Economic analysis of legal standard for deceit in English tort law

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1. Introduction

The law and economics movement has made a huge impact on the legal research. Among all of the successes, the law of tort is one of the first areas to which the economic approach was applied. The economic analysis of intentional tort can be dated back from Landes and Posner (1981). In this seminal paper, the authors developed a theoretical framework for economic analysis of intentional tort. Surprisingly, afterwards there are few researches which applied Landes and Posner’s analytical framework to the analysis of specific form of intentional tort, and nearly none is made of fraudulent misrepresentation. This paper fills the gap in the literature by applying both Landes and Posner’s framework and other relevant economic theories of tort to the study of English law of deceit. It seeks to show that law and economics approach could generate valuable insights for our understanding of the economic functions served by the legal standard. The paper proceeds as follows. In Section 2, I will briefly review the English law of deceit, and then in Section 3, I argued that the legal standard can serve three economic functions, viz. improving efficiency of legal remedy, enhancing the legal deterrence and minimizing the cost of using legal system. The critical evaluation of the English law of deceit is presented in Section 4 to 6. Finally, Section 7 concludes the discussion.

2. Legal Background

The action of deceit, which was developed by English courts of common law, provides a remedy in damages for a person who has suffered loss by acting on a statement which was made to him fraudulently. In order to succeed in the action of deceit, the claimant (the representee) should establish the existence of four conditions: (1) an intention to deceive, (2) a false statement; (3) losses sustained and (4) causation between the loss and the misrepresentation.

2.1. Intention to Deceive

Intention to deceive was first established as a requirement for an actionable deceit in Pasley v. Freeman. However, the explicit judicial interpretation of this point was offered by Lord Herschell a century later, in Derry v. Peek. He stated:

“First, in order to sustain an action of deceit, there must be proof of fraud and nothing short of that will suffice. Secondly, fraud is proved when it is shown that a
false representation has been made (i) knowingly, (ii) without belief in its truth, or (iii) recklessly, careless whether it be true or false. Although I have treated the second and third as distinct cases, I think the third is but an instance of the second, for one who makes a statement under such circumstances can have no real belief in the truth of what he states. To prevent a false statement from being fraudulent, there must I think, always be an honest belief in its truth."

The representor’s intention to deceive can be established by showing that he either knew of the false element in his statement or was reckless as to its truth. It is easy to define the word “knowingly”, which simply means that the representor did not honestly believe the representation. (Cartwright 2002, 109) However, it is more difficult to decide the meaning of the representor’s being reckless. Recklessness does not amount simply to negligence or a failure to take care; (Cartwright 2002, 100) the legal definition of recklessness requires the representor’s dishonesty. Since negligence is not dishonesty, mere negligence is not sufficient for deceit. A typical example of recklessness is the failure to correct an earlier misrepresentation. If the representor believed the statement was true at the time of representing, but in fact it was false, then when he later realises the truth he is obliged to disclose it to the representee; otherwise, the law will treat his intention as reckless. As Lord Blackburn said in Brownlie v. Campbell5:

“When a statement or representation has been made in the bona fide belief that it is true, and the party who has made it afterwards comes to find out that it is untrue, and discover what he should have said, he can no longer honestly keep up that silence on the subject after that has come to his knowledge, thereby allowing the other party to go on and still more, inducing him to go on upon a statement which was honestly made at the time when it was made, but which he has not now retracted when he has become aware that it can be no longer honestly persevered in.”

Once the legal requirement to show the representor’s knowledge or recklessness is fulfilled, the motive is immaterial. “It is not necessary to prove that the false representation was made from a corrupt motive of gain to the defendant or a wicked motive of injury to the plaintiff.”6 The fact that the representor was not actually dishonest,7 or acted for the purpose of facilitating a bona fide business transaction,8 is irrelevant.

Additionally, the representor must have intended the representee to rely upon the representation.9 The law does not require the representor to know the representee individually; it is sufficient for him to have intended that a person in the position of the representee should act on the representation.10

In brief, the requirement of intention to deceive comprises two elements: (1) the representor knows of or is reckless as to the falsity of his statement; (2) he actually desires the claimant to rely on his statement and appreciates that in the absence of some unforeseen intervention the representee will actually do so.11

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5 (1880) 5 AC 925, 950.
6 Derry v. Peek (1889) All ER 1, 17.
7 Standard Chartered Bank v. Pakistan National Shipping Corp’n (No.2) [2000] 1 LR 218, 224 (Evans L.J.).
8 Ibid.
9 Peek v. Gurney (1873) LR 6 377, 413.
2.2. False Statement

There are three issues to be addressed in relation to the requirement of false statement. First, a statement, to be an actionable deceit, must be false. It can be either the false statement of fact or of opinion. In the law of deceit, both are actionable. (Cartwright 2002, 110)

Secondly, sales talk or ‘puffery’ cannot qualify as actionable deceit. This refers to statements which either are on their face assertions of fact but are clearly exaggerations, “puffing the product” and not to be taken seriously; or are not sufficiently clear and precise to constitute actionable misrepresentations. (Cartwright 2002, 19) When deciding whether the statement is sales talk, the whole circumstances of the contract and its negotiation should be considered. The core question is whether the representee as a reasonable person was entitled to take the statement seriously and so to rely on it in deciding whether to enter into the contract. If after considering all of the relevant circumstances the court believes that a reasonable man would not have taken the statement seriously, the statement will be treated as sales talk and so not actionable.\footnote{De Beer Abrasive Products Ltd v. International General Electric Co. of New York Ltd [1975] 1 WLR 972.}

Thirdly, sometimes a half-truth statement may also be an actionable deceit. For example, in Nottinghamshire Patent Brick and Tile Co v. Butler,\footnote{(1866) 16 QBD 778.} the buyer asked the seller’s solicitor whether the land on sale was under any restrictive covenants, to which the solicitor replied that he was not aware of any. The court held that this was a misrepresentation. Although the statement was true, in that the solicitor was indeed not aware of any such covenants, this was because he had not troubled to look. (Roger 2001, 33) Thus, a half-truth statement is still actionable if it is misleading.

