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## COMMENTS

### DECEIT DAMAGES IN CALIFORNIA: OLD PROBLEM—NEW DEPARTURE?

In the summer of 1963, Mr. Burkhouse and his wife responded to an intriguing newspaper advertisement which offered for sale a forty-five acre "Gentleman's Farm", including a large orchard of English walnuts and a comfortable home.<sup>1</sup> The Burkhouses were interested in purchasing property to which they could eventually retire. The owner of the property and his broker assured the prospective buyers that the yearly net income from the walnut crop was sufficient to cover the trust deed payments and expenses of maintaining the property. The Burkhouses purchased the land.

In a short time, the unfortunate vendees discovered that the net income from the walnut crop had been greatly overstated; consequently, they were unable to maintain the mortgage payments on the "Gentleman's Farm" and the seller foreclosed. When they sued the seller and broker for fraud, the jury returned a verdict in favor of the defendants. The trial judge was required to instruct the jury that under California law the defrauded buyers could not recover unless the land they purchased was of lesser value than the sum paid for it. This was apparently not true of the Burkhouses' "Gentleman's Farm."<sup>2</sup>

Sadly, the experience of the Burkhouses is not atypical. Many innocent purchasers who have sought relief against deceitful vendors have encountered California's stringent damage rule for fraud<sup>3</sup> in the purchase, sale and exchange of property.

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1. The facts are based on the case of *Burkhouse v. Phillips*, 18 Cal. App. 3d 661, 96 Cal. Rptr. 197 (1971). See notes 34-39 and accompanying text *infra*.

2. The story had a relatively happy ending. On appeal the verdict of the jury was vacated on grounds that the trial court's instruction, limiting damages to the difference between what the plaintiffs paid and the value of what they received, was erroneous under the circumstances. Upon adequate proof that the foreclosure resulted from the fraud, plaintiffs were allowed to recover their down payment and sums paid toward the purchase price. While the ruling of the appellate court seems fair, its reasoning was somewhat tortured. See notes 37-39 and accompanying text *infra*.

3. Actual fraud by a party to a contract is defined in CAL. CIV. CODE § 1572 (West 1971) as follows:

Actual fraud, within the meaning of this Chapter, consists in any of the following acts, committed by a party to the contract, or with his

The law of damages for fraud in property transactions has indeed had a troubled history in California.<sup>4</sup> Confronted for years with a relatively clear but overly restrictive statutory rule for fraud damages in the sale of property, the California judiciary created an elaborate scheme of exceptions and fictions in an attempt to obtain complete and satisfactory relief for the wronged plaintiff. Even so, recoverable damages for fraud in the sale of property fell short of the relief available for breach of contract.

In 1971, the state legislature substantially modified the statutory mandate on fraud damages in the purchase, sale and exchange of property by amending California Civil Code section 3343.<sup>5</sup> The amended statute may assist those fraud victims who

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connivance, with intent to deceive another party thereto, or to induce him to enter into the contract:

1. The suggestion, as a fact, of that which is not true, by one who does not believe it to be true;

2. The positive assertion, in a manner not warranted by the information of the person making it, of that which is not true, though he believes it to be true;

3. The suppression of that which is true, by one having knowledge or belief of the fact;

4. A promise made without any intention of performing it; or,

5. Any other act fitted to deceive.

Liability for fraudulent deceit is established under CAL. CIV. CODE § 1709 (West 1971) which provides that "[o]ne who willfully deceives another with intent to induce him to alter his position to his injury or risk, is liable for any damage which he thereby suffers." A deceit, within the meaning of section 1709 is defined as either:

1. The suggestion, as a fact, of that which is not true, by one who does not believe it to be true;

2. The assertion, as a fact, of that which is not true, by one who has no reasonable ground for believing it to be true;

3. The suppression of a fact, by one who is bound to disclose it, or who gives information of other facts which are likely to mislead for want of communication of that fact; or,

4. A promise, made without any intention of performing it.

CAL. CIV. CODE § 1710 (West 1971).

The fraud and deceit provisions have been held to be interchangeable and the same damage rules apply to both. *Stone v. Farnell*, 239 F.2d 750, 754 (9th Cir. 1956); *Sixta v. Ochsner*, 187 Cal. App. 2d 485, 490, 9 Cal. Rptr. 617, 620 (1960).

4. Crane, *Recent Decisions on Damages in Commercial Cases in California*, 12 HAST. L.J. 109 (1960); Project, *A Comparison of California Sales Law and Article Two of the Uniform Commercial Code*, 11 U.C.L.A. L. REV. 78, 138 (1963); Comment, *Recovery in Deceit Actions in California*, 11 HAST. L.J. 183 (1959); Comment, *Imposing Liability on Data Processing Services—Should California Choose Fraud or Warranty?*, 13 SANTA CLARA LAW. 140, 152 (1972); Comment, *Expanded Remedies for Real Estate Broker's Misrepresentations*, 12 STAN. L. REV. 270 (1959); 43 CALIF. L. REV. 356 (1955); 48 CALIF. L. REV. 342 (1960); 47 CALIF. ST. B.J. 126 (1971); 13 S. CAL. L. REV. 168 (1939); 7 U.C.L.A. L. REV. 147 (1960).

5. CAL. CIV. CODE § 3343 (West Supp. 1973), amending CAL. CIV. CODE § 3343 (West 1970). Amended section 3343 provides as follows:

(a) One defrauded in the purchase, sale or exchange of property is entitled to recover the difference between the actual value of that with which the defrauded person parted and the actual value of that which he received, together with any additional damage arising from the particular transaction, including any of the following:

find themselves in the position of Mr. and Mrs. Burkhouse, and will reduce the anomalous disparity between recoverable damages under different legal theories. However, the ultimate remedial effect of the amendment to section 3343 is unclear. Although the 1971 version of the statute has not yet been construed in a reported decision, this comment will recommend guidelines for its interpretation based on the history of the statute, standard principles of statutory construction, and considered criticism of the traditional fraud damage rules.<sup>6</sup>

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(1) Amounts actually and reasonably expended in reliance upon the fraud.

(2) An amount which would compensate the defrauded party for loss of use and enjoyment of the property to the extent that any such loss was proximately caused by the fraud.

(3) Where the defrauded party has been induced by reason of the fraud to sell or otherwise part with the property in question, an amount which will compensate him for profits or other gains which might reasonably have been earned by use of the property had he retained it.

(4) Where the defrauded party has been induced by reason of the fraud to purchase or otherwise acquire the property in question, an amount which will compensate him for any loss of profits or other gains which were reasonably anticipated and would have been earned by him from the use or sale of the property had it possessed the characteristics fraudulently attributed to it by the party committing the fraud, provided that lost profits from the use or sale of the property shall be recoverable only if and only to the extent that all of the following apply:

(i) The defrauded party acquired the property for the purpose of using or reselling it for a profit.

(ii) The defrauded party reasonably relied on the fraud in entering into the transaction and in anticipating profits from the subsequent use or sale of the property.

(iii) Any loss of profits for which damages are sought under this paragraph have been proximately caused by the fraud and the defrauded party's reliance on it.

(b) Nothing in this section shall do either of the following:

(1) Permit the defrauded person to recover any amount measured by the difference between the value of property as represented and the actual value thereof.

(2) Deny to any person having a cause of action for fraud or deceit any legal or equitable remedies to which such person may be entitled.

The amendment to section 3343 was part of the 1971 legislative program of the State Bar of California and was sponsored by Senator Song as Cal. S.B. 669, Reg. Sess. (1971).

6. CAL. CIV. CODE § 3343(b)(1) (West Supp. 1973) reserves to the plaintiff who has a cause of action for fraud or deceit all legal and equitable remedies to which he may be entitled. In considering alternative theories of recovery relevant factors include not only the applicable measure of damages, but also the statute of limitations, allocation of the burden of proof, pleading requirements, defenses or equitable limitations, and election of remedies problems. The practitioner might look to the following in addition to damages for fraud: 1) Fraud as a defense to contractual obligations; 2) Damages for breach of warranty or contract (See CAL. CIV. CODE § 3306 (West 1970)); 3) Specific performance, with abatement for deficiencies in defendant's title, lost profits, etc. (*Ellis v. Mihelis*, 60 Cal. 2d 206, 348 P.2d 7, 32 Cal. Rptr. 415 (1963); *D-K Investment Corp. v. Sutter*, 19 Cal. App. 3d 537, 96 Cal. Rptr. 830 (1971); *Collins v. Marvel Land Co.*, 13 Cal. App. 3d 34, 91 Cal. Rptr. 291 (1970); *HETLAND, CALIFORNIA REAL ESTATE SECURED TRANSACTIONS* § 3.33, at 76 (California Continuing Education of the Bar 1970) [hereinafter cited as *HETLAND*]; 4) Contractual rescission for fraud, actual or constructive (CAL. CIV. CODE §§ 1688-93 (West 1973)); *cf.*

## ALTERNATIVE MEASURES OF DAMAGES FOR FRAUD

Under the common law two distinct rules for measuring damages for fraud in the purchase, sale and exchange of property were developed.<sup>7</sup> One rule, the "loss of bargain" standard, respects the plaintiff's contractual expectancy and puts him in the position he would have enjoyed had the representation been true. The other rule, called the "out of pocket" measure, has a pre-transaction orientation and is based on the familiar tort principle of restoring plaintiff to the position he enjoyed prior to the harm. It has been recognized that there are limitations to each of these rules. Accordingly, the modern view is that a court should enjoy some flexibility in determining the appropriate rule for damages in property transaction cases.

Knowledge of these alternative common law damage rules and their application is important to an understanding of California's new version of section 3343. In some respects the new fraud damage statute represents a departure from the traditional "loss of bargain" and "out of pocket" standards. But the structure and content of the legislation can only be explained and criticized in terms of prior judicial experience with the "loss of bargain" and "out of pocket" rules.

*The "Benefit of Bargain" Rule*

A majority of American jurisdictions have adopted the "benefit of bargain" standard<sup>8</sup> which awards to the defrauded plaintiff an expectancy interest; it puts him in the position he would have enjoyed had the false representation been true.<sup>9</sup> Most often the measure of recoverable loss under the "benefit of bargain" standard is calculated by taking the difference between the actual

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Kent v. Clark, 20 Cal. 2d 779, 128 P.2d 868 (1942); Snelson v. Ondulando Highlands Corp., 5 Cal. App. 3d 243, 84 Cal. Rptr. 800 (1970); HETLAND § 12.22. Exemplary damages have been awarded where rescission is based on fraud. Mahon v. Berg, 267 Cal. App. 2d 588, 73 Cal. Rptr. 356 (1968); HETLAND § 12.22, at 55 (Supp. 1972); 5) Specific statutory relief (Song-Beverly Consumer Warranty Act, CAL. CIV. CODE § 1790 *et seq.* (West 1973); Automobile Sale Finance Act, CAL. CIV. CODE § 2981 *et seq.* (West Supp. 1973); Consumers Legal Remedies Act, CAL. CIV. CODE § 1750 *et seq.* (West 1973); CAL. CIV. CODE § 2224 *et seq.* (West 1954) (the so-called involuntary trust remedy)).

