

GLOBAL
EDITION



Contemporary Business Law

EIGHTH EDITION

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ALWAYS LEARNING

PEARSON

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been a significant factor in inducing the innocent party to enter into the contract. It need not have been the sole factor. Statements of opinion or predictions about the future generally do not form the basis for fraud.

2. Intent to Deceive

To prove that a person intended to deceive an innocent party, the person making the misrepresentation must have either had knowledge that the representation was false or made it without sufficient knowledge of the truth. This is called **scienter** (“guilty mind”). The misrepresentation must have been made with the **intent to deceive** the innocent party. Intent can be inferred from the circumstances.

scienter

(“guilty mind”) Knowledge that a representation is false or that it was made without sufficient knowledge of the truth.

3. Reliance on the Misrepresentation

A misrepresentation is not actionable unless the innocent party to whom the misrepresentation was made relied on the misrepresentation and acted on it. An innocent party who acts in **reliance on a misrepresentation** must justify his or her reliance. Justifiable reliance is generally found unless the innocent party knew that the misrepresentation was false or was so extravagant as to be obviously false.

4. Injury to the Innocent Party

To recover damages, the innocent party must prove that the fraud caused him or her **economic injury**. The measure of damages is the difference between the value of the property as represented and the actual value of the property. This measure of damages gives the innocent party the “benefit of the bargain.” In the alternative, the buyer can rescind the contract and recover the purchase price.

Individuals must be on guard in their commercial and personal dealings not to be defrauded. Basically, something sounding “too good to be true” is a signal that the situation might be fraudulent. Although the law permits a victim of fraud to rescind the contract and recover damages from the wrongdoer, often the wrongdoer cannot be found or the money has been spent.

There are various types of fraud. Several of these are discussed in the following paragraphs.

“A charge of fraud is such a terrible thing to bring against a man that it cannot be maintained in any court unless it is shown that he had a wicked mind.”

M. R. Lord Esher
Le Lievre v. Gould (1732)

fraud in the inception (fraud in the factum)

Fraud that occurs if a person is deceived as to the nature of his or her act and does not know what he or she is signing.

Fraud in the Inception

Fraud in the inception, or **fraud in the factum**, occurs if a person is deceived as to the nature of his or her act and does not know what he or she is signing. Contracts involving fraud in the inception are void rather than just voidable.

Example Heather brings her professor a grade card to sign. The professor signs the grade card on the front without reading the grade card. On the front, however, are contract terms that transfer all of the professor’s property to Heather. Here, there is fraud in the inception. The contract is void.

Fraud in the Inducement

Many fraud cases concern **fraud in the inducement**. Here, the innocent party knows what he or she is signing or doing but has been fraudulently induced to enter into the contract. Such contracts are voidable by the innocent party.

Example Lyle tells Candice that he is forming a partnership to invest in drilling for oil in an oil field and invites her to invest in this venture. In reality, though, there is no oil field, and Lyle intends to use whatever money he receives from Candice for his personal expenses. Candice relies on Lyle’s statements and invests \$30,000 with Lyle. Lyle absconds with Candice’s \$30,000 investment. Here, there has been fraud in the inducement. Candice has been induced to give Lyle \$30,000 based on Lyle’s misrepresentation of fact. Candice can rescind the contract and recover the money from Lyle, if she can find him and locate his money or property.

fraud in the inducement

Fraud that occurs when the party knows what he or she is signing but has been fraudulently induced to enter into the contract.

Fraud by Concealment

Fraud by concealment occurs when one party takes specific action to conceal a material fact from another party.⁶

Example Steel Inc. contracts to buy used manufacturing equipment from United Inc. United Inc. does not show Steel Inc. the invoices for repairs to the equipment even though Steel Inc. has asked to see all of the repair invoices for the equipment. Relying on the knowledge that the equipment is in good condition and has never been repaired, Steel Inc. purchases the equipment from United Inc. If Steel Inc. subsequently discovers that a significant repair record has been concealed by United Inc., Steel Inc. can sue United Inc. for fraud by concealment.

fraud by concealment

Fraud that occurs when one party takes specific action to conceal a material fact from another party.