2.3. Losses

To sue in the action of deceit, the claimant should prove that he suffered the loss as a result of replying on the defendant’s misrepresentation. If no loss is sustained, he cannot sue for the deceit. Damages in the action of deceit are awarded to compensate the representee’s loss resulting from relying on the misrepresentation made by the representor. Because the cause of action for this claim lies in tort law, the recoverable loss is measured in the light of the general principles of damages measurement in tort law. The basic principle of tortious damage is \textit{restitutio in integrum}, which simply means restoration to the previous condition or the status quo. Therefore, damages for fraudulent misrepresentation will generally be designed to compensate the representee for the loss which he has sustained by entering into the contract, using financial compensation to restore him to the position which he would have occupied had no contract been made in reliance on the misrepresentation. But it is also possible that the court will avoid punitive damages to the claimant. Therefore, in the action of deceit the claimant may receive more than the loss which he suffered. This paper does not aim to discuss the measurement of damages and its economic features. Readers who are interested in this topic can refer to Zhou (2007).

2.4. Causation

Besides the three legal requirements outlined above, there must be a causal link between the
loss which the claimant suffered and the misrepresentation which the defendant made. The question which the court asks is whether the representee would have acted as he did, had the representation not been made. If he would not have done so, the necessary causation is established.\textsuperscript{14} It does not matter whether the representee would have acted in the same way if he had been told the truth.\textsuperscript{15} For instance, in \textit{Downs v. Chappell}, the plaintiff was induced to purchase the defendant’s business by a fraudulent misrepresentation. He then sued for damages on the ground of deceit. At the trial, the judge concluded that causation was not established, because the plaintiff would still have completed the purchase had the true information been disclosed. The plaintiff appealed and the appeal judge, Lord Hobhouse, quashed the judgment of the trial court, stating that:

“The judge was wrong to ask how they [the plaintiffs] would have acted if they had been told the truth. They were never told the truth. They were told lies in order to induce them to enter into the contract. The lies were material and successful; they induced the plaintiffs to act to their detriment and contract with Mr Chappell [the defendant]. The judge should have concluded that the plaintiffs had proved their case on causation.”\textsuperscript{16}

Moreover, the misrepresentation need not be the sole or even the predominant cause of the decision to contract,\textsuperscript{17} which is generally motivated by a range of factors. As long as the misrepresentation is one of them, the causation is established. It suffices that the state of the representee’s mind was disturbed by the misrepresentation and such disturbance was a partial cause of what he did.\textsuperscript{18}

When deciding whether the representee relied on the misrepresentation, the court will take a subjective rather than an objective one, by asking whether the representee actually relied on the statement, not whether it was reasonable for him to rely on it. Although reasonable reliance is a relevant issue in the tort of negligent misrepresentation, an action of deceit is sustained only if the representee actually relied on the representor’s statement. (Cartwright 2002, 46)

Finally, the burden of proof has shifted from the representee to the representor. In other words, rather than the representee having to prove his reliance on the representation, it is the representor’s duty to demonstrate that the representee did not rely upon the misrepresentation. If he fails to do so, the law will assume that the representee was indeed induced by the misrepresentation.\textsuperscript{19}

3. Economic Functions of the Legal Standard

The legal standard for deceit comprises a range of criteria which are explicitly designed by the law to determine in what circumstance the representee is entitled to damages in the action of deceit. It may perform three economic functions.

First, it could enhance the efficiency of private legal remedy by demarcating the scope of deceit.

\textsuperscript{14} \textit{Holmes v. Jones} (1907) 4 CLR 1962.
\textsuperscript{15} \textit{Downs v. Chappell} [1997] 1 WLR 426.
\textsuperscript{16} Ibid, 433.
\textsuperscript{17} \textit{Attwood v. Small} (1838) 6 Cl. & Fin. 232 at 502; \textit{Smith v. Kay} (1859) 7 H.L.C. 750, 775-776.
\textsuperscript{18} \textit{Edgington v. Fitzmaurice} (1885) 29 Ch D 459.
\textsuperscript{19} \textit{Smith v. Chadwick} (1884) AC 187, 196.
In the action of deceit, the court sometimes grants the claimant compensation greater than the actual loss which he suffered, making the representee much better off if he can establish a claim of fraudulent rather than non-fraudulent misrepresentation. (Zhou 2007, 92) Appropriate design of legal standards can correctly distinguish those misrepresentations which are made fraudulently and those which are not, thereby guiding courts in applying legal remedies accurately.