7. D. DOBBS, HANDBOOK ON THE LAW OF REMEDIES 592 (1973) [hereinafter cited as DOBBS]; C. MCCORMICK, HANDBOOK ON THE LAW OF DAMAGES 450-51 (1935) [hereinafter cited as MCCORMICK]; W. PROSSER, HANDBOOK ON THE LAW OF TORTS 734 (4th ed. 1971) [hereinafter cited as PROSSER].

8. Perhaps two-thirds of American jurisdictions have adopted the "loss of bargain" rule for deceit actions. PROSSER, *supra* note 7, at 734; Comment, *Recovery in Deceit Actions in California*, 11 HAST. L.J. 183, 184; Annot., 13 A.L.R.3d 875 (1967).

9. DOBBS, *supra* note 7, at 595.

value of the property which plaintiff received and the value that this property would have had if the representations concerning it had been truthful.<sup>10</sup> If, for example, farm acreage was purchased on the basis of a deliberately false representation that the land included an operating water well, the buyer would be entitled to the difference in value between the same farm with a working well and the property which he actually received.

Sometimes the "benefit of bargain" standard is formulated as the cost of putting the property into the represented condition.<sup>11</sup> Thus, in the example given above, the plaintiff's damages would be equal to the cost of drilling a new well and installing a pump. Before 1935, California had no statutory measure of damages for fraud in the sale of property.<sup>12</sup> During this era of judicial discretion California courts generally applied the "benefit of bargain" rule to determine plaintiffs' recoverable loss, but the "cost of conformation" measure (the expense of putting the property into the represented condition) was not unknown.<sup>13</sup> For example, in *Crystal Pier Amusement Co. v. Cannan*<sup>14</sup> the plaintiff, Crystal Pier, decided to erect an amusement pier, including a ballroom, at Pacific Beach on the California coast. In negotiations with plaintiff the defendants, materialmen and contractors, fraudulently indicated that piling, caps and braces treated with creosote, a wood preserving material, were necessary and would be supplied for construction of the pier. Defendants actually supplied materials which were not treated with creosote but with an inferior sealing product. The amusement pier was closed for safety reasons and the plaintiff sued for damages. The appellate court affirmed an award in excess of \$91,000, which was based on the cost of replacing three-fourths of the pier.<sup>15</sup> It was noted that had the more common "benefit of bargain" rule been applied an even larger recovery would have been warranted.

In any event, it is clear that in "loss of bargain" cases proof

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10. *Jacobs v. Levin*, 58 Cal. App. 2d Supp. 913, 915, 137 P.2d 500, 501 (1943); *McKeever v. Locke-Paddon Co.*, 58 Cal. App. 51, 55, 207 P. 1040, 1042 (1922); *McCORMICK* 451; *PROSSER*, *supra* note 7, at 734; Annot., 13 A.L.R.3d 875, 899 (1967).

11. *DOBBS*, *supra* note 7, at 595.

12. See notes 59-64 and accompanying text *infra*.

13. *Id.*

14. 219 Cal. 184, 192, 25 P.2d 839, 842-43 (1933). The "cost of conformation" generally has been considered probative in determining the actual value of the property received at the time of sale for "out of pocket" damage purposes. Annot., 13 A.L.R.3d 875, 925 (1967), *citing inter alia* *McNeill v. Bredberg*, 192 Cal. App. 2d 458, 13 Cal. Rptr. 580 (1961) and *Central Mut. Ins. Co. v. Schmidt*, 152 Cal. App. 2d 671, 313 P.2d 132 (1957).

15. *Crystal Pier Amusement Co. v. Cannan*, 219 Cal. 184, 192, 25 P.2d 839, 842-43 (1933).

of the actual amount paid by the defrauded person for the property is per se irrelevant. The material values are the worth of the property received and its hypothetical value were it as represented. Nevertheless, the consideration which plaintiff gave for the property may be probative as to the value of what he received.<sup>16</sup> Thus, if a defrauded buyer pays four thousand dollars for arid property falsely represented to be benefitted by water rights, and the value of the land without the water rights is one hundred dollars, the high price paid by the vendee is relevant and material evidence of the true value of the property as it was deceptively described.

The "loss of bargain" damage rule approximates the recovery which is available for breach of warranty in contract actions.<sup>17</sup> This is not surprising, for the affinity between the damage measure for breach of warranty and for deceit can be traced to their common procedural origin in the common law writ of trespass on the case,<sup>18</sup> or "action on the case in the nature of deceit",<sup>19</sup> as it was sometimes called. There is, moreover, a theoretical link between the two damage rules in that the defendant in fraud actions involving the sale of goods is said to "warrant" the truth of his statements<sup>20</sup> in the same way that the contract vendor warrants his goods.

In practical terms, the "loss of bargain" damage formula insures that the fraud victim receives the gains he legitimately expects and to which he is entitled under a contract for the purchase, sale, or exchange of property. It is noteworthy that an action for benefit of bargain damages, although based on fraud, has traditionally been interpreted as an "affirmation" of the underlying contract between plaintiff and defendant. As a result, plaintiffs have been obligated to accept the burden of the contract to enjoy the benefit of their bargain.<sup>21</sup>

Criticism of the "loss of bargain" damage rule has been

16. *Divani v. Donovan*, 214 Cal. 447, 6 P.2d 247 (1931); *Hines v. Brode*, 168 Cal. 507, 510, 143 P. 729, 730 (1914).

17. *Hines v. Brode*, 168 Cal. 507, 511, 143 P. 729, 731 (1914); *McCORMICK*, *supra* note 7, at 451; *PROSSER*, *supra* note 7, at 592; *Annot.*, 13 A.L.R.3d 833 (1967).

18. *DOBBS*, *supra* note 7, at 592.

19. *PROSSER*, *supra* note 7, at 685.

20. *S. WILLISTON, A TREATISE ON THE LAW OF CONTRACTS* § 1392, at 439-40 (3d ed. 1968).

21. *McKeever v. Locke-Paddon Co.*, 58 Cal. App. 51, 56, 207 P. 1040, 1042 (1922). At common law an election was required between rescission of a contract for fraud and a suit for damages. *Garvey v. Lashells*, 151 Cal. 526, 91 P. 498 (1907); *Worely v. Nethercott*, 91 Cal. 517, 27 P. 767 (1891); *Gates v. McLean*, 70 Cal. 42, 11 P. 489 (1886). *Cf. CAL. CIV. CODE* § 1692 (West 1973), *added by Cal. Stats.* (1961), ch. 589, § 3, at 1734; *CAL. COMM. CODE* § 2721 (West 1964), *added by Cal. Stats.* (1963), ch. 819.

scanty and confined to arguments of a specious nature relating to the indeterminability of expectancy damages and the inappropriateness of bargain loss damages under a tort theory of recovery.<sup>22</sup>

By a revision of section 3343 in 1971, the California legislature has eschewed both the "cost of conformation" standard and the traditional "loss of bargain" rule.<sup>23</sup> California law, however, now permits a defrauded purchaser to recover, under restricted circumstances,<sup>24</sup> lost profits or gains which were reasonably anticipated from use or resale of the property.<sup>25</sup>

### "Out of Pocket" Damages

The second general rule devised by the common law for measuring damages in fraud actions is the so-called "out of pocket" standard. This rule is directed towards restoring plaintiff to the financial position he enjoyed prior to the fraudulent transaction.<sup>26</sup> It is therefore sometimes called the "restitutionary measure". Under the "out of pocket" formula, damages are measured by the difference in actual value at the time of the transaction, if any, between what the defrauded party gave and that which he received in return.<sup>27</sup>

Operation of the "out of pocket" and "loss of bargain" rules can be illustrated by elaboration on an earlier example. Suppose the plaintiff pays \$4,000 for the arid acreage falsely said to be benefitted by certain water rights which would make cultivation possible. The land without the water rights is worth only \$100. The true value of the property with the alleged water rights would be \$5,000. Under the "out of pocket" rule the

22. Comment, *Recovery in Deceit Actions in California*, 11 HAST. L.J. 183, 194 (1959), citing DAWSON AND PALMER, *CASES ON RESTITUTION* 235 (2d ed. 1958). The arguments are summarily refuted in Annot., 13 A.L.R.3d 875, 883-84 (1967).

23. CAL. CIV. CODE § 3343(b)(1) (West Supp. 1973) provides: "Nothing in this section shall . . . [p]ermit the defrauded person to recover any amount measured by the difference between the value of the property as represented and the actual value thereof."

24. The defrauded party must have been induced to purchase or otherwise acquire the property by reason of the fraud. CAL. CIV. CODE § 3343(a)(4) (West Supp. 1973). The property must have been acquired for use or resale for a profit. CAL. CIV. CODE § 3343(a)(4)(i) (West Supp. 1973). The defrauded person must reasonably have relied on the fraud in anticipating profits from the use or resale of the property. CAL. CIV. CODE § 3343(a)(4)(ii) (West Supp. 1973). And the lost profits must be a proximate result of the fraud and the party's reliance thereon. CAL. CIV. CODE § 3343(a)(4)(iii) (West Supp. 1973).

25. CAL. CIV. CODE § 3343(a)(4) (West Supp. 1973).

26. McCORMICK, *supra* note 7, at 449.

27. CAL. CIV. CODE § 3343 (West 1954), as amended, CAL. CIV. CODE § 3343 (a) (West Supp. 1973); PROSSER, *supra* note 7, at 733-34.



plaintiff would be entitled to the difference in value between what he gave (\$4,000) and what he got (\$100) or, \$3,900. The "loss of bargain" rule would allow recovery of the difference in value between the actual value of the property which the deceived buyer received (\$100) and the value it would have had had the water rights been available (\$5,000) or, \$4,900.

