be appropriate to impose a duty on brokers to avoid resorting to psychological manipulation and perhaps even to overstate the riskiness of securities to certain investors. Professor Langevoort does not seem willing to propose such a radical transformation in the law governing broker-investor interactions. Instead, he focuses on the situations in which the broker not only manipulates the investor's preferences for risk but also makes material misrepresentations about matters such as the securities' risk and return.

[123] Langevoort, *supra* note 121, at 652-58.

[124] *Id.*

opposed to insisting that they assume liability for pre-contractual representations.

There is no doubt that many individuals are susceptible to this kind of manipulation of their cognitive processes. It may even be the case that all individuals acting on their own behalf should be presumed to be vulnerable to this sort of exploitation and so barred from agreeing to many types of disclaimers of liability. This would be consistent with the thrust of contemporary consumer protection legislation, including product liability law. However, Langevoort fails to present a compelling argument that relatively large profit-seeking organizations such as the institutional investors that he spends so much time discussing are incapable of protecting themselves from attempts to manipulate the perceptions of their agents.

There are a number of ways in which an enterprise might protect itself. For starters it might try to hire the least gullible agents available. This should, in turn, induce those seeking to become agents to learn how to be "a tough sell".[125] Enterprises might also engage in some form of monitoring. In many contexts this is most likely to consist of having lawyers play a significant role in important transactions. Lawyers, and especially those that belong to independent law firms, are specifically trained to be distrustful and often have a material incentive to see that agreements are put in a legally binding form.[126] Finally, if none of these options are viable, enterprises might simply formulate policies that require their agents to deal only with especially reputable trading partners or else insist that all material agreements be put in legally binding form.

This last point suggests that the best way of conceptualizing these types of situations is to think of two enterprises trying to minimize the costs of being forced to conclude their transaction through agents. One enterprise is trying to minimize the potential costs associated with the fact that some of its agents are untrustworthy. The other enterprise is concerned with minimizing the costs associated with the fact that its

[125] *Id.* at 656 n.94 (considering this possibility but suggesting that people who are inclined to be resistant to sales pitches might be too rigid to be successful investment agents).

[126] The role that lawyers might play in helping to dispel their clients' cognitive illusions is a topic that does not seem to have been adequately explored in the growing literature on behavioral economics. *But see* Rachlinski, *supra* note 63, at 170-73. For a general discussion of the ways in which various institutions in society transform preferences, see Jonathon R. Macey, *Packaged Preferences and the Institutional Transformation of Interests*, 61 U. CHI. L. REV. 1443 (1994).

agents are overly trusting. There is no reason to presume *ex ante* that the optimal solution to this problem is for the enterprise with the untrustworthy agents to assume liability for all of their misrepresentations. In some situations it may be best to force the other enterprise to ensure that its agents are less trusting. It is difficult to see why the law should prevent enterprises from pursuing this option.

IX. IMPLICATIONS FOR JUDICIAL POLICY

This article has posited itself in a position to reassess the various approaches that courts have taken to determining the enforceability of disclaimers of liability for fraudulent and negligent pre-contractual misrepresentations. Recall that many courts bar even sophisticated parties from contracting out of liability for fraud. Some courts have gone even further and limited parties' ability to contract out of liability for negligent misrepresentations. On the other hand, it is possible to find cases in which a contractual provision has shielded even individuals from liability for fraud. In most of those cases the individual was an agent of the enterprise that contracted with the defrauded party, but occasionally individuals have been protected from liability by contracts that they negotiated on their own behalf. The drafters of the Restatement (Second) of Agency adopted something of a compromise. They recognized that it might make sense to permit an innocent principal to disclaim liability for deceit based on his agents' misrepresentations. However, they would only permit a contractual provision to affect a person's ability to rescind a contract on the basis of a misrepresentation in rare circumstances. The drafters of the Restatement also adopted a rather peculiar definition of an innocent principal.

The analysis in this article challenges all of these approaches. Rather than restating the grounds of that challenge, I will devote the remainder of this article to defending the preferred approach. That approach consists of adhering to the following principles.

1. An individual cannot rely upon a contractual provision to prevent another person from avoiding a contract that the individual procured by means of a fraudulent misrepresentation.

This rule is consistent with the moralistic view that contract law should not condone fraud in any way. On the other hand, it is inconsistent with the pure form of the will theory that holds that courts must respect individual autonomy by enforcing all voluntary contractual obligations. Ultimately, however, the argument that condoning fraud involves endorsing a refusal to respect individual autonomy and therefore is fundamentally incompatible with the will theory is most persuasive.