From an economic perspective, the imposition of severe private legal sanctions on a fraudulent representor can be justified as strengthening legal deterrence. It is generally assumed that the law should create a higher level of deterrence for fraudulent misrepresentation, because fraudulent representors are more culpable than non-fraudulent ones. Compared to non-fraudulent misrepresentation, the probability of the representee being misled is higher in the case of fraudulent misrepresentation. As Landes and Posner have argued, when a person intends to inflict an injury, he is more likely to inflict it than when the injury occurs as a by-product of some other activity. (Landes and Posner 1981, 129)

In addition, a fraudulent misrepresentation is an intentional action which requires the representor to invest deliberately in it. (Posner 2003, 111) Any resource used in making the fraudulent misrepresentation is wasted from the standpoint of society as a whole. (Zhou 2007, 87) By contrast, there is no such cost associated with a non-fraudulent misrepresentation. A severe private legal remedy could create a disincentive for parties to devote resources to social waste.

The second economic function of the legal standard is to improve legal deterrence. The probability of private legal enforcement is lower in the case of fraudulent misrepresentation. (Landes and Posner 1981) The deterrent effect of private law relies on the representee to bring an action against the representor, but there are many negative factors which discourage representees from suing, e.g. high litigation costs and judicial errors. In reality, many representees choose to abstain from suing the representor, so remain uncompensated. This makes legal enforcement imperfect.

Furthermore, if the representor intends to mislead the representee, he will try to avoid the discovery by the representee of his fraud. Compared with a non-fraudulent misrepresentation, it is hard for the representee to discover the misrepresentation in order to sue the representor. Consequently, this will raise the cost of litigation to the representee, thereby undermining legal deterrence.

The legal standard can be used to enhance private legal enforcement by adjusting the legal requirements for deceit. In order to establish an action of deceit, the representee must show the court that the misrepresentation meets all of the conditions prescribed by the law. The easier these conditions, the higher the probability that the representee will win the case. It can be assumed that there is an inverse correlation between the legal standard and the probability of legal enforcement. Therefore, the likelihood of legal enforcement can be improved by lowering the legal standard. An increased probability of legal enforcement will raise the representee’s ex ante compensation recoverable, thus stimulating him to bring the action. As a result, legal deterrence will be enhanced. (Craswell 1999, 2185; Landes and Posner 1974, 15)

Thirdly, the legal standard may be designed to minimize the social costs arising from both fraudulent misrepresentations and the use of legal remedy. An inappropriate adjustment to the legal standard could affect the various types of cost.

In the first place, setting the legal standard inappropriately low will encourage frivolous litigation. Undoubtedly, no legal standard can in practice distinguish perfectly between fraudulent
and non-fraudulent misrepresentation. If the legal standard is set very low, the cost to the representee of litigation will decrease. Some representees in non-fraudulent cases may gamble on litigation in the hope that the court will misperceive the representation as fraudulent and award higher compensation than it would otherwise have done. Not only do administrative cost rise as a consequence, but the resources used for pursuing such litigation are also wasted.

Conversely, if the legal standard is set inappropriately high, there is a risk that it will undermine legal deterrence. A high legal standard indicates a low probability of legal enforcement; it increases the representee’s litigation cost and lowers the representor’s liability cost. As a result, the representor’s ex ante profit from the fraudulent misrepresentation rises, while the representee’s ex ante profit from the litigation is reduced. Therefore, an inappropriately high legal standard not only increases the incentive to fraudulent misrepresentation, but also reduces the probability of legal enforcement.

Finally, the cost of judicial error is also positively correlated with the complexity of the legal standard. A complex legal standard requires the judge to consider more factors, so the more complicated the standard, the higher the probability of judicial error and thus the greater the error costs. Therefore, the legal standard could also be designed explicitly to reduce judicial error costs by simplifying its rules.

4. Economic Analysis of Legal Definition of Intention to Deceive

The representor’s intention to deceive is a necessary condition for the action of deceit. The intention is found if the representee can prove two facts: first, the false representation has been made knowingly or recklessly; second, the representor intended to induce the representee to rely on his misrepresentation. Furthermore, to decide whether the representor has the intention to deceive, the court will take the subjective test. The representor is held to have been fraudulent, only if it can be shown that he actually knew the falsity, or was reckless as to the truth, of the statement. It is irrelevant what a reasonable person in the position of the representor would have believed.

The economic function of the requirement of intention to deceive is to distinguish fraudulent from non-fraudulent misrepresentations in order for the court to apply correctly the rules of damages measurement in the action of deceit. From a legal perspective, fraudulent misrepresentation is a type of intentional tort. Therefore, the economic theory of intentional tort is a good starting point for our analysis. (Ellis 1983; Epsten 1975; Klevorick 1985; Ayres and Klass 2005)

4.1. Economic Interpretation of Intentional Tort

In their influential paper, “An Economic Theory of Intentional Torts”, Landes and Posner propose three economic interpretations of intentional torts. (Landes and Posner 1981) First, if the

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20 Note 6 above, 376.
probability of injury caused by the injurer is very high, the behaviour should be treated as an intentional tort, because in general circumstances, harm is more likely to occur if a person deliberately inflicts an injury than as a by-product of some other activity. (Landes and Posner 1981, 129) Second, if the costs to the injurer of avoiding the injury are negative, the behaviour should also be treated as an intentional tort, because it is implied that the injurer deliberately spent the resource on pursuing the injury. (Landes and Posner 1981, 139) Third, behaviour should be treated as an intentional tort if the costs to the injurer of avoiding the injury are trivial relative to the expected accident costs. A typical example is where a driver decides to close his eyes in order to rest them, while driving down a busy street. The cost of keeping his eyes open is trivial, while the expected cost of an accident arising from closing them is very great. The law usually uses the term “reckless” to describe this kind of intentional tort. (Landes and Posner 1981, 133)

4.2. Its Application to the Legal Definition

Obviously, the first definition proposed by Landes and Posner is an incorrect description of the English legal definition of deceit, since it is clear that the court cannot observe the state of the representor’s mind, but has to infer his intention from his behaviour. The high probability of misleading the representee does to some extent indicate the representor’s intention to deceive, but it merely has an evidential function. It is an issue of fact, not of the law.