The "restitutionary measure" represents the English position,<sup>28</sup> the old federal rule,<sup>29</sup> the Restatement position,<sup>30</sup> and the minority American rule.<sup>31</sup> Between 1935 and 1971, the "out of pocket" measure was ostensibly the exclusive standard for fraud damages in California,<sup>32</sup> and the formula is even today the cornerstone of California's fraud damage statute.<sup>33</sup>

Although the "out of pocket" rule is simple, definite, and easy to apply, it has been criticized on a number of distinct grounds. For example, the measure works a hardship on plaintiffs when the market value of the property at the time of the transaction is difficult to establish and when, despite the fraud, the actual value of the property received was equivalent to the consideration paid.

The recent case of *Burkhouse v. Phillips*,<sup>34</sup> alluded to earlier, illustrates this failing. In *Burkhouse* plaintiff purchased a forty-five acre "Gentleman's Farm" for \$80,000 in reliance on the fraudulent representations of the vendors and their broker that walnut trees on the property produced a standard crop which would net sufficient income to pay for the property.<sup>35</sup> Plaintiff was unable to make the trust deed payments, because the property did not yield the income represented by the defendants. Plaintiff sued for rescission and damages, deleting the cause of action for rescission after defendants foreclosed the deed of trust and sold to a third party. Unfortunately, evidence adduced at

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28. *Peek v. Derry*, 37 Ch. D. 541 (1887).

29. *Sigafus v. Porter*, 179 U.S. 116 (1900); Comment, *Recovery in Deceit Actions in California*, 11 HAST. L.J. 183, 184 (1959), citing *Jacobs v. Levin*, 58 Cal. App. 2d Supp. 913, 916, 137 P.2d 500, 501 (1943). *Jacobs v. Levin* stated that in the wake of *Erie R. Co. v. Tompkins*, 304 U.S. 64 (1938), which abolished federal common law on substantive matters, "the main support for the minority rule would appear to have collapsed." 58 Cal. App. 2d Supp. at 916, 137 P.2d at 501.

30. RESTATEMENT OF TORTS § 549 (1934); RESTATEMENT (SECOND) OF TORTS § 549 (Tent. Draft No. 10, 1964) adopts the flexibility theory. See note 44 *infra*.

31. PROSSER, *supra* note 7, at 734, found twelve jurisdictions adhering to the "out of pocket" rule.

32. See notes 67-70 and accompanying text *infra*.

33. CAL. CIV. CODE § 3343(a) (West Supp. 1973) retains the old "out of pocket" rule, while the remainder of the amended statute provides for consequential damages.

34. 18 Cal. App. 3d 661, 96 Cal. Rptr. 197 (1971).

35. *Id.* at 664, 96 Cal. Rptr. at 199.

trial indicated that at the time of sale the property's market value was worth slightly more than plaintiff had paid for it.<sup>36</sup> The trial court's instruction, based on a strict application of the "out of pocket" rule, resulted in plaintiff's establishing all the elements of fraud and being left without provable damages or the right of rescission.

On appeal, the instruction of the trial judge was held to be erroneous. The appellate court in *Burkhouse* did recognize that under the "out of pocket" rule the plaintiffs cannot get damages for fraud when there is no difference between the sale price of the land and its market value. The *Burkhouse* court also carefully noted that the defrauded buyers had no right to rescind the transaction and return the real property for their down payment because the property had been sold to third parties in the foreclosure sale. Faced with the spectre of a provable fraud and economic loss without a corresponding right to damages or rescission, the court ruled that the foreclosure was a "subsequent circumstance" to be considered, and that "out of pocket" damages must be "realistically" applied.<sup>37</sup> If it were established on remand that the defendants committed fraud and that the plaintiffs were unable to make their installment payments as a proximate result thereof, the proper measure of damages was indicated to be the sum of the down payment and installments paid.<sup>38</sup> While the court called this potential recovery by the *Burkhouse* plaintiffs "out of pocket loss", it is apparent that the circumstances of the case required the fashioning of a unique remedy for the plaintiffs.

The *Burkhouse* result seems correct; if the plaintiffs received damages equal to their down payment and installments they would be essentially restored to their pre-transaction status—the theoretical goal of the "out of pocket" standard. Unfortunately the *Burkhouse* ruling leaves essentially unharmed the fraudulent seller who foreclosed and bought in at the foreclosure sale.

The "out of pocket" rule has often been criticized precisely because it does not deter frauds. Thus, an unscrupulous vendor may make false representations concerning the character, quality, value, rents or income of property to induce its sale. Yet the "out of pocket" rule will protect the unprincipled seller from liability for damages so long as the property is sold, as in *Burkhouse*, for its market value.<sup>39</sup>

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36. *Id.*

37. *Id.* at 665-66, 96 Cal. Rptr. at 200.

38. *Id.*

39. S. WILLISTON, *supra* note 20, § 1392, at 442. The argument is also made in the dissenting opinion of Justice Schauer in *Bagdasarian v. Gragnon*, 31 Cal. 2d 744, 764, 192 P.2d 935, 947 (1948) and in *Jacobs v. Levin*, 58 Cal. App. 2d Supp. 913, 916, 137 P.2d 500, 501 (1943). The force of the argu-

*Gagne v. Bertran*<sup>40</sup> further shows how the "restitutionary measure" can work a hardship on defrauded persons. In *Gagne* defendant falsely represented himself as a qualified soil tester. Plaintiff relied on defendant's incorrect report as to the amount of fill on certain lands, and exercised his option to purchase the property. Because there was no proof of "out of pocket" damages, plaintiff was barred from recovering the additional construction costs which resulted from having to build on deep fill.<sup>41</sup>

Justice Schauer dissented in *Gagne*, arguing that the defendant soil tester was not himself a fraudulent vendor of property and that California's existing "out of pocket" damage statute was therefore inapplicable.<sup>42</sup> The statute only applied to frauds in the purchase, sale and exchange of property. Justice Schauer characterized the inaccurate soil test as the breach of a contract for skilled personal services or as negligence in the performance of such services. In either case the plaintiffs would be entitled to the increased cost of installing the foundation on deep fill. *Gagne* illustrates the complexities and inequities of applying the restrictive "out of pocket" rule to fraud actions concerning the sale of property while simultaneously permitting a broader measure of recovery for negligence and breach of warranty.

A final objection to the "out of pocket" rule is that it offends basic principles of justice when it fails to compensate an innocent party for loss, through deceit, of legitimately expected profit. This is a fortiori true when plaintiffs can recover lost profits in contract actions where intent to deceive is absent.<sup>43</sup>

### *Flexibility Theory*

Cognizant of the merits and failings of both the "loss of bargain" and "out of pocket" rules for damages in fraud actions,

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ment is mitigated somewhat when exemplary damages are available. See *Ward v. Taggart*, 51 Cal. 2d 736, 743, 336 P.2d 534, 538 (1959); *Haigler v. Donnelly*, 18 Cal. 2d 674, 680-82, 117 P.2d 331, 335 (1941); *McCORMICK*, *supra* note 7, at 45-54.

40. 43 Cal. 2d 481, 275 P.2d 15 (1954).

41. *Id.* at 490-91, 275 P.2d at 21-22 (dicta). The majority believed that California Civil Code section 3333 was the applicable measure of damages and, in any event, saw no causal link between defendant's representations and the additional costs of construction. However, it was actually the "out of pocket" rule which the court applied. Compare *Rogaff v. Bartles*, 115 Cal. App. 429, 1 P.2d 517 (1931) where the vendor himself represented that there was no fill on the property. As to lost profits recovery for breach of contract, see notes 108-110 and accompanying text *infra*.

42. 43 Cal. 2d 481, 494, 275 P.2d 15 (1954) (dissenting opinion of Justice Schauer).

43. See *Bagdasarian v. Gragnon*, 31 Cal. 2d 744, 764, 192 P.2d 935, 947 (1948) (dissenting opinion of Justice Schauer); *PROSSER*, *supra* note 7, at 734-35.

courts, legislatures and commentators have turned to a more flexible system whereby the standard for relief elected would be based on the equities of the case and the available proof.<sup>44</sup> This flexibility theory is considered the modern or emerging view.<sup>45</sup> The 1971 amendment to section 3343 appears to bring California somewhat closer to the flexibility theory.<sup>46</sup>

While the flexibility theory permits a choice between the "out of pocket" and "loss of bargain" rules, the election of the proper standard for a given factual context should be exercised on a consistent and rational basis. Although case law relative to the choice between the damage rules is sparse, some guidelines have emerged.

It has been asserted that the "loss of bargain" rule is best suited to most situations for two reasons. First, the "loss of bargain" rule will yield a larger recovery to the wronged purchaser who has negotiated a good deal than would the "out of pocket" rule. The value of the property *as represented*, in such cases, substantially exceeds the value of the property actually received. Obviously, the more exaggerated the deceitful claims, the greater the disparity between the value of the property as described and its actual value. Secondly, the "loss of bargain" measure operates as a deterrent to fraud, unlike the "out of pocket rule". This is so because under the restitutionary rule the fraudulent vendor is only required to restore the profit he made on the particular trans-

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44. Annot., 13 A.L.R.2d 875 (1967); DOBBS, *supra* note 7, at 596; RESTATEMENT (SECOND) OF TORTS § 549 (Tent. Draft No. 10, 1964) has explicitly adopted the "flexibility theory" as follows:

(1) The recipient of a fraudulent misrepresentation is entitled to recover as damages in deceit against the maker the pecuniary loss to him of which the misrepresentation is a legal cause, including

- (a) the difference between the value of what he has received in the transaction and its purchase price or other value given for it; and
- (b) pecuniary loss suffered otherwise as a consequence of the recipient's reliance upon the misrepresentation.

(2) The recipient of a fraudulent misrepresentation in a business transaction is also entitled to recover damage sufficient to give him the benefit of his contract with the maker, if such damages are proved with reasonable certainty.

The *Restatement* indicates that the "out of pocket" rule does not afford just and satisfactory compensation when the value of what the plaintiff has received is equal to the consideration he has parted with and also when the thing plaintiff receives has value but is useless to him because of the misrepresentation. RESTATEMENT (SECOND) OF TORTS § 549, comments i, j, at 158-59 (Tent. Draft No. 10, 1964).

45. DOBBS, *supra* note 7, at 596. Professor Dobbs found four jurisdictions which explicitly or implicitly adhere to the flexibility theory. *Id.* at 597 n.16.

