

# GOOD FAITH DISCLOSURES REQUIRED DURING PRECONTRACTUAL NEGOTIATIONS

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"[T]he process . . . is not discovery, but creation; . . . the doubts and misgivings . . . are . . . part of the travail of mind, . . . in which principles that have served their day expire, and new principles are born."<sup>1</sup>

## I. PREFACE

All of us, lawyers and nonlawyers, are exposed to situations where good faith and fair dealing are at issue. The question addressed in this Article involves the extent to which the province of ethics becomes co-extensive with the mandates of law. Drawing this line is particularly troublesome when good faith disclosures during the formation of a contract are the issue. I had a revealing experience some years ago. At the negotiation table with American counterparts, in the sale of a business, statements were made to me that were inconsistent with my understanding of the law as a civil lawyer. Wall Street lawyers of world fame, echoed by their clients, told me that good faith disclosures during negotiations are not required in the world of sophisticated businessmen during negotiations in the United States. The concept of good faith, they conceded, was not unknown, but its application was limited to the phase of contract performance. During contract negotiations, neither good faith dealing nor good faith disclosures was required, and everyone was free to take advantage of the ignorance or misperceptions of another, no matter how unfair or unethical, except

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\*\* Editor's note. Citation in the Appendix conforms to Italian and German rules of citation, rather than to The Bluebook.

<sup>1</sup> BENJAMIN N. CARDOZO, *THE NATURE OF THE JUDICIAL PROCESS*, 166-67 (1921).

in the context of a special relationship where the parties repose trust and confidence in each other (as, for instance, in a fiduciary relation), which usually does not apply to arm's length business transactions. Moreover, I was told, even cases of outright fraud lead to no liability where one negates reliance with a skillfully drafted integration or disclaimer clause.

Much of my background is in the law system of Italy. After graduating from the University of Bologna, I practiced law in Milan for many years. Although I subsequently studied the common law of England, the notions of my original training in the law still permeate my mind, profoundly and indelibly. In Italian law, the precontractual duty of good faith is embodied in the law itself.<sup>2</sup> No Italian lawyer would ever think that the duty only applies to the phase of contractual performance. Although I was told by my American colleagues that caveat emptor still applied to arm's length transactions, and that an American judge would tell a plaintiff, who in the negotiation of a contract had been circumvented, that he should have been "more circumspect and astute," I could not believe that this was really true. In any event, it was not possible for me to adapt to this novel legal culture and, of necessity, I kept acting in accordance with the principles that I had been taught, which I knew had stood firm for many years, and which had so far guided my professional life.

The "American" approach as described to me was, I sensed, out of touch with today's reality of the law. I undertook an in depth research of the duty of good faith, and especially of good faith disclosures during contract negotiations, in the law of the United States. Upon closer scrutiny, I found that the developments which formed the basis of the doctrine of caveat emptor, and the historical context in which this doctrine took hold during the latter part of the nineteenth century, along with the establishment of a powerful and selfish industrial and merchant class, were also the doctrine's limitation. I discovered that recent political and social

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<sup>2</sup> See Articles 1337, 1338 *codice civile* (c.c.). In Italian law, the parties owe each other a duty of good faith in the negotiation and formation, as well as in the execution, of the contract, and they are obliged to disclose all material information of which they have actual or constructive knowledge. See Francesco Benatti, *Culpa in contrahendo*, in *CONTRATTO E IMPRESA*, 1987, 287, in particular at 296, 308. It has been noted that through the concept of good faith the rules of social fairness and of loyalty in business, which taken by themselves would be outside the field of both contract and torts, have entered into the legal order as sanctioned duties. Angelo DeMartini & Giovanni Ruoppolo, *RASSEGNA DI GIURISPRUDENZA SUL CODICE CIVILE*, IV.2, Milano 1972, at 177 with further references. See *infra*, Appendix, Notes on the Precontractual Duty of Good Faith in Italian Law.



developments, and a wealth of scholarly writing and judicial interest in the possibility of limiting (or eliminating) caveat emptor, were shaking the foundations of this widely accepted theoretical framework. More recent cases, which allegedly established the "predominant" authority of the "old" law of caveat emptor, merely turned out to recite the old precedents in summary form, thereby revealing serious weaknesses in their analyses. And I discovered a wealth of authorities that showed, in fact, that the old doctrines were being eroded, that the traditional analyses were being challenged, that more and more exceptions were being carved out from the old precedents, and that new avenues, where ethics have their place "even" in arm's length commercial transactions, were being pursued.