In addition, this definition has a significant shortcoming. If it were adopted as the legal definition, many fraudulent representors would escape legal liability, with the consequence that legal deterrence would be weakened. This would be true in a case where the representor’s profit from the fraud was very great, but the probability of obtaining the profit was very low. For instance, if A spent £100 on a fraud to mislead B, he would possibly gain £10,000,000. But the probability of B being misled was 1/10,000. The ex ante profit to A would be £1,000 (£10,000,000 \times 1/10,000= £1,000), which is clearly more than the cost of making the misrepresentation, £100. Therefore, A would have a sufficient incentive to deceive. According to this economic definition, a misrepresentation would be regarded as fraudulent, only if the probability of the representee being misled were very high; but in this example the misrepresentation has a low probability of misleading, so it would be more likely to be excluded from the scope of deceit. Thus, adoption of this economic definition would undermine the deterrence of private legal remedy.

As the intention to deceive in English law is defined as the representor knowing of the falsity of the statement or being reckless as to its truth, it may be said that the second definition proposed by Posner and Landes is by and large a fair description of English law. The main difference between a fraudulent and a non-fraudulent misrepresentation is that the cost of making the former is positive. If the representor intends to mislead the representee by investing in a fraud, he must know of the falsity of the statement in the first place. Logically, the representor’s knowledge of the falsity is a necessary condition for the fraudulent misrepresentation. Therefore, as long as it is found that the statement is false and that the cost of making the misrepresentation is positive, it can be confidently said that the representor has the intention to deceive.

If the court has perfect information as to the cost to the representor of making the misrepresentation, the second definition proposed by Landes and Posner can contribute to an improvement in legal deterrence by defining the broad scope of deceit. However, because of
information asymmetry, the court is unlikely to be able to observe this cost; the second definition seems thus to be unfeasible in practice.

In addition, this definition could generate high administrative costs. We have seen in Section 3 that inappropriate design of the legal standard can raise the cost of using the legal rule. Independently of determining which misrepresentations are deceits, the legal standard should also aim to reduce the various types of cost associated with the private legal remedy. In other words, the economic efficiency argument would suggest that the legal standard should exclude a misrepresentation from the scope of deceit if the social cost generated by it would be outweighed by the administrative cost generated by the potential litigation.

From the perspective of cost minimization, it seems that the second definition proposed by Landes and Posner broadens the scope of deceit excessively. According to this definition, a misrepresentation will be held as an actionable deceit as long as the cost of making the misrepresentation is positive, no account being taken of the potential administrative cost. It follows that the scope of actionable fraudulent misrepresentation under this definition would be broader than the socially optimal scope. Broadening the scope of deceit would tend to raise the number of actionable cases, which would drive up the overall administrative cost.

In fact, the problem of administrative cost is much more severe under current English law, because the scope of deceit is even broader than that of the second definition proposed by Posner and Landes. In English law, a party is held as fraudulent if he knows of the falsity of the statement. The representor’s knowledge of falsity is not necessarily followed by intentional investment in a false statement. If a representor knows that the representee’s belief in his statement is incorrect and remains silent, his state of mind meets the requirement in English law for the intention to deceive, but it does not qualify as an intentional tort in accordance with Posner and Landes’ second definition. This is because his silence does not incur the positive cost of making a fraudulent misrepresentation, so the cost to the representor of avoiding the representee’s loss is not negative, but nil. By contrast, in English law some non-disclosure behaviours may also be treated as fraudulent misrepresentation.22 Compared to Landes and Posner’s proposition, the current legal definition of fraud generates a higher administrative cost, because more misrepresentations can qualify as deceit.

The problem identified above can be ameliorated by another requirement in the legal definition of intention to deceive: the representor must intend the representee to act on the representation in the manner which resulted in damage to him.23 Under the current law, if A intended to mislead only B, and C suffered a loss from contracting with A by relying on the misrepresentation, C could not sue A in the action of deceit. This requirement narrows the scope of deceit by preventing the group of potential representees like C from bringing frivolous litigations. Accordingly, the administrative costs of these litigations are saved.

At first glance, it seems that this requirement undermines legal deterrence. A narrow scope of deceit creates a disincentive for representees to sue. Thus, it may reduce the probability of private legal enforcement, which would then increase the representor’s ex ante profit from the fraud. However, the truth is that narrowing the scope of actionable fraudulent misrepresentation in this way does not have such a negative effect on legal deterrence. If the misled person is not the one whom the representor intends to induce, any profit derived from the contract with him is an

22 Brownlie v. Campbell (1880) 5 AC 925, 950.
unexpected gain to the representor and will not be taken into account in his ex ante cost-benefit appraisal. Therefore, the representor’s incentive to deceive is unaffected.