46. California Civil Code section 3343 now allows the recovery of lost profits in addition to "out of pocket" damages, if certain limitations are met. *See* note 5 *supra*. The issue still remains whether California courts will allow defrauded plaintiffs to receive damages measured by the "loss of bargain" rather than the "out of pocket" rule.

action without suffering sufficient detriment to discourage similar fraudulent conduct later.<sup>47</sup> The possibility of consequential and exemplary damages,<sup>48</sup> however, somewhat detracts from the force of this argument.

While the "out of pocket" or restitutionary rule does not deter fraud, a court might consider it to be the preferable measure of damages when the fraudulent representation is less definite, when the "loss of bargain" damages would be difficult to ascertain, or when the defendant appears to be less culpable.<sup>49</sup> For example, the deterrent effect of the "loss of bargain" rule would be inappropriate where the defendant was an innocent seller who was held liable as principal for fraud committed by his agent, a real estate broker.<sup>50</sup>

In addition to the aspect of deterrence, certainty of proof has been a critical factor in selecting between the "out of pocket" and "loss of bargain" rules in instances in which discretion has been available to the courts. For example, the difficult problem of valuing real property is compounded when an exchange of two or more parcels is involved. There has accordingly been a preference for the "out of pocket" rule in cases involving fraud in the exchange of property.<sup>51</sup> The "out of pocket" measure only requires a determination of the market value of the two parcels at the time of the exchange, and avoids speculation as to the hypothetical value of property as represented. In the early case of *Barbour v. Flick*,<sup>52</sup> the plaintiffs were residents of Chicago who traded certain encumbered property which they owned in that city for a ranch which defendant owned in San Diego County, including certain personal property. Plaintiff executed a \$13,000 note and mortgage to cover the supposed difference in values between the two properties. The trial awarded the plaintiffs the difference between the market value of the ranch and personal property at the time of the exchange (\$15,000) and the value of the same property as represented (\$30,000), although the parties hotly contested the value of the California ranch as the defendant

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47. DOBBS, *supra* note 7, at 596. See note 39 and accompanying text *supra*.

48. See 23 CAL. JUR. 2d *Fraud and Deceit* § 91 (1955).

49. See *McDonald v. Roeth*, 179 Cal. 194, 176 P. 38 (1918); *Hines v. Brode*, 168 Cal. 507, 511, 143 P. 729, 730 (1914); *Williams v. Spazier*, 21 P.2d 470 (Cal. Ct. App. 1933) (not reported in Official State Reports); *MCCORMICK*, *supra* note 7, at 454; *PROSSER*, *supra* note 7, at 735.

50. See 23 CAL. JUR. 2d *Fraud and Deceit* § 48 (1955).

51. *Cross v. Bouck*, 175 Cal. 253, 256, 165 P. 702, 703 (1917); *Barbour v. Flick*, 127 Cal. 628, 633, 59 P. 122, 124 (1899); Annot., 13 A.L.R.3d 875, 885 (1967). While California courts generally applied the "benefit of bargain" standard prior to enactment of Civil Code section 3343, *Barbour* and *Cross* each employed the "out of pocket" rule to cases involving exchanges of property.

52. 126 Cal. 628, 59 P. 122 (1899).

described it. The California Supreme Court sustained the defendants' contention that the true measure of plaintiffs' damages was the difference between the market value of the San Diego property and the net market value of the Chicago property (the value less liens and encumbrances).<sup>53</sup> Consistent with the "out of pocket" or restitutionary rule which was found proper, the court permitted cancellation of the \$13,000 note and mortgage plaintiffs had executed. Evidence of the value of the San Diego property as represented was therefore unimportant.

The "flexibility theory" is also supported by the practical consideration that the "loss of bargain" and "out of pocket" rules will not conform to the factual structure of all fraudulently induced sales and purchases. To illustrate, when a seller is fraudulently induced to part with his property by a false devaluation of what he relinquishes, the "out of pocket" measure is really the only applicable rule.<sup>54</sup> This is so because the "loss of bargain" standard is only concerned with the actual and represented values of the property which the plaintiff *receives*, and these values are identical when a seller is defrauded by a false undervaluation of what he gives.

There appears to be no preference between the rival fraud damage rules in situations where the false representation pertains to a collateral matter which ultimately induces a property transaction, as opposed to situations where defendant's false statements relate to the value, condition, or characteristics of the property itself.<sup>55</sup> Suppose, for example, that a certain commercial lot includes several large storage tanks. The land is relatively worthless as it stands, but could become quite profitable if a regular supply of scarce fuel oil for the tanks could be arranged. Plaintiff is induced to buy the property by the real estate broker's false representation that he can procure just such a fuel oil supplier for the purchaser. In this type of situation, courts have tolerated recoveries measured by both the restitutionary and "loss of bargain" rules.

An important distinction has been recognized between cases in which the fraud induces a contract between plaintiff and defendant (where the "loss of bargain" is allowed) and cases in which the plaintiff bargains with a third person in reliance on defendant's fraudulent statements (where the "out of pocket" rule

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53. *Id.* at 633, 59 at 124.

54. DOBBS, *supra* note 7, at 598.

55. McDonald v. Roeth, 179 Cal. 194, 176 P. 38 (1918); McCORMICK, *supra* note 7, at 456; Comment, *Expanded Remedies for Real Estate Broker's Misrepresentations*, 12 STAN. L. REV. 270, 271-72 (1959), discussing Ward v. Taggart, 51 Cal. 2d 736, 336 P.2d 534 (1959); 13 S. CAL. L. REV. 168, 169 (1939).

applies). In *MacDonald v. Roeth*<sup>56</sup> the defendants were officers of a bank who deceitfully misrepresented the condition of the bank to induce the plaintiff to purchase stock of the institution. Mr. MacDonald, in reliance on the fraud, bought some shares from the bank itself and others from a third party, Perine. The California Supreme Court affirmed the trial court's ruling which distinguished between the "benefit of bargain" damages formula to be applied to the shares bought directly from the defendants and the "out of pocket" measure of loss for those shares purchased from Perine.<sup>57</sup>

Application of the "out of pocket" rule when fraud induces a contract with a third person may reflect a policy judgment that the chain of causation between deceit and damage is too weak to warrant imposition of contractual expectancy damages. Or, the rule might be based on the theoretical objection that the "loss of bargain" cannot be awarded to plaintiff, since the "bargain" he entered into was with a third party, and not with the defendant.<sup>58</sup>

#### FRAUD DAMAGES IN CALIFORNIA

California's experience with the rules for fraud damages in property transactions has been uneven and unfortunate. The ensuing discussion explores the interaction between the judiciary and the legislature in the search for the appropriate standard for "property fraud" damages. In broad outline, the "benefit of bargain" rule prevailed prior to a statutory enactment in 1935, which abruptly reversed existing law and established the "out of pocket" damage measure. Judicial dissatisfaction with this legislation led to the creation of a patchwork of exceptions and distinctions between 1935 and 1971. An amendment in 1971 to the statutory damage rule for fraud in the purchase, sale and exchange of property admits recovery of plaintiffs' lost profits for the first time but might be construed to forbid use of the "loss of bargain" rule under any circumstance.

#### *Common Law Background*

Prior to 1935, California courts had no statutory mandate on the measure of damages for fraud. It would be an overstatement to say that during this period the judiciary worked out a flexible system, alternating freely between the "benefit of the bargain" rule and the "out of pocket" measure according to available proof

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56. 179 Cal. 194, 176 P. 38 (1918).

57. *Id.* at 200-02, 176 P. at 38.

58. *Id.*; DOBBS, *supra* note 7, at 594.

and equitable considerations.<sup>59</sup> Rather, the "benefit of bargain" measure was generally, although not exclusively, employed.<sup>60</sup> In most cases the judiciary adverted to the standard formulation of "benefit of bargain" rule specifically, the difference between the actual value of the property received and its value had the property been as represented.<sup>61</sup>

The pre-1935 judiciary did apply the "out of pocket" measure on occasion, when the "loss of bargain" rule was difficult to apply or when it would work a hardship on plaintiff or defendant.<sup>62</sup>

In *MacDonald v. Roeth*,<sup>63</sup> discussed above, the California Supreme Court used the more limited "out of pocket" rule to measure recoverable loss when plaintiffs purchased overvalued stock from a third person, Perine. The court concluded that the restitutionary rule would achieve substantial justice because the defendants had no knowledge nor any connection with plaintiff's transaction with Perine, and because the false representations were not made with the distinct intention of inducing the purchase of the Perine stock.<sup>64</sup>

### *The 1935 Statute*

In 1935, the California legislature enacted Civil Code section 3343.<sup>65</sup> The statute provided that a person defrauded in the

59. Comment, *Recovery in Deceit Actions in California*, 11 HAST. L.J. 183, 194 (1959) may have read too much into the oft-quoted dicta of *Hines v. Brode*, 168 Cal. 507, 511, 143 P. 729, 730 (1914) that the "benefit of the bargain" rule was applied in "clear cases and on just terms."

60. *Divani v. Donovan*, 214 Cal. 447, 454, 6 P.2d 247, 249 (1931); *Hines v. Brode*, 168 Cal. 507, 511, 143 P. 729, 730 (1914); *Spreckels v. Gorrill*, 152 Cal. 383, 92 P. 1011 (1907); *Holcomb v. Long Beach Inv. Co.*, 129 Cal. App. 285, 19 P.2d 31 (1933); *Rogaff v. Bartles*, 115 Cal. App. 429, 433, 1 P.2d 517, 518-19 (1931).

61. See note 10 *supra*; *McKeever v. Locke-Paddon Co.*, 58 Cal. App. 51, 55, 207 P. 1040, 1042 (1922); *Jacobs v. Levin*, 58 Cal. App. 2d Supp. 913, 915, 137 P.2d 500, 501 (1943). However, awards of the "cost of conformation" were not unknown. See *Crystal Pier Amusement Co. v. Cannan*, 219 Cal. 184, 192, 25 P.2d 839, 842-43 (1933).

62. It was stated in *Jacobs v. Levin*, 58 Cal. App. 2d Supp. 913, 916, 137 P.2d 500, 501 (1943), that "[n]either rule ["out of pocket" nor "loss of bargain"] has proved altogether satisfactory and as a result the law has fluctuated from time to time. . . ."

63. 179 Cal. 194, 176 P. 38 (1918).

64. *Id.* at 201, 176 P. at 41.

65. Added by Cal. Stat. (1935), ch. 536, § 1, at 1612. Section 3343 then read as follows:

One defrauded in the purchase, sale or exchange of property is entitled to recover the difference between the actual value of that with which the defrauded person parted and the actual value of that which he received, together with any additional damage arising from the particular transaction.