CONCEPT SUMMARY

TYPES OF FRAUD

1. **Fraud in the inception (fraud in the factum).** Fraud that occurs if a person is deceived as to the nature of his or her act and does not know what he or she is signing.
2. **Fraud in the inducement.** Fraud that occurs when the party knows what he or she is signing but has been fraudulently induced to enter into the contract.
3. **Fraud by concealment.** Fraud that occurs when one party takes specific action to conceal a material fact from another party.

Silence as Misrepresentation

Generally, neither party to a contract owes a duty to disclose all the facts to the other party. Ordinarily, such silence is not a misrepresentation unless (1) nondisclosure would cause bodily injury or death, (2) there is a fiduciary relationship (i.e., a relationship of trust and confidence) between the contracting parties, or (3) federal and state statutes require disclosure. The *Restatement (Second) of Contracts* specifies a broader duty of disclosure: Nondisclosure is a misrepresentation if it would constitute a failure to act in “good faith.”⁷

Example Some states require that home sellers disclose material facts about their property, such as structural problems, the existence of mold or mildew, water leaks in the foundations or walls, or unresolved disputes with adjacent landowners about the size or lot lines of the property. Some states require disclosure of suicides and other deaths that have occurred on the property within a certain time period prior to listing the property for sale. Nondisclosure of such required facts constitutes silence as misrepresentation and violates the law.

“Whoever is detected in a shameful fraud is ever after not believed even if they speak the truth.”

Phaedrus (Thrace of Macedonia)

Misrepresentation of Law

Usually, a **misrepresentation of law** is not actionable as fraud. The innocent party cannot generally rescind the contract because each party to a contract is assumed to know the law that applies to the transaction, either through his or her own investigation or by hiring a lawyer. There is one major exception to this rule: The misrepresentation will be allowed as grounds for rescission of the contract if one party to the contract is a professional who should know what the law is and intentionally misrepresents the law to a less sophisticated contracting party.⁸

Innocent Misrepresentation

An **innocent misrepresentation** occurs when a person makes a statement of fact that he or she honestly and reasonably believes to be true even though it is not. Innocent misrepresentation is not fraud. If an innocent misrepresentation has been made, the aggrieved party may rescind the contract but may not sue for damages. Often, innocent misrepresentation is treated as a mutual mistake.

In the following case, the court found fraud and awarded punitive damages.

innocent misrepresentation

Fraud that occurs when a person makes a statement of fact that he or she honestly and reasonably believes to be true even though it is not.



CASE 12.1 STATE COURT CASE Fraud

Krysa v. Payne

176 S.W.3d 150, Web 2005 Mo.App. Lexis 1680 (2005)
Court of Appeals of Missouri

“Payne’s conduct can only be seen as exhibiting a very high degree of reprehensibility.”

—Ellis, Judge

Facts

Frank and Shelly Krysa were shopping for a truck to pull their 18-foot trailer. During the course of their search, they visited Payne’s Car Company, a used car dealership owned by Emmett Payne. Kemp Crane, a used car salesman, showed the Krysas around the car lot. The Krysas saw an F-350 truck that they were interested in purchasing. Crane told the Krysas that the truck would tow their trailer and that the truck would make it to 400,000 miles, and that it was “a one-owner trade-in.” The Krysas took the truck for a test drive and decided to purchase the truck. The Krysas paid for the truck and took possession.

Later that day, the Krysas noticed that the power locks did not work on the truck. A few days later, the truck took three hours to start. The heater was not working. Mr. Krysa tried to fix some problems and noticed that the radiator was smashed up, the radiator cap did not have a seal, and the thermostat was missing. Mr. Krysa noticed broken glass on the floor underneath the front seats and that the driver’s side window had been replaced. Shortly thereafter, Mr. Krysa attempted to tow his trailer, but within two miles, he had his foot to the floor trying to get the truck to pull the trailer. A large amount of smoke was pouring out of the back of the truck. Mr. Krysa also noticed that the truck was consuming a lot of oil. Mr. Krysa obtained a CARFAX report for the truck, which showed that the truck had had 13 prior owners. Evidence proved that the truck was actually two halves of different trucks that had been welded together. An automobile expert told the Krysas not to drive the truck because it was unsafe.

Mr. Krysa went back to the dealership to return the truck and get his money back. Payne would not give Krysa his money back. The Krysas sued Payne for fraudulent nondisclosure and fraudulent misrepresentation, and they sought to recover compensatory and punitive damages. The jury returned a verdict for the Krysas and awarded them \$18,449 in compensatory damages and \$500,000 in punitive damages. Payne appealed the award of punitive damages.