The intention to deceive can also be found if the representor is reckless as to the truth of his statement. Landes and Posner argue that the legal definition of recklessness is captured by their third economic interpretation of intentional tort. (Landes and Posner 1981, 133) The classical example of the reckless representor is one who fails to disclose the false element in a statement he has made when realising it later. From an economic perspective, a reckless misrepresentation differs from an intentional misrepresentation in that the maker does not deliberately invest in making the misrepresentation. Although he still intends to mislead the representee, he does not do this by wasting resources in the fraud, but by making use of changes in external circumstances. In this sense, the cost of making the fraudulent misrepresentation is nil in a case where the misrepresentation results from the representor’s recklessness. Two questions then arise: why should the law not regard the reckless behaviour as negligence, and what is the economic justification for the law to regard the reckless mind as an intention to deceive?

As noted in Section 2, the principal difference in the law of damages between a fraudulent and a non-fraudulent misrepresentation is that exemplary damages may be awarded in the former case. From an economic perspective, qualifying the representor’s reckless behaviour as a deceit is also justified by the need for the application of exemplary damages in the case of public misrepresentation. (Landes and Posner 1981, 136)

Sometimes, although it is very costly for the representor to correct his earlier misrepresentation, the cost of correction is still very small compared to the cost generated by the misrepresentation. However, because of the high cost of correction, a rational representor might intentionally abstain from correcting the misrepresentation, preferring to wait to pay damages when sued. This situation normally arises when the misrepresentation was made publicly. For example, a pharmaceutical company invented a new drug and no serious side-effect was found. The medicine was then advertised and sold in the market. Afterwards, a scientist employed by the company accidentally found that the drug might cause serious damage to the liver. Let us assume that it costs £5,000 for a customer to cure the harm to his liver resulting from taking the new medicine. If 1,000 persons suffer such harm by taking the medicine, the total cost of the company’s misrepresentation is five million pounds. The cost to the company of disclosing the side-effects to the public via the media is one million pounds. From a social point of view it is efficient for the company to disclose. However, only 1 in 10 patients will realise that their liver damage was caused by taking the new medicine and sue the company, so the potential damages paid by the company are £500,000. Thus, from the company’s standpoint, it is rational to abstain from disclosure and instead to pay damages when sued. Apparently, normal damages cannot effectively induce the company to correct its misrepresentation; exemplary damages are necessary. Qualifying the representor’s reckless behaviour as a deceit can make the application of exemplary damages possible, thereby creating an incentive for the representor to correct the public misrepresentation. It should be noted that in such a situation, criminal law or regulation could play a better deterrence role than private law. But one should by no means underestimate the deterrence function of exemplary damages. (Cooter 1982; Chapman and Trebilcok 1989; Abraham and Jeffries 1989; Schwartz 1982)

Moreover, it can be justified on the ground of saving administrative costs. It has been generally agreed among scholars of law and economics that observing and proving the actor’s state of mind is notoriously difficult and costly. In general circumstances, if the representor fails to disclose the
false element in an earlier statement when realising it later, it can be confidently said that he intends to mislead the representee, but it is difficult for both the representee and the court to decide whether the representor actually knew of the falsity when making the statement. By contrast, it appears to be easier for them to observe whether the representor was reckless as to the truth of his statement. Failure to disclose, by itself, is strong evidence of the representor’s fraudulent mind. It could be said that the requirement of accuracy in observing the representor’s recklessness is lower than that for observing his actual knowledge of falsity, so the resources and efforts devoted to determining the former are also relatively low. Regarding the reckless mind as proving an intention to deceive can save the administrative cost to the court of observing the representor’s state of mind.

4.3. Subjective Test and Judicial Error

In English law, the test of intention to deceive is subjective rather than objective. In other words, when determining whether the representor had the intention to deceive, the court will consider what the representor actually believed at the time of making the statement, rather than what a reasonable person would have believed in the position of the representor. To see the economic features of the subjective test of fraud, we need to consider it in relation to human cognitive limitations. (Ulen 1989; Noll and Krier 1990)

The subjective test shifts the risk of misrepresentation from the representor to the representee. It is less burdensome to the representor, so compared to the objective test, the negative effect on the representor’s incentive for transaction is relatively small. It is generally assumed that the objective test – the reasonable person standard – is an appropriate standard of behaviour which is accepted by the majority of people in that field. However, because of their differing educational backgrounds, people vary in their expertise. The contracting party may have sophisticated knowledge in one field, but know almost nothing in another. The objective test of fraud would increase the transaction cost to a representor who had relatively limited knowledge on the subject matter of the contract, thereby creating a disincentive for him to trade.

Assume, for example, that due to his lack of expertise, the seller made an honest misrepresentation as to the quality of the goods which would not have been made by a reasonable seller in the industry. His state of mind would not pass the objective test. This creates an incentive for him to take more care when making statements, because even if he honestly believes that the statement is true, he may still be held to be a fraudulent representor. More precaution indicates a lower \textit{ex ante} profit from the sale, which then undermines his incentive to make the contract. By contrast, under the subjective test, as long as he honestly believed that his statement was true, his representation would not be considered fraudulent. Therefore, he would not take the extra care which he would take if the objective test were applied. Under the subjective test, his \textit{ex ante} payoff from the sale is higher, so he has a stronger incentive to trade.

For the opposite reason, the representee will take greater precautions against fraudulent misrepresentation under the subjective than the objective test. As a result, the subjective test creates a disincentive for him to contract.