Nothing herein contained shall be deemed to deny to any person



purchase, sale or exchange of properties was "entitled" to recover the difference between the actual value of that which he parted with and that which he received. The 1935 law also provided for recovery of "additional damage arising from the particular transaction." Although the statute was couched in permissive terms ("is entitled to recover"), section 3343 was almost immediately interpreted as substituting the minority "out of pocket" rule for the prevailing "loss of bargain" standard.<sup>66</sup>

In 1948 the California Supreme Court ruled in the leading case of *Bagdasarian v. Gragnon*<sup>67</sup> that section 3343 established "out of pocket" damages as the *exclusive*, rather than an alternative, rule for fraudulent sales in California. Appellant Bagdasarian sold his farm to respondent Gragnon, taking a cash down payment and two notes, one secured by a trust deed on the real property and one by a crop and chattel mortgage. The sale to Gragnon was induced by material misrepresentations concerning various crop yields of the farm, including plums, nectarines, olives, figs, oranges and grapes. The purchasers defaulted and Bagdasarian brought suit to foreclose the crop and chattel mortgages. Gragnon successfully cross-complained for damages on grounds that he had been fraudulently induced to purchase the land. The appeal by the seller was based *inter alia* on grounds that the trial court had improperly applied the "loss of bargain" rule in establishing the buyer's recoverable loss because section 3343 established an exclusive, not permissive, measure of damages to one defrauded in the sale of property.<sup>68</sup> The California Supreme Court agreed.

The *Bagdasarian* court characterized the state of the law prior to enactment of section 3343 as uncertain and confusing, and, considering the "broad" language of the statute, concluded that the intent of the legislature was to provide a uniform rule for all such fraud cases.<sup>69</sup> The court reasoned that if the statutory rule was merely alternative then confusion as to the proper rule for a given case would be multiplied; it would also be unclear whether choice between alternative damage rules would be a matter of law for the judge to determine or a question of fact for the jury to decide.

Justice Schauer dissented in *Bagdasarian*. In a strong and

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having a cause of action for fraud or deceit any legal or equitable remedies to which such person may be entitled.

66. *Feckenscher v. Gamble*, 12 Cal. 2d 482, 499-500, 85 P.2d 941, 945 (1939); *Koyer v. McComber*, 12 Cal. 2d 175, 183, 82 P. 941, 945 (1938); *Rothstein v. Janss Investment Corp.*, 45 Cal. App. 2d 64, 113 P.2d 465 (1941).

67. 31 Cal. 2d 744, 762, 192 P.2d 935, 945-46 (1948).

68. *Id.* at 759-60, 192 P.2d at 944.

69. *Id.* at 762, 192 P.2d at 946.

well-reasoned opinion he argued that the purpose of the legislature in enacting section 3343 was not "*prohibitively to substitute* the 'out of pocket' rule for the 'benefit-of-the-bargain' rule but, rather, *permissively to provide* an additional or alternative remedy or measure of damages which might be applied in proper cases."<sup>70</sup>

The position of Justice Schauer in *Bagdasarian* was sound. The carefully chosen language of the statute indicates that the legislature intended section 3343 to permit an "out of pocket" award when, in the court's discretion, this was advisable.<sup>71</sup> The supreme court's strict reading of the fraud damage statute quite literally created a refuge for wrong-doers by incorporating into California law the inherent limitations of the "out of pocket" rule mentioned earlier.<sup>72</sup> For example, the *Bagdasarian* majority cited with approval an appellate department decision, *Jacobs v. Levin*.<sup>73</sup> *Jacobs* also had concluded that section 3343 established the "out of pocket" rule as an exclusive measure of damages. This conclusion required denying relief to the plaintiffs who purchased a home impliedly represented to contain a usable fireplace. Although the cost of putting the fireplace into working order was \$470.00, the plaintiffs had no right to damages because they had paid slightly less than the fair market value for the property.

### *Judicial Subversion of Bagdasarian v. Gragnon*

Dissatisfaction with the harsh results of the *Bagdasarian* ruling soon gave rise to a body of case law which either found the "out of pocket" rule inapplicable in certain situations or construed it quite liberally.

In property transaction cases involving the fraud of a fiduciary, the courts created a clear exception in that the broader damage provisions of California Civil Code sections 1709 (damages for fraudulent deceit) and 3333 (damages for torts generally)

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70. *Id.* at 765, 192 P.2d at 947 (emphasis original).

71. Prior to 1935 there was occasional uncertainty in California as to whether "out of pocket" damages could be awarded at all. *Wood v. Niemeyer*, 185 Cal. 526, 532, 197 P. 795, 798 (1921) (by implication). By enacting CAL. CIV. CODE § 3343 (West 1970) the legislature probably intended to dispel such doubt. This view is supported by the permissive language of section 3343 which states that plaintiff shall be "entitled to" out of pocket loss. Other damage rules are stipulated in mandatory language. See CAL. CIV. CODE § 3334 (West 1970) ("is deemed to be"); CAL. CIV. CODE § 3336 (West 1970) ("is presumed to be"). See also *Gagne v. Bertran*, 43 Cal. 2d 481, 494, 275 P.2d 15, 24 (1954) (dissenting opinion of Justice Schauer); *Bagdasarian v. Gragnon*, 31 Cal. 2d 744, 764, 192 P.2d 935, 947 (1948) (dissenting opinion of Justice Schauer); Comment, 12 STAN. L. REV. 270, *supra* note 4, at 273-74.

72. See notes 34-43 and accompanying text *supra*.

73. 58 Cal. App. 2d Supp. 913, 137 P.2d 500 (1943).

were held to be the pertinent measures of recovery rather than the stricter provisions of section 3343.<sup>74</sup> This conclusion was reached by different paths of reasoning. It was said, for example, that the principal's right to recover was based on the duties inherent in the agency or fiduciary relationship, and not on the transaction per se.<sup>75</sup> *Walsh v. Hooker & Fay*<sup>76</sup> was forthright in its simple assertion that faithless fiduciaries shall make good the full amount of loss occasioned by their breach of duty, and sanctioned awards of lost profits and earnings in the fiduciary context.<sup>77</sup> *Walsh* noted the particular injustice which results when the "out of pocket" rule is applied to cases involving stockbroker fraud. If, for example, the broker fraudulently misrepresented the stability of a certain stock or the financial security of the issuing corporation in order to induce a sale, he could escape damage liability by merely proving the equivalence of the stock's actual value and the sale price. Such an equivalence would occur frequently since the value of stock sold on an exchange or traded over the counter is generally determined by the price at which it is then bought and sold.<sup>78</sup>

Indeed, the *Bagdasarian* ruling unjustly deprived plaintiffs of damages whenever, despite the fraud, "out of pocket" damages—measured at the time of the transaction—were minimal or nonexistent.<sup>79</sup> In these cases, the judiciary began to consider important factors subsequent to the transaction (such as trust deed foreclosure), and would generally permit restitution of plaintiff to a pre-transaction status.<sup>80</sup>

It further became settled that anticipated revenue or profit, while not itself a proper measure of damages, nor includable under the rubric "additional damage", could nevertheless be considered in determining the actual value of property received in a fraudu-

74. *Savage v. Mayer*, 33 Cal. 2d 548, 203 P.2d 9 (1949) (secret profits by real estate broker); *Twomey v. Mitchum, Jones & Templeton, Inc.*, 262 Cal. App. 2d 690, 69 Cal. Rptr. 222 (1968) (investment counselors); *Walsh v. Hooker & Fay*, 212 Cal. App. 2d 450, 28 Cal. Rptr. 16 (1963) (salesman for stock brokerage firm); *Simone v. McKee*, 142 Cal. App. 2d 307, 298 P.2d 667 (1956) (secret profits in stock sales transaction).

75. *Savage v. Mayer*, 33 Cal. 2d 548, 551, 203 P.2d 9, 11 (1949).

76. 212 Cal. App. 2d 450, 461, 28 Cal. Rptr. 16, 24 (1963).

77. *Id.* See *Prince v. Harting*, 177 Cal. App. 2d 720, 731, 2 Cal. Rptr. 545, 551 (1963).

78. *Walsh v. Hooker & Fay*, 212 Cal. App. 2d 450, 462, 28 Cal. Rptr. 16, 24 (1963).

79. See, e.g., *Burkhouse v. Phillips*, 18 Cal. App. 3d 661, 96 Cal. Rptr. 197 (1971).

80. *Id.*; *Garrett v. Perry*, 53 Cal. 2d 178, 186, 346 P.2d 758, 763 (1959); *Feckenscher v. Gamble*, 12 Cal. 2d 482, 500, 85 P.2d 885, 893 (1939). See also *Garstang v. Skinner*, 165 Cal. 721, 726, 134 P. 329, 331 (1913) (dicta); *Carter v. Turner*, 90 Cal. App. 193, 200, 265 P. 870, 873 (1928) (dicta).

lent sale. In *Eatwell v. Beck*<sup>81</sup> an elderly couple and their children invested their entire savings in a ten unit motel property which they intended to occupy and use as a home and business. Defendant owners and their brokers fraudulently misrepresented that the motor court would produce a sufficient income to meet the monthly trust deed payments and the expenses of the business. The plaintiffs, who lost the property through foreclosure, sued for fraud but were nonsuited for failure to prove damages under the "out of pocket" rule of section 3343. The judgment was reversed by the California Supreme Court in an opinion by Justice Schauer. It was held that anticipated revenue from the motel was an element to be considered in determining its actual or market value for purposes of the "out of pocket" rule and that the trial court had erred in excluding such evidence.<sup>82</sup> Obviously, the actual or market value of property is smaller if it yields less income. Therefore, *Eatwell's* consideration of anticipated revenues in determining the value of the property received, potentially expanded the damage award under the "out of pocket" formula.

California courts also liberally construed the "additional damages" language of section 3343 to overcome the otherwise strict statutory limitation on fraud damages.<sup>83</sup> Recovery of consequential damages under the "additional damages" proviso included plaintiffs' actual expenditures, damage to other property, rental of suitable premises and the reasonable value of plaintiffs' time fruitlessly expended in reliance on a misrepresentation.<sup>84</sup> Nevertheless, a defrauded buyer could not recover lost profits or rentals under the "additional damages" language nor could the term be construed to permit use of the "loss of bargain" rule.<sup>85</sup>

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81. 41 Cal. 2d 128, 257 P.2d 643 (1953).

82. *Id.* at 134, 257 P.2d at 647. See *Zinn v. Ex-Cell-O Corp.*, 24 Cal. 2d 290, 149 P.2d 177 (1944).