Some years have passed since my encounter described above. My learned colleagues continue to write opinions stating that there is no duty of good faith disclosures during contract negotiations in the law of the United States. I thus hope that by sharing the results of my research, and through fruitful discussion of my conclusions, this troublesome area of the law, and of life in society, may become clearer.

## II. INTRODUCTION

Good faith and fair dealing has been, from time immemorial, a fundamental commandment of social behavior. In many legal systems, where no distinction is made between good faith during negotiations<sup>3</sup> or contract performance, the law imposes the duty of good faith and fair dealing, irrespective of whether a contract exists. This is not so clear, however, in the law of the United States, where the requirements of precontractual good faith disclosures have been, and still are, the subject of much debate.

Traditionally, United States law has not required full disclosure of material facts between sophisticated parties to commercial transactions, including the sale of businesses, unless there is a contract or agreement to provide such information.<sup>4</sup> As Professor E.

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<sup>3</sup> The duty of good faith and fair dealing, when applied to contract negotiations, has at least two distinct applications: first, it has been used to determine what facts or information should be disclosed between the parties; and second, it may require parties to negotiate in a fair manner to consummate a final agreement. This Article deals with the issue of good faith disclosures. Although many American courts have recognized that contemporary notions of good faith and fair dealing dictate disclosure requirements during negotiations, the type and extent of these requirements have been reduced and expanded as understanding of good faith requirements has changed.

<sup>4</sup> See, e.g., *Market St. Assoc. Ltd. Partnership v. Frey*, 941 F.2d 588, 594, 595 (7th

Alan Farnsworth, perhaps the most pessimistic of commentators on the topic,<sup>5</sup> has noted, "the courts have had great difficulty in dealing with the extent to which candor, as distinguished from honesty, is required [in dealing with concealment or non-disclosure]."<sup>6</sup> Courts are generally reluctant to acknowledge and enforce a precontractual duty of candor among businessmen dealing at arm's length<sup>7</sup> primarily because of the doctrine of caveat emptor,<sup>8</sup> under which there is a presumption that the purchaser is capable of assessing, and ought to be responsible for investigating all information necessary to satisfy his own self-interests.

This Article rejects the position that there is no duty of disclosure in an arm's length business transaction. A careful analysis of the common law of disclosures reveals that, regardless of the contractual transaction involved, the unifying principle behind required disclosures is the dictate of good faith and fair dealing, the violation of which permits tort remedies.<sup>9</sup> A duty of good faith and fair dealing applies whether there is a contract or not, and therefore also applies to precontractual negotiations as well as to contract performance. This duty generally requires the seller of a business to disclose all material facts.<sup>10</sup> A party, however, will be

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Cir. 1991) (stating that the parties confront each other during the precontractual stage with a natural wariness thus calling for a "minimal" duty of good faith disclosure).

<sup>5</sup> Compare the views of Professor Farnsworth, who sees no reason to require disclosures beyond those agreed to by the parties, with those of Robert-Joseph Pothier, who believed that parties to a transaction must disclose all material facts. For a further examination of Farnsworth and Pothier's divergent views, see *infra* Section IV. F. 1 and 6.

<sup>6</sup> E. ALAN FARNSWORTH, *FARNSWORTH ON CONTRACTS* § 4.11 (1990).

<sup>7</sup> An "arm's length transaction" is one "negotiated by unrelated parties, each acting in his or her own self-interest." *BLACK'S LAW DICTIONARY* 109 (6th ed. 1990).