The above discussion leads to another interesting question: to what extent does judicial error in determining the legal standard modify the behaviour of the contracting parties? In reality, the

\footnote{Note 22 above.}
occurrence of judicial error seems inevitable: evidence brought before the courts may be difficult to verify or subject to misinterpretation and judges themselves may misconstrue the law. (Polinsky and Shavell 1989, 99) The court may commit two types of error: “type I” errors, in which the truly fraudulent representor escapes from liability for deceit, and “type II” errors, in which the court finds a non-fraudulent representor liable. Therefore, we can assume a spectrum from type I at one extreme to type II at the other. The effect of judicial error on the parties’ incentive is dependent upon the relative frequency with which the court makes each type of error. (Calfee and Craswell 1986, 287)

On one hand, if the court more frequently commits type I errors, two effects on the parties’ incentive can be predicted. First, it will create an incentive for representors to make fraudulent misrepresentations. Type I error decreases the probability of legal enforcement, which then increases the representor’s ex ante profit. The profit from the fraud, by itself, creates an incentive for the representor to deceive. In this sense, type I error will undermine the legal deterrence for fraudulent misrepresentation. (Craswell and Calfee 1986, 287) Secondly, it could induce the representee to take precautions which he would not take if he did not expect the court to commit an error. Type I error increases the probability of the representee being uncompensated. If the extra precautionary cost is outweighed by the incremental damages uncompensated due to the judicial error, the representee will take the extra precaution. The side-effect is that if the extra precautionary cost exceeds the uncompensated damages, the representee will abstain from making the contract. (Craswell and Calfee 1986, 286) This indicates that type I error could create a disincentive for representees to trade.

On the other hand, if the court frequently commits type II errors, for the reason discussed above, the representor will over-comply by taking extra precautions. Therefore, type II errors undermine the representor’s incentive to trade. More interesting, but less obvious, is that type II errors also have a negative effect on legal deterrence by creating a positive probability that non-fraudulent representors will be found liable for deceit, thus reducing the reward for abstaining from fraud, which could in turn encourage some non-fraudulent representors to deceive. (Polinsky and Shavell, 105)

5. Economic Analysis of Legal Definition of False Statement

5.1. Misrepresentation of Opinion

In an action of deceit, there is no difference between misrepresentation of fact and of opinion. Once the causation between the false statement and the representee’s losses is established, the action will be sustained. As for the purpose of improving legal deterrence, there is no need to distinguish misrepresentation of fact from that of opinion.

However, it seems to be more difficult to regulate misrepresentations of opinion. Economists normally divide information into verifiable and unverifiable. Verifiable information can be both observed and verified not only by the holder of the information, but also by others. Unverifiable information can be observed by both, but verified only by the holder. (Bair, Gertner and Picker 1983, 53) A misrepresentation of fact concerns a piece of verifiable information; it is a statement
of existing fact whose falsity can be verified both by the representee and by the court. In contrast, a misrepresentation of opinion may be either verifiable or unverifiable. Take *East v Maurer*\(^{25}\) as an example. An owner of a hairdressing salon induced another to purchase his business by falsely promising that he would not compete with him in the same area in future. In fact, he continued to work full time in the area.\(^{26}\) His statement was a misrepresentation of opinion, but verifiable: the court was able to verify the statement by reference to his later behaviour. Conversely, in *Bisset v. Wilkinson*,\(^{27}\) an owner induced another to purchase his land by stating that the land would have the capacity to support 2000 sheep if only one team were employed in the agricultural working of the land. The buyer subsequently found the seller’s statement to be false. If the seller knew this when making it, he made a misrepresentation of opinion, but it cannot be verified whether the seller honestly believed that his statement was true when making it. In fact, the buyer in this case failed in his claim because the court was convinced by the seller that the statement was only as to his personal judgement and was made honestly, but it is possible that the seller knew of the true capacity of the land and lied to the buyer. The seller’s state of mind is entirely unverifiable.

If a misrepresentation of opinion turns on a piece of unverifiable information, this poses the problem of uncertainty. The court may commit judicial errors in relation to such information. In addition, the insufficiency of relevant information requires the court to devote more resources and effort to determining the representor’s state of mind by observing other factors. Therefore, it could be assumed that both error cost and administrative cost would be high.

Furthermore, the unverifiable nature of misrepresentation of opinion may also pose the famous “market for lemons” problem. (Akerlof 1970) Since the representee cannot distinguish an honest representor from a dishonest one, he may decide his willingness to pay on the basis of the average probability of trading with honest and dishonest representors, in which case his willingness to pay would be lower than if there were only honest representors. Consequently, the honest representor’s cost of telling the truth cannot be covered by the contract price. In the long term, all honest representors would be driven from the market. They would keep silence rather than giving an honest opinion.

Another problem with regulating misrepresentation of opinion is that the representor is more likely to misrepresent opinions than facts, because the cost of misrepresenting an opinion is relatively low. For instance, a misrepresentation of previous profits can be discovered easily by reading the account books of the business. Thus, to successfully mislead the representee by a misrepresentation of fact, the representor may need to invest in modifying or concealing the existing evidence, e.g. falsifying the accounts. But if the representor intentionally misrepresents his own opinion on the future profit, he need make no such investment. Therefore, it seems to be more difficult to deter the misrepresentation of opinion.

Given the difficulties outlined above, it seems that although a misrepresentation of opinion can qualify as an actionable deceit, the effectiveness of legal deterrence for fraudulent misrepresentations of opinion is in practice very doubtful.