83. See, e.g., *Hartong v. Partake, Inc.*, 266 Cal. App. 2d 942, 969, 72 Cal. Rptr. 722, 739-40 (1968); *Clar v. Board of Trade*, 164 Cal. App. 2d 636, 651-52, 331 P.2d 99, 106 (1958). "Additional damage" has been construed to include actual expenditures of time and money, damage to other property, and rental for other premises. *Burkhouse v. Phillips*, 18 Cal. App. 3d 661, 665, 96 Cal. Rptr. 197, 199-200 (1971); *Williams v. Graham*, 83 Cal. App. 2d 649, 189 P.2d 324 (1948); *RESTATEMENT OF TORTS* §§ 901, 903, 906 (1934).

84. 23 CAL. JUR. 2d *Fraud and Deceit* § 90 (1955). See *Hartong v. Partake, Inc.*, 266 Cal. App. 2d 942, 969, 72 Cal. Rptr. 722, 739-40 (1968); *Lawson v. Town & Country Shops, Inc.*, 159 Cal. App. 2d 196, 205, 323 P.2d 843, 849 (1958); *Annot.*, 167 A.L.R. 271 (1947).

85. See *Eatwell v. Beck*, 41 Cal. 2d 128, 257 P.2d 643 (1953); *Oliver v. Benton*, 92 Cal. App. 2d 853, 208 P.2d 375 (1949). In *Oliver* the defendants induced plaintiff to purchase improved real property by fraudulently representing to her that one of the dwelling units was leased for \$125 per month whereas the actual rental was \$77.50. Plaintiff was held not to have been damaged because the purchase price of the property did not exceed its actual value and be-

Some cases after *Bagdasarian* appear to have ignored the 1935 statute altogether, whether by mistake or design!<sup>86</sup> In *Nelson v. Marks*<sup>87</sup> a practicing attorney who also did some farming bought a used heavy tractor when the defendant told him the Caterpillar was "tiptop" and that "this tractor will go, you needn't worry about that."<sup>88</sup> Of course, the tractor did not "go". The court concluded that the damages awarded by the trial court were well within the amount that could have been awarded for the difference between the value of the tractor as its condition was represented and its actual proven condition (that is, the "loss of bargain"). The court ironically cited section 3343 to substantiate this proposition.<sup>89</sup>

*Ward v. Taggart*<sup>90</sup> and *Coleman v. Ladd Ford Co.*<sup>91</sup>

With characteristic insight and candor, former Chief Justice Roger Traynor substantially undermined the harshness of the *Bagdasarian* rule in *Ward v. Taggart*.<sup>92</sup> In *Ward*, an unprincipled real estate broker acquired some seventy-two thousand dollars in secret profits by falsely representing to plaintiff's broker that he, the defendant, had an exclusive listing for certain property and that plaintiff's initial offer to purchase this land had been rejected.<sup>93</sup> In fact, defendant was not the vendor's exclusive agent, and plaintiff's initial bid was acceptable.<sup>94</sup>

The court recognized that the defendant had committed fraud but could not award "out of pocket" damages because of an absence of relevant proof. Plaintiff did not establish that the \$500 per acre he paid for the land exceeded its market value. Nor was there a fiduciary relationship, since negotiations were at arm's length between two real estate brokers. Justice Traynor resolved the dilemma by invoking principles of constructive trust, unjust enrichment, and quasi-contract in order to justify an

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cause anticipated revenue was not "additional damage" within section 3343. 92 Cal. App. 2d at 56, 208 P.2d at 377.

86. *Nelson v. Marks*, 126 Cal. App. 2d 261, 269, 271 P.2d 900, 906 (1954). Cf. *Morris v. Harbor Boat Building Co.*, 112 Cal. App. 2d 882, 889, 247 P.2d 589, 593 (1952) (dicta).

87. 126 Cal. App. 2d 261, 271 P.2d 900 (1954).

88. *Id.* at 265, 271 P.2d at 903.

89. *Id.* at 270, 271 P.2d at 906.

90. 51 Cal. 2d 736, 336 P.2d 534 (1959). The case is discussed in Project, *A Comparison of California Sales Law and Article Two of the Uniform Commercial Code*, 11 U.C.L.A. L. REV. 78 (1963); Comment, *Expanded Remedies for Real Estate Broker's Misrepresentations*, 12 STAN. L. REV. 270 (1959); 48 CALIF. L. REV. 342 (1960); 7 U.C.L.A. L. REV. 147 (1960).

91. 215 Cal. App. 2d 90, 29 Cal. Rptr. 832 (1963).

92. 51 Cal. 2d 736, 336 P.2d 534 (1959).

93. *Id.* at 739-40, 336 P.2d at 535-36.

94. *Id.* at 740, 336 P.2d at 536-37.

award of both "loss of bargain" and exemplary damages.<sup>95</sup> *Ward*, in effect, reinterpreted section 3343 as *non-exclusive and admissible of exceptions*.

The *Ward* rationale was extended in *Coleman v. Ladd Ford Co.*<sup>96</sup> by sustaining an award of "loss of bargain" damages to a plaintiff who, relying on false assurances, purchased a new car from defendant. The fraudulent guarantees related not to the new automobile but to the sale of plaintiff's trade-in car and termination of the financing obligations thereon. In the court's view, only an award of "loss of bargain" and exemplary damages would both compensate plaintiff and adequately discourage defendant's conduct.<sup>97</sup> While *Ward* and *Coleman* eased the severity of section 3343 as interpreted in *Bagdasarian* by allowing recovery for the proceeds of fraud on a constructive trust-unjust enrichment theory,<sup>98</sup> the relief afforded by those cases was still inadequate. A plaintiff could expect "loss of bargain" damages only if the trier of fact was convinced that the defendant would otherwise be unjustly enriched and had violated some implied duty of fair dealing with the plaintiff.<sup>99</sup> The 1971 amendment to section 3343 creates complex questions regarding the precedential significance of the *Ward* and *Coleman* cases.<sup>100</sup>

### *Fraud Damages v. General Tort Recovery*

After *Bagdasarian v. Gragnon*,<sup>101</sup> Civil Code section 3343 generally was applied as the damage rule in fraud cases concerning the transfer of property. Some confusion has existed, however, even in the Supreme Court of California,<sup>102</sup> because lost profits were regularly awarded to aggrieved plaintiffs under

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95. This theory of recovery was not pleaded or raised by the parties. *Id.* at 742, 336 P.2d at 537. Cf. *Coleman v. Ladd Ford Co.*, 215 Cal. App. 2d 90, 93-94, 29 Cal. Rptr. 832, 834 (1963).

96. 215 Cal. App. 2d 90, 29 Cal. Rptr. 832 (1963).

97. *Id.* at 92, 29 Cal. Rptr. at 833.

98. Justice Burke wrote in *Coleman v. Ladd Ford Co.*, "In *Ward v. Taggart* the Supreme Court opened the door for such further court interpretation of the section [California Civil Code section 3343] as may be necessary to do justice." 215 Cal. App. 2d 90, 93, 29 Cal. Rptr. 832, 834 (1963) (citations omitted).

99. Letter from Harold F. Bradford, Legislative Representative for the State Bar of California to the Honorable Ronald R. Reagan on Senate Bill 669, Oct. 8, 1971, filed in the office of the SANTA CLARA LAWYER. See also McCauley v. Dennis, 220 Cal. App. 2d 627, 634, 34 Cal. Rptr. 90, 95 (1963).

100. See notes 138-39 and accompanying text *infra*.

101. 31 Cal. 2d 744, 762, 192 P.2d 935, 946 (1948).

102. Comment, *Imposing Liability on Data Processing Services—Should California Choose Fraud or Warranty?*, 13 SANTA CLARA LAW. 140, 153 n.83 (1972) noted that in *Gagne v. Bertran*, 43 Cal. 2d 481, 490, 275 P.2d 15, 22 (1954) the majority cites Civil Code section 3333 but in fact applies section 3343. See 43 CAL. L. REV. 356 (1955).

California Civil Code section 3333,<sup>103</sup> the general tort recovery statute. Thus, prior to 1971, a fraud victim could collect lost profits and earnings under section 3333 if the fraud did not concern the "purchase, sale or exchange of property."<sup>104</sup> Likewise, one who sued for simple negligence could pray for future lost earnings as damages while the fraud victim in property transactions was ostensibly barred from such recovery.<sup>105</sup>

Except for cases of fraud by a fiduciary, it seems clear that section 3333 does not state the damage rule for fraud in the purchase, sale, or exchange of property. First, the statute excludes by its own terms application to breach of contractual obligations.<sup>106</sup> Moreover, the express provision for fraud damages in property transactions, contained in section 3343, precludes operation of section 3333.<sup>107</sup>

### *Fraud Damages v. Recovery in Contract*

In cases not falling within the Uniform Commercial Code, California's statutes, prior to 1971, allowed plaintiffs to recover a larger measure of damages in an action for simple breach of contract than in an action for fraud arising from the purchase, sale or exchange of property.<sup>108</sup>

For a breach of contract the aggrieved party is entitled to an "amount which will compensate . . . (him) for all the detriment proximately caused thereby, or which, in the ordinary course of things, would be likely to result therefrom."<sup>109</sup> Like the

103. CAL. CIV. CODE § 3333 (West 1970) provides:

For the breach of an obligation not arising from contract, the measure of damages, except where otherwise expressly provided by this Code, is the amount which will compensate for all the detriment proximately caused thereby, whether it could have been anticipated or not.

104. *Sutter v. General Petroleum Corp.*, 28 Cal. 2d 525, 534, 170 P.2d 898, 903 (1946) (fraud); *Seaboard Music Co. v. Germano*, 24 Cal. App. 3d 618, 622, 101 Cal. Rptr. 255, 257 (1972); *Hartong v. Partake, Inc.*, 266 Cal. App. 2d 942, 969-70, 72 Cal. Rptr. 722, 739-40 (1968).

105. *Sutter v. General Petroleum Corp.*, 28 Cal. 2d 525, 534, 170 P.2d 898, 903 (1946).

106. See note 103 *supra*.

107. According to standard principles of statutory interpretation,

[a] special statute dealing expressly with a particular subject controls and takes precedence over a general statute covering the same subject. Where a general statute includes the same matter as that covered by a special act, the special act will be considered an exception to and paramount to the general act.