Issue

Did Payne engage in fraudulent nondisclosure, fraudulent misrepresentation, and reckless disregard for the safety of the Krysas and the public to support the award of \$500,000 in punitive damages?

Language of the Court

The record clearly supports a finding that Payne acted indifferently to or in reckless disregard of the safety of the Krysas in selling them a vehicle that he knew or should have known was not safe to drive. The evidence also supported a finding that the harm sustained by Krysas was the result of intentional malice, trickery, or deceit, and was not merely an accident. Payne’s conduct can only be seen as exhibiting a very high degree of reprehensibility.

Decision

The court of appeals found that Payne’s fraudulent concealment, fraudulent misrepresentation, and reckless disregard for the safety of the Krysas and the public justified the award of \$500,000 of punitive damages to the Krysas.

Ethics Questions

Did Payne, the used car dealer, act ethically in this case? Should punitive damages have been awarded in this case?

► DURESS

duress

A situation in which one party threatens to do a wrongful act unless the other party enters into a contract.

Duress occurs when one party threatens to do some wrongful act unless the other party enters into a contract. If a party to a contract has been forced into making the contract, the assent is not voluntary. Such a contract is not enforceable against the innocent party. Thus, if someone threatens to physically harm another person unless that person signs a contract, this is *physical duress*. If the victim of the duress signs the contract, it cannot be enforced against the victim. Duress can also occur where a threat does not involve physical harm.

Example The threat to commit extortion unless someone enters into a contract constitutes duress. A threat to bring (or not drop) a criminal lawsuit unless someone enters into a contract constitutes duress even if the criminal lawsuit is well founded.⁹ A threat to bring (or not drop) a civil lawsuit, however, does not constitute duress unless such a suit is frivolous or brought in bad faith.

► EQUITABLE DOCTRINE: UNDUE INFLUENCE

The courts may permit the rescission of a contract based on the equitable doctrine of **undue influence**. Undue influence occurs when one person (the **dominant party**) takes advantage of another person's mental, emotional, or physical weakness and unduly persuades that person (the **servient party**) to enter into a contract. The persuasion by the wrongdoer must overcome the free will of the innocent party. A contract that is entered into because of undue influence is voidable by the innocent party.¹⁰ The following elements must be shown to prove undue influence:

- A fiduciary or confidential relationship must have existed between the parties.
- The dominant party must have unduly used his or her influence to persuade the servient party to enter into a contract.

If there is a confidential relationship between persons—such as a lawyer and a client, a doctor and a patient, a psychiatrist and a patient—any contract made by the servient party that benefits the dominant party is presumed to be entered into under undue influence. This rebuttable presumption can be overcome through proper evidence.

Example Mr. Johnson, who is 70 years old, has had a stroke and is partially paralyzed. He is required to use a wheelchair, and he needs constant nursing care. Prior to his stroke, Mr. Johnson had executed a will, leaving his property upon his death equally to his four grandchildren. Edward, a licensed nurse, is hired to care for Mr. Johnson on a daily basis, and Mr. Johnson relies on Edward's care. Edward works for Mr. Johnson for two years before Mr. Johnson passes away. It is later discovered that Mr. Johnson had executed a written contract with Edward three months before he died, deeding a valuable piece of real estate to Edward. If it is shown that Edward has used his dominant and fiduciary position to unduly influence Mr. Johnson to enter into this contract, then the contract is invalid. If no undue influence is shown, the contract with Edward is valid, and Edward will receive the property deeded to him by Mr. Johnson.

► STATUTE OF FRAUDS

In 1677, the English Parliament enacted a statute called “An Act for the Prevention of Frauds and Perjuries.” This act required that certain types of contracts had to be in writing and signed by the party against whom enforcement was sought. Today, every U.S. state has enacted a **Statute of Frauds** that requires certain types of contracts to be in *writing*. This statute is intended to ensure that the terms of important contracts are not forgotten, misunderstood, or fabricated. One court stated about the Statute of Frauds, “It is the purpose of the Statute of Frauds to suppress fraud, i.e., cooked-up claims of agreement, sometimes fathered by wish, sometimes imagined in the light of subsequent events, and sometimes simply conjured up.”¹¹

Writing Requirement

Although the statutes vary slightly from state to state, most states require the following types of contracts to be in writing.¹²

- Contracts involving interests in real property
- Contracts that by their own terms cannot possibly be performed within one year
- Collateral contracts in which a person promises to answer for the debt or duty of another

undue influence

A situation in which one person takes advantage of another person's mental, emotional, or physical weakness and unduly persuades that person to enter into a contract; the persuasion by the wrongdoer must overcome the free will of the innocent party.