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\(^{26}\) Ibid.
\(^{27}\) [1927] AC 177, Privy Council.
5.2. Sales Talk

From an economic perspective, sales talk or puffery is defined as a type of persuasive speech by a seller which aims to achieve its consumption-inciting effect not through the conveyance of facts, but instead through an emotional appeal or in some similar way. (Coase 1977, 8) Sales talk might help sellers to create false stories about the properties of their products, convincing buyers to buy when they would not otherwise do so, by causing them to believe that the puffed goods need no further investigation. (Hoffman 2006)

If buyers do not rely on sales talk, no legal intervention is needed. In the first place, if listeners to sales talk are sceptical and do not rely on it when deciding whether to enter into a contract, nobody will be misled. Second, in the long term, sales talk will be washed out by efficient markets. Over time, buyers will come to disbelieve puffery and puffing sellers will thereby lose the incentive to invest in sales talk.

The key issue is how to decide the reliance of the representee. In English law, an action of deceit cannot be sustained if a statement is regarded as sales talk or puffing the product – a reasonable person would not take it seriously and so rely on it. The court sets an objective rather than subjective test by asking the question whether, after considering all of the relevant facts, a reasonable person would take the sales talk seriously and rely on it. This approach seems to be problematic. The research in behavioural law and economics has already been pointed out the bounded rationality of human beings. People usually have a bias towards optimism, which encourages the belief that good things are more likely than average to happen and that bad things are less likely than average to happen. (Korobkin and Ulen 2000, 1091) This bias not only encourages sellers to make sales talk, but also induces buyers irrationally to rely on it. If a buyer is less rational than a reasonable buyer in his position, the seller’s false statement may be treated as sales talk and no remedy will be awarded. Therefore, the objective test for the representee’s reliance may leave some less rational representees without legal remedy when they have been misled by a representor’s false statement. Furthermore, it encourages representors to address misleading sales talk to those representees who are the least sophisticated and most vulnerable.

6. Economic Analysis of Causation

As outlined in Section 2, apart from being required to show the court that the representor had the intention to deceive and actually made a false statement, the representee, to establish an action of deceit, must also prove that there is a causal relation between the damage which he has suffered and the misrepresentation. In other words, he must show that this damage resulted totally or partially from his reliance on the misrepresentation.

If the objective of the law of fraudulent misrepresentation were merely to create effective deterrence, there would be no need to for the requirement of causation. Arguably, the legal deterrence would be more effective if the law provided that anyone could sue a representor who had made a fraudulent misrepresentation. Such a rule would not only improve the probability of legal enforcement, but also increase the potential liability cost to the fraudulent representor. (Calabresi 1975; Shavell 1980; Burrows 1999 Young, Faure and Fenn 2004; Singh 2007; Landes
and Posner 1983; Wright 1985) Therefore, the requirement of causation must serve an economic function other than improving deterrence. (Calabresi 1975, 69-108)

The first function of causation is to reduce administrative costs. (Shavell 1980, 465) Without the requirement of causation, the legal standard for fraudulent misrepresentation would generate a high administrative cost. By contrast, including the causation element in the legal standard can maintain the same level of deterrence at a lower administrative cost. To illustrate, consider the following example.

Assume that the law provides that if a person makes a fraudulent misrepresentation, any person contracting with him can sue him for damages which he has suffered in relation to the contract with the fraudulent representor. There is no need to prove that the loss was caused by his reliance on the misrepresentation. Such a rule does not include the element of causation in the legal standard. Now let us consider how this rule would affect the administrative cost. Assume further that if the seller, A, spends £50 on the fraud, he can charge the buyer, B, £100 more for the goods. Therefore, B would suffer a loss of £100 as a result of relying on A's fraud. Now, a second buyer, C, also makes a contract to buy the same goods from A and also sustains a loss of £100, but his loss is attributable to a reason other than A's fraud. It is clear that A would have sufficient incentive to invest in the fraud, no matter whether it would mislead C, because he can always make a profit of £50 (£100-£50) by misleading B. Let us now make three other assumptions: (1) A's fraud incurs only one type of social cost – the cost of making the fraudulent misrepresentation, which is £50; (2) legal enforcement is perfect; (3) the administrative cost is £30 per actionable claim.

In this scenario, if the law allowed both B and C to sue A, the total administrative costs would be £60 (£30 + £30 = £60). But the social costs incurred by A's fraudulent misrepresentation were only £50, so such a legal rule would be inefficient. However, if the law allowed only B to sue A, the administrative costs would be £30. More importantly, A's fraud could also be deterred effectively, because A would receive a negative payoff from the misrepresentation after compensating B. This example shows that the requirement of causation in the legal standard could narrow the scope of deceit, thereby reducing the administrative cost without undermining legal deterrence. However, if the administrative cost per actionable claim is assumed to be same, the claim of either B or C could effectively deter A's fraud, raising the question of why the law should confer the right to sue on B rather than C. The search for the answer to this question leads us to the second economic function of causation – avoiding the inefficient allocation of legal entitlement.