<sup>8</sup> *Black's Law Dictionary* defines caveat emptor as "[l]et the buyer beware" and explains that "[t]his maxim summarizes the rule that a purchaser must examine, judge, and test for himself." *Id.* at 222. The failure to require broader disclosure requirements is also based on the tort concept that mere nonfeasance is not actionable. William B. Goldfarb, *Fraud and Nondisclosure in the Vendor-Purchaser Relation*, 8 *WEST. RES. L. REV.* 5, 13 (1956); W. PAGE KEETON, ET AL., *PROSSER AND KEETON ON THE LAW OF TORTS* § 106, at 737 (5th ed. 1984).

<sup>9</sup> See *infra* Section IV. F. for a discussion of the duty of good faith as it relates to disclosures.

<sup>10</sup> A buyer of a business may also be under duty to make good faith disclosures. *But see* WILLIAM L. PROSSER, *HANDBOOK OF THE LAW OF TORTS* § 106, at 698 (4th ed. 1971) ("There seems to be no corresponding tendency in the case of special information in the hands of one who buys rather than sells. The buyer is permitted to reap the advantage which his industry in discovering the facts, and his business acumen, can bring him.") See also PROSSER AND KEETON, *supra* note 8, at § 106, at 739 ("It is much more likely that a seller will be required to disclose information than a purchaser . . .").

liable for a failure to disclose facts he is aware of only if the other elements of a tort for non-disclosure of facts are established.<sup>11</sup>

In arguing that parties involved in precontractual negotiations have a good faith duty to disclose, this Article does not mean to suggest that the parties ought to forego their own independent investigation of the facts. While such an investigation may impact on the duty of disclosure,<sup>12</sup> it is always advisable to be as informed as possible before entering any transaction.

Although the thesis of this Article, that businessmen owe each other a good faith duty of disclosure, seems foreclosed by some older cases dating from the landmark decision of *Laidlaw v. Organ*,<sup>13</sup> this Article examines the modern legal trends that support a heightened duty of good faith and fair dealing in precontractual negotiations. Such trends include the rise of the doctrine of good faith in the context of contract performance, the recognition that the duty of good faith and fair dealing is not limited solely to post-contractual dealings, the statutory use of the duty of good faith, the application of the doctrine of good faith as a duty imposed by law, the increasing application of ethics and morality in the law and the decline of caveat emptor doctrine.<sup>14</sup> Consistent with those trends, a modern movement toward requiring disclosure of all material facts can be discerned.<sup>15</sup>

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<sup>11</sup> See *infra* note 307 (discussing the elements of the tort of nondisclosure).

<sup>12</sup> See *infra* note 319 and accompanying text, for a discussion pertaining to independent investigations.

<sup>13</sup> 15 U.S. (2 Wheat.) 178 (1817). For a discussion of *Laidlaw*, see notes *infra* 183-98 and accompanying text.

<sup>14</sup> See *infra* Section III. C to H, for an extended discussion on the modern ascent of good faith and fair dealing.

<sup>15</sup> See, e.g., *Heineman v. S&S Machinery Corp.*, 750 F. Supp. 1179, 1186 (E.D.N.Y. 1990) (quoting WILLIAM L. PROSSER, *HANDBOOK OF THE LAW OF TORTS* § 106, at 698 (4th ed. 1971)) ("The law appears to be working toward the ultimate conclusion that full disclosure of all material facts must be made whenever elementary fair conduct demands it."); *Bethlahmy v. Bechtel*, 415 P.2d 698, 706 (Idaho 1966) (quoting W. Page Keeton, *Fraud-Concealment And Non-Disclosure*, 15 TEX. L. REV. 1, 31 (1937)) (noting that "courts have drawn away from the doctrine [of caveat emptor] in favor of a rule which would 'impose on parties to the transaction a duty to speak whenever justice, equity, and fair dealing demand it'"); Eric M. Holmes, *A Contextual Study Of Commercial Good Faith: Good-Faith Disclosure in Contract Formation*, 39 U. PITT. L. REV. 381, 452 (1978) (advocating that in the formation stage of a contract parties should exhibit good faith and fair conduct which translates into a duty to disclose material facts in good faith); Friedrich Kessler & Edith Fine, *Culpa in Contrahendo, Bargaining In Good Faith, And Freedom Of Contract: A Comparative Study*, 77 HARV. L. REV. 401, 444 (1964) (stating that the law is working toward "'full disclosure of all material facts . . . whenever elementary fair conduct demands it'") (quoting PROSSER, *TORTS* 535 (2d ed. 1955)); W. Page Keeton, *Fraud-Concealment And Non-disclosure*, 15 TEX. L. REV. 1, 31 (1936) (noting that courts have undergone a change in attitude towards non-disclo-