CRITICAL LEGAL THINKING

Is it difficult to determine when undue influence has occurred? Do you think that undetected undue influence occurs very often?

Statute of Frauds

A state statute that requires certain types of contracts to be in writing.

“Statute of Frauds: That unfortunate statute, the misguided application of which has been the cause of so many frauds.”

Bacon, Viscount
Morgan v. Washington (1878)

- Promises made in consideration of marriage
- Contracts for the sale of goods for \$500 or more
- Contracts for the lease of goods with payments of \$1,000 or more
- Real estate agents' contracts
- Agents' contracts where the underlying contract must be in writing
- Promises to write a will
- Contracts to pay debts barred by the statute of limitations or discharged in bankruptcy
- Contracts to pay compensation for services rendered in negotiating the purchase of a business
- Finder's fee contracts

CRITICAL LEGAL THINKING

What is the purpose of the Statute of Frauds? Why does it not apply to all contracts?

Generally, an **executory contract** that is not in writing even though the Statute of Frauds requires it to be is unenforceable by either party. The Statute of Frauds is usually raised by one party as a defense to the enforcement of the contract by the other party.

If an oral contract that should have been in writing under the Statute of Frauds is already executed, neither party can seek to **rescind** the contract on the grounds of noncompliance with the Statute of Frauds. That is, the contract may be voluntarily performed by the parties.

Example Edward enters into an oral contract to sell his house to Lana for \$400,000, closing of the transaction to be in 30 days. At the time of closing, Edward signs the deed to the property to Lana and Lana pays Edward the \$400,000 purchase price. Under the statute of frauds, this contract for the sale of real estate would have had to be in writing to be enforceable. However, since both parties have performed the oral contract, neither party can raise the statute of frauds to rescind the contract.

Generally, contracts listed in the Statute of Frauds must be in writing to be enforceable. There are several equity exceptions to this rule. The contracts that must be in writing pursuant to the Statute of Frauds and the exceptions to this rule are discussed in the following paragraphs.

Contracts Involving Interests in Real Property

Under the Statute of Frauds, any contract that transfers an ownership interest in **real property** must be in writing to be enforceable. Real property includes the land itself, buildings, trees, soil, minerals, timber, plants, crops, fixtures, and things permanently affixed to the land or buildings. Certain items of personal property that are permanently affixed to the real property are fixtures that become part of the real property.

Example Built-in cabinets in a house are *fixtures* that become part of the real property.

Other contracts that transfer an ownership interest in land must be in writing under the Statute of Frauds. These interests include the following:

- **Mortgages.** Borrowers often give a lender an interest in real property as security for the repayment of a loan. This action must be done through the use of a written **mortgage** or **deed of trust**.

Example Ida purchases a house for \$500,000. She pays \$100,000 toward the payment of the house and borrows \$400,000 of the purchase price from Country Bank. Country Bank requires that the house be collateral for the loan and takes a mortgage on the house. Here, the mortgage between Ida and Country Bank must be in writing to be enforceable.

- **Leases.** A **lease** is the transfer of the right to use real property for a specified period of time. Most Statutes of Frauds require leases for a term more than one year to be in writing.
- **Life estates.** On some occasions, a person is given a **life estate** in real property. In other words, the person has an interest in the real property for the person's lifetime, and the interest will be transferred to another party on that person's death. A life estate is an ownership interest that must be in writing under the Statute of Frauds.

real property

The land itself, as well as buildings, trees, soil, minerals, timber, plants, crops, fixtures, and other things permanently affixed to the land or buildings.

mortgage (deed of trust)

An interest in real property given to a lender as security for the repayment of a loan.

lease

The transfer of the right to use real property for a specified period of time.

life estate

An interest in real property for a person's lifetime; upon that person's death, the interest will be transferred to another party.