If the law allowed C rather than B to sue A, it would create an undesirable incentive for C. In fact, C's loss was not caused by relying on A's misrepresentation. Therefore, there were two possible causes, the first being an unforeseeable contingency, e.g. a fire; second, the loss might be caused by a third party’s behaviour, e.g. negligence by C's employee leading to the loss or destruction of the goods. If C’s loss was incurred by the first cause, from the economic perspective, in dealing with foreseeable contingency, the law should find the least-cost insurer to bear the loss in order to create an incentive for him to take insurance against the risk. (Posner and Rosenfield 1977) In our example, compared to both A and B, C can be assumed to be the least-cost insurer, because he knows more of his own situation and potential risks than others. If the law made A liable for C’s loss, C’s incentive to take precautions would be weakened or eliminated.(Cooter 1985) This result would be inefficient. By the same token, if C’s loss was incurred by third-party behaviour, making A liable would also be inefficient, because it would
encourage the third party’s negligence. Therefore, the requirement of causation can prevent the inefficient allocation of legal entitlement.

7. Representee’s Incentive for Precaution

If the claimant could be compensated perfectly for his loss resulted from replying other the defendant misrepresentation, he would take no precaution. However, because both private legal enforcement and compensation is far from perfect, the representee always has an incentive to take care against misrepresentation. This raises two questions: first, if the representee can receive perfect compensation, according to the damages rules in tort law, for the loss generated by the fraudulent misrepresentation, does he still have an incentive to invest in precaution? Second, if the answer to the first question is positive, what level of precaution will the representee take under the English law of deceit?

The answer to the first question is positive. As damages in tort law are intended to compensate only for the difference between the contract price and the true market value of the goods, rather than that between the contract price and the representee’s expectation value of the goods, the damages received by the representee will always fall short of his expectation value. Therefore, the representee will always have an incentive to take precaution.

Turning to the second question, the answer depends upon whether there is a correlation between the precautionary cost and the representee’s private loss. Economists normally assume that a rational person will take an optimal level of precaution against any undesirable contingency in the future. (Cooter 1985, 3) In other words, the person will invest in precaution up to the level where the marginal precautionary cost is just equal to the marginal losses incurred by that contingency.

The validity of the above argument is dependent upon the condition that there is a negative correlation at a marginal rate between the precautionary cost and the cost of fraudulent misrepresentation. A marginal increase in the former leads to a marginal decrease in the latter. If this condition cannot be held, the optimal precaution model is no longer a correct generalization of individuals’ precautionary behaviour. In other words, if the loss to the representee generated by the fraudulent misrepresentation does not vary with his precautionary cost, the actual level of precaution taken by the representee will not be the same as that predicted by the optimal precaution model.

To illustrate, take the following example. The seller of a used car lies to the buyer in stating that the engine of the car has no latent defects, which can only be discovered by the examination of an expert to whom the buyer would have to pay at least £50 for this inspection. If the buyer discovers the seller’s misrepresentation, he will not enter into the contract; if he remains ignorant of it and does enter the contract, he will suffer a loss of £1,000, assessed as the difference between the true value of the car and his expectation value of it. Therefore, whether the seller’s fraudulent misrepresentation inflicts a loss on the buyer will depend on whether the buyer remains ignorant and contracts with him or learns of the lie and refrains. Let us say that the cost of inspection by the buyer himself is £10, which might be calculated as the opportunity cost of the time and effort expended in making the inspection. However, this £10 precaution cost will not reduce the buyer’s loss incurred by the misrepresentation, because he does not have the expert knowledge and skill required to discover the defect. Thus, the increase in the marginal precaution cost from nil to ten
pounds will not reduce his private losses from the seller’s fraud. Indeed, no precaution expenditure less than £50 would reduce the buyer’s loss, while any above £50 is unnecessary. Therefore, in this case, the marginal calculation is unnecessary: the rational representee will calculate the total precaution cost against the loss resulting from relying on the misrepresentation.

The representee will take a certain precaution only if the precautionary cost which can effectively verify the statement made by the representor is outweighed by his ex ante loss, which is measured as his potential loss resulting from a misrepresentation, discounted by the possibility of that representation being false. Recall our example above. If the buyer believes that there is a 1/200 chance that the seller would make a fraudulent misrepresentation, his ex ante loss is £50 (£1000 × 1/200 = £50), so his precautionary cost is just equal to his ex ante loss. He cannot make any profit by taking that precaution. In this case, the buyer will do so only if he assesses the possibility of the seller’s statement being a fraudulent misrepresentation as exceeding 1/200.

To sum up, the representee will have the incentive to take precautions against fraudulent misrepresentation; therefore, the precautionary cost is always positive. In addition, we can make two predictions as to the representee’s precautionary behaviour. First, the representee can be assumed to take the optimal precaution if his private loss has a marginally inverse correlation with the precautionary cost. Second, if it is not, the representee takes the precaution only when the precautionary cost is outweighed by his ex ante loss.

7. Conclusion

In this paper, I sought to illustrate the economic functions of legal standard by applying the economic analytical framework to the study of English law of deceit. After the brief review of the law presented in Section 2, I have shown, in Section 3, that the legal standard for the deceit can serve three economic functions: (1) to improve efficiency of legal remedy; (2) to improve the legal deterrence of fraud; and (3) to minimize the costs of using legal system. And then I developed a critical evaluation of each legal requirement in English law. Finally, I examined how the legal rule changes the representee’s incentive to take precaution. It is found that despite far from perfect, the legal standard for a deceit in English tort law does perform the three economic functions outlined in the section 3. In addition, under the current law, even if the representee could receive a perfect compensation, he would still have an incentive to take precautions against the expectation loss.

References:

**Legal Studies, 13, 399.**