45 CAL. JUR. 2d *Statutes* § 120 (1958).

108. For the breach of a contract the injured party is entitled to damages which will give him the benefit of his bargain and place him in the position he would have been in had the promisor performed. See *Coughlin v. Blair*, 41 Cal. 2d 587, 262 P.2d 305 (1953). In a contract suit the plaintiff is also entitled to loss of profits resulting from the breach. See *Mann v. Jackson*, 141 Cal. App. 2d 6, 296 P.2d 120 (1956); *Ross v. Frank W. Dunne Co.*, 119 Cal. App. 2d 690, 260 P.2d 104 (1953).

109. CAL. CIV. CODE § 3300 (West 1973).

similarly phrased tort recovery statute, the damage rule for breach of contract has been construed to permit awards to plaintiff of lost profit or gains, at least to the extent that the lost profits were foreseeable when the contract was made.<sup>110</sup>

In short, California's statutory structure before 1971 tolerated the injustice that plaintiffs in negligence and simple breach of contract cases could sue for their lost earnings and lost profits while the "out of pocket" rule barred the fraud victim in property transaction cases from recovering more than the difference between the amount he paid for the property and its actual value. Moreover, defrauded persons whose situations involved the purchase or sale of property were denied, by statutory law, the right to lost earnings and profits while those damages were recoverable by other fraud victims.

The adoption of the Uniform Commercial Code in California further complicated the tangle of rules for fraud damages. California Commercial Code section 2721<sup>111</sup> allows defrauded persons to secure the benefit of their bargain.<sup>112</sup> The provision was intended to equalize the remedy of buyer or seller in fraud and breach of warranty cases.<sup>113</sup> California's "out of pocket" statute was not repealed despite its sharp conflict with the Commercial Code.<sup>114</sup>

### THE 1971 AMENDMENT

In 1971 the California legislature amended Civil Code section 3343, the statutory damage rule for fraud in the purchase, sale and exchange of property. In essence, the amendment allows persons fraudulently induced to purchase property to recover damages for lost profits. Several important questions raised by

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110. *Coughlin v. Blair*, 41 Cal. 2d 587, 603, 262 P.2d 305, 314 (1953); *Tomlinson v. Wander Seed & Bulb Co.*, 177 Cal. App. 462, 472, 2 Cal. Rptr. 310, 315-16 (1960).

111. Uniform Commercial Code section 2-721 was adopted without change in California in 1963 as CAL. COMM. CODE § 2721 (West 1964). It provides in part that "[r]emedies for material misrepresentation or fraud include all the remedies available under this division for nonfraudulent breach."

112. See Project, *A Comparison of California Sales Law and Article Two of the Uniform Commercial Code*, 11 U.C.L.A. L. REV. 78, 138-39 (1963) which suggests that enactment of section 2721 of the Commercial Code would reinstate the "loss of bargain" rule in California without reliance on either the *Ward* or *Coleman* cases. Cf. Official Comment to CAL. COMM. CODE § 2721 (West 1964) and corresponding California Code Comment.

113. Project, *A Comparison of California Sales Law and Article Two of the Uniform Commercial Code*, 11 U.C.L.A. L. REV. 78, 138-39 (1963).

114. CAL. COMM. CODE § 2721 (West 1964) also conflicted with the election of remedies rule in CAL. CIV. CODE § 1789 (West 1973). See note 21 *supra*. However, unlike section 3343, section 1789 was repealed when the Commercial Code was enacted.



the statutory modification will be considered. First, it is unclear whether the new "lost profits" provision is available to a defrauded purchaser if the deceitful representation pertains to some collateral matter and not to the value, quality or condition of the property sold. Second, the specification of particular items of consequential damages in the amended statute might influence the traditional interpretation of the "additional damages" term. Third, and most important, the impact of the 1971 amendment on the *Ward* and *Coleman* decisions is a critical issue to be resolved.

### *Loss of Profits and "Other Gains"*

The 1971 amendment to section 3343 took the form of an addition to the "out of pocket" rule. While the statute has always permitted recovery of "additional damages", the present law enumerates specific types of consequential damages which are included within the term. Now expressly recoverable, although sometimes subject to qualifications, are: 1) amounts expended in reliance on the fraud;<sup>115</sup> 2) amounts compensating for loss of use and enjoyment of property due to the fraud;<sup>116</sup> and, 3) lost profits or other gains which would have been earned were the property as falsely represented.<sup>117</sup>

It should be emphasized that amended section 3343, by its terms, prohibits recovery of damages for fraud measured by the

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115. CAL. CIV. CODE § 3343(a)(1) (West Supp. 1973) provides that one defrauded in the purchase, sale or exchange of property is entitled to "out of pocket" damages "together with any additional damage arising from the particular transaction, including . . . [a]mounts actually and reasonably expended in reliance on the fraud."

116. CAL. CIV. CODE § 3343(a)(2) (West Supp. 1973) provides for:  
[a]n amount which would compensate the defrauded party for loss of use and enjoyment of the property to the extent that any such loss was proximately caused by the fraud.

117. CAL. CIV. CODE § 3343(a)(3)-(4) (West Supp. 1973) provides for the following "additional damages":

(3) Where the defrauded party has been induced by reason of the fraud to sell or otherwise part with the property in question, an amount which will compensate him for profits or other gains which might reasonably have been earned by use of the property had he retained it.

(4) Where the defrauded party has been induced by reason of the fraud to purchase or otherwise acquire the property in question, an amount which will compensate him for any loss of profits or other gains which were reasonably anticipated and would have been earned by him from the use or sale of the property had it possessed the characteristics fraudulently attributed to it by the party committing the fraud, provided that lost profits from the use or sale of the property shall be recoverable only if and only to the extent that all of the following apply:

(i) The defrauded party acquired the property for the purpose of using or reselling it for a profit.

(ii) The defrauded party reasonably relied on the fraud in entering into the transaction and in anticipating profits from the subsequent use or sale of the property.

(iii) Any loss of profits for which damages are sought under this paragraph have been proximately caused by the fraud and the defrauded party's reliance on it.

traditional "loss of bargain" formula.<sup>118</sup> Allowing lost profits as consequential damages while not approving the "loss of bargain" rule is difficult to understand. Both future lost profits and the "loss of bargain" represent an expectancy interest which may be difficult to estimate in calculating damages. Indeed, there may be no satisfactory basis on which to measure the profits which a new business would generate.<sup>119</sup> In contrast, the value of property "as represented" can frequently be estimated with reasonable certainty by the cost of making it conform to the represented condition or by looking to the value of property with comparable characteristics. If land is sold to an entrepreneur on the false representation that it is zoned for commercial development, the lost profits of the unestablished business due to the fraud would be speculative, while the value of equivalent but properly zoned real estate for the application of the "loss of bargain" rule could reasonably be determined by standard appraisal techniques.

Lost profit damages for fraud in the purchase or exchange of property may only be recovered if three statutory conditions are met.<sup>120</sup> The first, and perhaps most restrictive limitation, is that the defrauded party must have acquired the property to use or resell for a profit.<sup>121</sup> Commentators who view the 1971 amendment to section 3343 as a boon to consumers have apparently overlooked this language which primarily benefits commercial entities and individuals who purchase property for their trade or business.<sup>122</sup>

Nevertheless, in this writer's view, section 3343 may permit lost profit damages to purchasers of residential homes. Certainly investment value is one factor motivating the purchase of a home, particularly in urban areas where the population is mobile and land values are soaring. Moreover, profit motive may well be the dominant factor in the acquisition of a second home, especially when the unit is sold in a "resort setting" based on an investment pitch. This first qualification on lost profit damages does not require that acquisition for profit or resale be the sole or dominant motive of the purchaser. In accordance with the amel-

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118. CAL. CIV. CODE § 3343(b)(1) (West Supp. 1973) provides:

Nothing in this section shall . . . [p]ermit the defrauded person to recover any amount measured by the difference between the value of the property as represented and the actual value thereof.

119. As to the treatment of lost profits damage in actions for breach of contract, see *Grupe v. Glick*, 26 Cal. 680, 160 P.2d 832 (1945); *Kuffel v. Seaside Oil Co.*, 11 Cal. App. 3d 354, 90 Cal. Rptr. 209 (1970).

120. CAL. CIV. CODE § 3343(a)(4)(i)-(iii) (West Supp. 1973).

121. CAL. CIV. CODE § 3343(a)(4)(i) (West Supp. 1973).

122. 47 CALIF. ST. B.J. 126 (1972) described the 1971 amendment as pro-consumer.

iorative purposes of the statute, it should be sufficient to satisfy the profit motive requirement that use or resale for profit is merely one element which contributes to the buyer's decision to purchase.<sup>123</sup>

A second limitation on recovery of lost profits is that the plaintiff must reasonably have relied on the fraud in entering into the transaction and in anticipating profits from the use or resale of the property.<sup>124</sup>

The third restriction imposed is that the lost profits for which damages are sought must be proximately caused by the fraud and the defrauded party's reliance on the representation.<sup>125</sup> Incorporation of "proximate cause" into the damage statute merely restates the familiar tort principle that only those damages are recoverable which are the proximate result of the breach of an obligation.<sup>126</sup> "Proximate cause", however, denotes numerous vague rules and policies which are wholly unrelated to causation, so that this single phrase will considerably complicate fraud cases wherein lost profits are sought as damages.<sup>127</sup>

Section 3343 permits the defrauded purchaser to recover lost profits or other gains which "would have been earned by him from the use or sale of the property had it possessed the characteristics fraudulently attributed to it . . . ." <sup>128</sup> Implicit in the statutory language is a requirement that the defrauded plaintiff must rely on a representation pertaining to characteristics of the property sold if he is to recover lost profits. It remains unclear whether lost profits would be recoverable when the misrepresentation concerned a collateral matter other than "characteristics of the property sold."

To illustrate, assume that an investor is considering the purchase of a plot of land which includes a commercial building. The prospective buyer is willing to purchase the property if the building could be economically converted into suitable offices.

123. Statutes must be given a reasonable and common sense construction, consonant with the underlying legislative purpose and intention. See *Ivens v. Simon*, 212 Cal. App. 2d 177, 27 Cal. Rptr. 801 (1963); *Rose v. State*, 19 Cal. 2d 713, 123 P.2d 505 (1943). That construction of a statute is favored which will lead to a wise policy rather than mischief and absurdity. See *Kennard v. Rosenberg*, 127 Cal. App. 2d 340, 273 P.2d 839 (1954).