This first rule may also come into conflict with the view that all economically efficient agreements should be enforced. It is conceivable that parties might want to disclaim liability for even fraudulent pre-contractual misrepresentations in order to reduce expected litigation costs; Rule 1 would keep them from doing that. The economic significance of this restriction on freedom of contract seems minimal though. First of all, over the long run, enforcement of this rule may have an economically beneficial impact upon people's propensities to engage in fraudulent behavior. Second, this rule would only have an adverse economic impact upon a relatively small set of transactions, namely those involving individuals who wish to disclaim liability for fraud when contracting with relatively sophisticated parties. This is because the rule does not apply to enterprises that attempt to disclaim liability and because Rule 4 (below) would bar an individual from relieving herself of liability to consumers for fraud in any event. Another point to keep in mind is that Rule 1 will only have an adverse impact on parties who wish to disclaim liability for fraud in order to avoid incurring litigation costs, as opposed to those who do so inadvertently or because the costs of putting a representation in legally enforceable form are prohibitive.

If courts were to accept Rule 1, they would refuse to follow cases like *Danann* in which individuals have essentially been allowed to contract out of liability for fraud. This rule should not however bar people from enforcing agreements to have claims of fraud settled by arbitration. A court that allows a person alleged to have committed fraud to rely upon an arbitration agreement should not be seen as condoning fraud; it is simply permitting another body to make the necessary determination of the propriety of the person's conduct in relation to his or her trading partner. The courts should not be presumed to have exclusive authority to vindicate private rights.[127] Of

[127] This is particularly compatible with the view that the right to a remedy for fraud is an inherently personal right which may, but need not, be vindicated by the courts so long as it is vindicated in some forum. *See* Edward M. Morgan, *Contract Theory and The Sources of Rights: An Approach to The Arbitrability Question*, 60 S. CAL. L. REV. 1059 (1987). On this view, however, the disclaimer would not necessarily bar a criminal prosecution for fraud,

course enforcing arbitration agreements is also compatible with the will theory and is quite likely to be efficient as well.

Finally, in rare cases it may be possible to conclude that a person has effectively retracted a prior fraudulent misrepresentation. In these circumstances it may be appropriate to conclude that a subsequent contract was not "procured by" the misrepresentation. However, this conclusion should not be reached unless the misrepresentation was specifically brought to the attention of the party and then identified as unreliable.

2. A principal may rely upon a contract with another person to prevent that person from avoiding a contract with the principal or holding the principal liable in any way because of a misrepresentation made by an agent, including a misrepresentation that was made fraudulently or in a grossly negligent manner.

This rule is much easier to defend than Rule 1. Obviously, Rule 2 is fully compatible with the will theory. It will also usually be compatible with moral values, because it typically does not require the courts to endorse any form of wrongdoing on the part of the principal. Contrary to the view that is implicit in the Restatement (Second) of Agency, it is not immoral to permit a principal to keep the benefit of a fraudulently induced agreement when another party has expressly agreed to this way of dealing with the consequences of an agent's fraud. This seems particularly reasonable in light of the fact that such agreements will often be mutually beneficial to parties who wish to minimize the costs of transacting through agents.

From an economic perspective this rule seems like a significant improvement over the Restatement (Second) of Agency, which would almost always permit a contract induced by an agent's misrepresentation to be rescinded. Although rescission is a relatively mild remedy, a rule that virtually guarantees its availability still imposes costs upon a principal, because it exposes him to the risk of costly litigation and

because that proceeding would seek to vindicate public rights, a function that is presumed to be within the exclusive competence of the state.

increases the risk of uncompensated detrimental reliance upon an agreement prior to its being rescinded.[128]

The central thesis of this article is that it is critical for courts to distinguish between the situations covered by Rule 1 and those covered by Rule 2. In other words, judges must recognize the difference between disclaimers of primary liability and disclaimers of vicarious liability. This distinction could result in substantial economic benefits for certain types of sophisticated contracting parties, including many that have not been discussed so far in this article. To give one more example, corporate acquisitions frequently give rise to situations in which agents have incentives to make misrepresentations that cannot be easily monitored by their principals. A classic situation is where employees or other agents of a target company are charged with providing material information to the acquirer as part of its due diligence. For a variety of reasons those agents might have a strong interest in doing whatever they can to ensure that the deal goes through, up to and including lying. It seems plausible that there will be many situations in which the best way for the parties to the acquisition to deal with the risk that agents will make these kinds of misrepresentations is to have the acquirer agree to let the target disclaim liability for any representations not set out in an easily monitored format such as the final agreement and specified appendixes or schedules. Rule 2 would allow parties to capture the benefits of this arrangement.[129]

3. Rule 2 only applies to an innocent principal, meaning a person who has not behaved in a fraudulent or grossly negligent manner by failing to prevent an agent's misrepresentation from being made.