124. CAL. CIV. CODE § 3343(a)(4)(ii) (West Supp. 1973).

125. CAL. CIV. CODE § 3343(a)(4)(iii) (West Supp. 1973).

126. CAL. CIV. CODE § 3333 (West 1970).

127. Dean Prosser described "proximate cause" as "a tangle and a jungle, a palace of mirrors and a maze." Prosser, *Proximate Cause in California*, 38 CALIF. L. REV. 369 (1950). Cf. C. MORRIS, *MORRIS ON TORTS* 187-92 (1953); PROSSER, *supra* note 7, at 236-90; 43 CALIF. L. REV. 356 (1955). See *Gagne v. Bertran*, 43 Cal. 2d 481, 491-92, 275 P.2d 15, 22-23 (1954).

128. CAL. CIV. CODE § 3343(a)(4) (West Supp. 1973).

To induce the sale the real estate broker falsely represents that he can procure a building contractor who will complete the modifications at a favorable rate. Under these circumstances the cheated buyer may have no right to anticipated rentals from the offices because the false representation did not pertain to the value, quality, condition, income or other characteristic of the property sold. Rather, the unscrupulous broker misrepresented his ability to find a contractor who could complete the offices at a particularly good cost.

It seems doubtful that the legislature in enacting section 3343 deliberately intended to exclude recovery of lost profits when the fraud concerned a matter other than a characteristic of the property sold. In such a case the loss due to deception is equally genuine and provable. In this regard the limitations of reasonable reliance<sup>129</sup> and proximate cause<sup>130</sup> would adequately protect a seller from spurious claims to lost profits due to fraud.

Despite the ambiguities and manifold restrictions on awards of "lost profits", section 3343, as amended, will eliminate the need for strained judicial fictions such as the "subsequent factor" of foreclosure in *Burkhouse v. Phillips*. The plaintiff in *Burkhouse* purchased the multi-acre "Gentleman's Farm" anticipating a net profit from the sale of the walnut crop. Although there were no "out of pocket" damages resulting from the sale, Mr. Burkhouse would be entitled, under the 1971 statute, to the profits which he expected from the land he purchased. The "Gentleman's Farm" was acquired for profitable use as well as for a residence, and the sale to Mr. Burkhouse was induced by fraudulent representations regarding a characteristic of the property—its crop yield.<sup>131</sup>

### *Fraud Inducing Sale*

While it generally happens that it is the seller of property who misleads the buyer, sometimes the buyer defrauds the seller. If the buyer deceives the seller into believing that his property is worth much less than its true market value, the general American rule permits the seller to recover the difference between the price paid and its actual value.<sup>132</sup> California, in accordance with the majority position, has applied the "out of pocket" rule of section 3343 in the "buyer cheats seller" situation.<sup>133</sup> *Zinn v.*

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129. See note 124 and accompanying text *supra*.

130. See note 125 and accompanying text *supra*.

131. See note 35 and accompanying text *supra*.

132. DOBBS, *supra* note 7, at 598.

133. *Zinn v. Ex-Cell-O Corp.*, 24 Cal. 2d 290, 149 P.2d 177 (1944); *Wehner v. Wehner*, 68 Cal. App. 789, 230 P. 458 (1924).

*Ex-Cell-O Corporation*,<sup>134</sup> for example, used the restitutionary rule to measure the damages suffered when an incorporated manufacturer's representative was fraudulently induced to sell its capital no par stock to the manufacturer at a low price.<sup>135</sup>

As amended, section 3343 specifically provides that a person fraudulently induced to sell property is entitled to sue for profits or gains which might reasonably have been earned had the property been retained.<sup>136</sup> Hitherto lost profits have not been permitted as consequential damages in fraud actions concerning transactions in property.

Interpretation of the provision for "lost profits" or "other gains" will involve interesting questions of statutory interpretation. If an owner has been induced through fraud to sell valuable yet non-income producing property such as jewelry, antiques or art, has he suffered lost profits? Certainly such a seller loses the appreciated value of his asset which would be reflected in his net worth were the property retained. Nevertheless, his gain by retention of the property does not constitute rents, issues or profits.<sup>137</sup> The language of section 3343 is broad enough to embrace as consequential damages the detriment sustained by a fraudulent inducement to sell appreciated but non-income producing property.

A further difficulty arises if and when the unscrupulous vendee misrepresents the value of what he proposes to give as consideration for the plaintiff's property. Under these circumstances the "out of pocket" rule will yield no compensable damages so long as the market value of the vendee's property equals or exceeds that of the vendor. The "benefit of bargain" rule is most appropriate, then, when the vendee overvalues his property.<sup>138</sup> In its absence, the California plaintiff must rely on *Ward*, and predicate his claim for the recovery of lost profits on a constructive trust-unjust enrichment theory.<sup>139</sup> He might also sue for exemplary damages.<sup>140</sup>

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134. 24 Cal. 2d 290, 149 P.2d 177 (1944).

135. *Id.* at 297, 149 P.2d at 181.

136. CAL. CIV. CODE § 3343(a)(2) (West Supp. 1973).

137. *See Eatwell v. Beck*, 41 Cal. 2d 128, 257 P.2d 643 (1953); *Oliver v. Benton*, 92 Cal. App. 2d 853, 208 P.2d 375 (1949).

138. DOBBS, *supra* note 7, at 598.

139. *See* notes 90-95 and accompanying text *supra*.

140. In an action for breach of an obligation not arising from contract, where the defendant has been guilty of fraud, the plaintiff may recover exemplary damages in addition to actual damages. CAL. CIV. CODE § 3294 (West 1970). It was held in *Bagdasarian v. Gragnon* that section 3343 was not intended to, and does not, preclude recovery of exemplary damages. 31 Cal. 2d 744, 763, 192 P.2d 935, 946 (1948).

*Reliance Damages and Loss of Use*

In addition to lost profits, section 3343, as amended, specifies two particular items of consequential damage recoverable by one defrauded in the purchase, sale or exchange of property. One item of enumerated "additional damage" covers amounts actually and reasonably expended in reliance upon the fraud.<sup>141</sup> The damage rule also provides for an amount which would compensate the defrauded party for loss of use and enjoyment of the property to the extent that such loss was proximately caused by the fraud.<sup>142</sup>

California courts will have to exercise care to prevent a duplication of damage awards when plaintiff claims under both the "lost profits" provision and either the "reliance" or "loss of use and enjoyment" sections. This is true because the rule for lost profits recovery (amounts which the property would have earned were it as represented) itself includes damages and costs incurred in performing plaintiff's side of the contract.<sup>143</sup>

For example, suppose that a buyer purchases property improved with rental housing, the sale being induced by a fraudulent representation as to its occupancy rate and rental income. Even if the buyer suffered no out of pocket damages he would be entitled under section 3343 to the loss of profits occasioned by the fraud. He should not be allowed to recover additionally the purchase price paid for the apartments, although spent in reliance on the fraud. The purchase price of the property was a cost that went into plaintiff's initial calculation of profit and he is fully compensated when lost profits are given to him.

Traditionally, "additional damage" has included such items as costs of moving to suitable property, rent for other property, the cost of improvements to land which are lost and the costs of perfecting title.<sup>144</sup> There appears to be little danger of duplicating damages in awarding lost profits in addition to such items of consequential damages. Nevertheless, caution must be exercised to insure that one item of special damages is not directly or indirectly measured by another.

Finally, the specifications of lost profits and loss of use and enjoyment as items of additional damage in amended section 3343 should not be construed to restrict the range of consequential damages awardable under the statute. The relevant language is

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141. CAL. CIV. CODE § 3343(a)(1) (West Supp. 1973).

142. CAL. CIV. CODE § 3343(a)(2) (West Supp. 1973).

143. See DOBBS, *supra* note 7, at 601; McCORMICK, *supra* note 7, at 601.

144. See 23 CAL. JUR. 2D *Fraud and Deceit* § 90 (1955); 37 AM. JUR. 2D *Fraud and Deceit* § 362 (1968).

expansive, not limiting,<sup>145</sup> and tort policy favors a broad range of damages for intentional wrongs such as fraud.<sup>146</sup>

### CONCLUSION

Ever since the *Bagdasarian* decision misconstrued the 1935 version of Civil Code section 3343 to establish the "out of pocket" rule as the exclusive measure of fraud damages in property transactions, California courts have found ways to circumvent that rule in the interests of justice. Unfortunately, the patchwork judicial relief arising from the *Bagdasarian* decision has operated unevenly.

In 1971, the legislature amended section 3343 but rejected both the majority "loss of bargain" rule and the emerging "flexibility theory" for establishing damages for fraud in the purchase, sale, or exchange of property. Instead, the "out of pocket" rule was retained as the basic California measure of damages and further recovery of "lost profits or other gains" was permitted under restrictive circumstances.

The amended statute alleviates some of the oppression which the "out of pocket" rule creates, and generally equalizes the recoverable damages in a fraud action concerning a property transaction with damages in actions for breach of contract, negligence, and simple fraud. The triple limitation on lost profit awards, however, could create a hardship in situations involving the purchase of goods where both a personal and a business interest motivate the buyer. This threefold restriction also leaves unclear whether plaintiff can be awarded "lost profits or other gains" when the fraudulent misrepresentation does not pertain to a characteristic of the property sold but rather to a collateral matter.

Retention of the "out of pocket" rule in California will no doubt continue to work a hardship on defrauded buyers and sellers, despite the addition, in 1971, of lost profits as rewardable consequential damages. It is not difficult to conceive of a case in which non-income producing property is sold for its market price, although fraud induced the sale. For example, it must be supposed that developers of residential properties sometimes fraudulently overstate the value of the home but agree to sell "at a bargain", that is, at its actual value. Faced with these facts,

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145. CAL. CIV. CODE § 3343(a) (West Supp. 1973) allows the defrauded plaintiff to recover "additional damage arising from the particular transaction, including any of the following" (emphasis added). *Id.* See 45 CAL. JUR. 2D *Statutes* § 151 (1958) for the proposition that the word "including" is ordinarily a word of enlargement.

146. See DOBBS, *supra* note 7, at 602; PROSSER, *supra* note 7, at 30-31.

a court would still find no measurable damages under section 3343 and should return to the constructive trust-unjust enrichment principles of *Ward* and *Coleman* to allow plaintiff to recover the benefit of his bargain.

A broad reading of section 3343 would move California closer to the desirable "flexibility theory" which applies the "out of pocket" or "loss of bargain" rule according to the available proof, the culpability of the defendant and the proximity between the false representation and the loss. Neither rule alone can operate equitably in all fraud cases involving property transactions. It is imperative that an enlightened judiciary and vigorous bar vindicate cheated plaintiffs and discourage fraudulent practices by construing liberally the terms of section 3343.

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