This rule reflects a conception of organizational culpability that may not be universally shared. It also conflicts with the will theory. However, it seems inevitable that some judges will take the view that

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[128] In theory this second difficulty would be resolved if detrimental reliance always allowed the principal to benefit from the change in position defense. However, I have not been able to find a case in which a principal successfully relied on this defense. It is also important to note that the judicial definition of a change in position may not capture all forms of detrimental reliance. *See* Jonathan Dawe, *The Change of Position Defence in Restitution*, 52 U. TORONTO FAC. L. REV. 275 (1994) (regarding the difficulty of accurately assessing a change in position).

[129] For a case with similar facts, see Grumman Allied Industries, Inc. v. Rohr Industries, Inc. 748 F.2d 729 (2d Cir. 1984).

certain enterprises are too blameworthy to be allowed to hide behind a contractual provision. This rule is also compatible with economic goals.

It is important to note the differences between the definition of an innocent principal set out here and the definition of innocence contained in the Restatement (Second) of Agency. First, this rule, unlike section 260 of the Restatement (Second) of Agency, does not presume that a partner or a senior executive of a partnership or corporation represents the enterprise for the purposes of determining its guilt or innocence. Most theories of organizational culpability seem to require fault to be fairly widespread before it inculpates an enterprise as opposed to just individual agents. Second, although it is not explicitly stated above, an enterprise should not be considered to be at fault simply because it recognizes the risk that its agents will make misrepresentations and so uses a contract to give its trading partner an incentive to monitor pre-contractual misrepresentations.

These distinctions can be elucidated by referring to the facts of *Bates v. Southgate*. The Restatement's approach to the determination of innocence would support the conclusion that none of the partners of Southgate Bros. were innocent, because the truly culpable partner would be deemed to have spoken on behalf of the partnership. By contrast, a court that adopted the approach suggested here would probably find that the partners who did not make any misrepresentations were innocent unless they knew or clearly should have known that their partner was dishonest.

4. No person may rely upon a provision in a contract to prevent another person from bringing any claim based on a misrepresentation if that other person did not understand the consequences of agreeing to the provision in question.

This rule is easy to defend in principle and is compatible with virtually all theories of contractual obligation. The rule should apply to virtually all low-value transactions involving consumers, meaning individuals acquiring goods or services primarily for personal, family, or household purposes. It also seems appropriate to apply the rule to cases in which a person seems to have agreed to relieve another person of liability for a material pre-contractual representation inadvertently or because of the high costs of putting the representation in a legally binding form. By contrast, this generally will not apply to transactions involving large amounts of money and sophisticated commercial enterprises—especially when the parties have been represented by counsel. Such enterprises should be presumed to be capable of making sound decisions about whether they or their agents should agree to a disclaimer. In fact, it may not be appropriate to ever apply this rule in favor of a person who has been represented by an attorney. This is because lawyers tend to read contracts carefully and advise their clients of their meaning. It also seems reasonable to presume that they will counsel their clients against investing inordinate amounts of trust in representations that are not legally binding.

Cases involving individuals acting in a commercial capacity are on the borderline. When they have been represented by an attorney, the rule probably will not apply for the same reasons that it does not apply to similarly represented consumers. In other cases, though, courts will face a more difficult task. For example, there has been a fair amount of litigation involving franchisees who have claimed that they were induced to enter into franchising agreements by franchisors' misrepresentations concerning expected profits.[130] Cases go both ways on the question of whether a contractual disclaimer can protect a franchisor from such claims.[131] There is a fairly widespread perception that many franchisees are relatively unsophisticated, at least when compared to franchisors, and it does seem reasonable to assume that franchisees are prone to the same sort of cognitive illusions that induce excessive trust in consumers contemplating large transactions.[132] On the other hand, many franchisees are experienced business-people operating multi-million dollar businesses.[133] This suggests that in any given case courts seeking to apply this fourth rule should examine the facts closely and discard any stereotypical pre-conceptions about franchisees' ability to protect themselves.[134]

In determining whether or not to apply Rule 4 the courts should not only examine the characteristics of the party against whom a disclaimer

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[130] *See generally* Kim Lambert, *The Battle Against Claims of Presale Misrepresentations and Allegations of Guaranteed Success*, 11 FRANCHISE L. J. 95 (1992).
[131] *See, e.g.*, Slater v. KFC Corp., 621 F.2d 932 (8th Cir. 1980) (provision not enforceable under Missouri law); Western Chance #2, Inc. v. KFC Corp., 734 F. Supp. 1529 (D. Ariz. 1990); Rosenberg v. Pillsbury Co., 718 F. Supp. 1146 (S.D.N.Y. 1989) (holding than an integration clause is enforceable if it is clear and specific).
[132] *See, e.g.*, Gillian Hadfield, *Problematic Relations: Franchising and the Law of Incomplete Contracts*, 42 STAN. L. REV. 927, 960-65 (1990).
[133] Michael Selz, *Enterprise for Franchisees, Taking Control Can Be a Boon*, WALL ST. J., Sept. 30, 1991 at B1; Michael J. McCarthy, *When Franchises Become Rebellious–Outlet's Impact Grows on Fate of Franchisers*, WALL ST. J., Sept. 13, 1989 at B1.
[134] People v. Kline, 110 Cal. App. 3d 587, 595 (1980).

is being asserted, but also the language of the disclaimer and the conditions under which the parties' agreement was concluded. If the language of the disclaimer is clear and specifically refers to the type of misrepresentation alleged to have caused harm, then Rule 4 is unlikely to apply. The situation is different, however, if the language is vague. In that case the disclaimer should not be enforced if it seems likely that the party against whom the disclaimer is being asserted did not understand the consequences of entering into the agreement.

This view is definitely consistent with judicial practice. Many courts have held that general, vaguely worded, merger clauses are "mere boilerplate" that cannot bar claims based on a pre-contractual misrepresentation;[135] others have held that only a "specific disclaimer of reliance" can bar a claim of fraud.[136] The practical difficulty of course lies in determining whether any given provision should be characterized as vague boilerplate or a specific disclaimer of reliance. In carrying out this task, judges' primary goal should be to protect the reasonable expectations of the victim of the misrepresentation regarding the effect of their agreement. However, it is also important for judges to consider the interests of the party seeking to rely on the disclaimer. For instance, other than in cases where a principal has reason to know that its agents are prone to making particular types of misrepresentations, judges should try to avoid placing too heavy a burden on principals to predict the specific types of misrepresentations that their agents will make. Insisting upon a high a degree of specificity could prevent many parties from earning the potential gains associated with disclaimers of vicarious liability for pre-contractual misrepresentations. This is because those gains could be outweighed by the costs of drafting disclaimers that are sufficiently detailed to meet the legal standard.

X. CONCLUSION

This article makes a number of contributions to both contract law and agency law. Its stated purpose is to examine the ways in which various theories of the basis of contractual obligation suggest courts should resolve the conundrum of whether to enforce contractual provisions that relieve one party of liability for fraudulent and grossly negligent pre-contractual misrepresentations. When that party is a

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[135] Wohl v. Owen, 153 Misc. 2d 854, 856 (N.Y. Civ. Ct. 1992).

[136] La Bier v. Merrill Lynch, Pierce, Fenner & Smith, Inc. 177 A.D.2d 767, 769 (N.Y. App. Div. 1991); Marine Midland Bank, N.A. v. CES/Compu-Tech, Inc., 147 A.D.2d 396, 397-98 (N.Y. App. Div. 1989).

natural person, the appropriate rule is admittedly debatable, but here I have suggested that a rule of non-enforceability is appropriate. The situation is somewhat clearer in cases where the party relying on the disclaimer is an enterprise seeking to avoid the consequences of an agent's misrepresentation. Then, contrary to the position taken by the Restatement (Second) of Agency, and several courts, it seems appropriate to enforce the disclaimer, except in cases involving unsophisticated parties such as consumers and perhaps also in cases where it seems right to blame the enterprise as a whole for the misrepresentation.

One of the most remarkable features of the judicial decisions in this area is how infrequently they acknowledge the fact that principles of agency law might be applicable. Agency relationships are now so pervasive in commercial life as to be almost invisible. However, an important lesson to be drawn from the analysis in this article is that it is critical to distinguish between the rules applicable to enterprises that act through agents and those applicable to individuals who bargain face-to-face. This is particularly important for contract law scholars, because most rules of contract law are used to resolve disputes between enterprises rather than individuals.[137] This article demonstrates the significance of that insight.

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137 Consider, for example, the problem of whether to enforce representations or warranties given by a vendor under an agreement of purchase and sale where the purchaser is aware at all material times that the warranty is not accurate. The preceding analysis suggests that the law's response should depend upon whether or not the purchaser is an individual who has personally obtained knowledge of the inaccuracy. It seems difficult to justify allowing such an individual to recover more than nominal damages for breach of the warranty or misrepresentation, even if the agreement says that the purchaser's remedies are not to be affected by any investigations that she has made. However, the insights contained in this article suggest that it may be less difficult to justify recovery if the purchaser is actually a principal who did not have—and may not even be capable of having—any personal knowledge, and the question is whether to artificially impute an agent's knowledge to that principal.