This Article surveys the law of disclosure and demonstrates that courts have added exceptions, over time, to the traditional rule that silence is not actionable. The addition of exceptions to the traditional rule permitting nondisclosures, along with the broadening of those exceptions, suggests that courts have become increasingly uncomfortable with caveat emptor. One of the most striking examples of this discomfort is the decision, by many courts, to abandon the requirement that a plaintiff perform an independent investigation before justifiable reliance on an omission or misrepresentation will be found. The modern trend is to permit reliance by plaintiffs on representations or omissions, as long as that reliance is in good faith.

Next, this Article demonstrates that the requirements of good faith and fair dealing are the reason why disclosures are required. The most important positions on good faith and fair dealing disclosure requirements are set forth and these standards are then applied in the specific context of the sale of a business. The Article concludes with a discussion of the reasons why caveat emptor is not applicable to the sale of a business and why there is an obligation on the part of the seller to reveal all material facts.

The Article will show that upon closer scrutiny the concepts of the duty of good faith and fair dealing, and of good faith disclosures as understood in the United States, are not that dissimilar from those in the nations of continental Europe—described, for convenience, as the civil law systems.<sup>16</sup> A brief survey of Italian law

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sure by imposing a "duty to speak whenever justice, equity, and fair dealing demand it"). Professor Keeton added that the duty to speak was not derived from an implied silence, but rather, from the belief that the refusal to speak is tantamount to unfair conduct. *Id.* See also Frona M. Powell, *The Seller's Duty to Disclose in Sales of Commercial Property*, 28 AM. BUS. L.J. 245, 274 (1990) (concluding that disclosure of defects should be required in the sale of either residential or commercial property when "standards of good faith and fair conduct demand it"); PROSSER AND KEETON, *supra* note 8 § 106, at 739 (observing that courts have found, in recent years, a duty to disclose when an "ordinary ethical person would have disclosed"); Robert S. Summers, "Good Faith" In General Contract Law And The Sales Provisions Of The Uniform Commercial Code, 54 VA. L. REV. 195, 203, 228 (1968) (generating a list of "good faith" behavior that included "fully disclosing material facts," Professor Summer stated that there is evidence that caveat emptor is being put "to rest in some fields.") [hereinafter *General Contract Law*]; 37 C.J.S. Fraud § 16(a) (1943) ("It is well settled that the suppression of a material fact which a party is bound in good faith to disclose is equivalent to a false representation.").

<sup>16</sup> Without attempting to describe, in a brief footnote, all the differences between the civil law and the common law, it should be understood that the civil law: (1) is characterized by a tendency for abstraction in order to capture entire aspects of the law in broad categories or systems; (2) has developed through the reception of Roman law and the interpretation of the CORPUS JURIS of Justinian, and is to a great

(and, less extensively, German law), as the law of representatives of the tradition of Roman jurisprudence in Europe, is included in the Appendix for further support of this thesis.

### III. THE CONCEPT OF GOOD FAITH AND FAIR DEALING

Public policy standards of good faith and fair dealing determine legal disclosure requirements. Accordingly, to appreciate what conduct good faith and fair dealing requires and to understand the evolution and direction of the law in this area, it is helpful to address the history and development of the legal duty of good faith and fair dealing and its relationship to, and impact upon, the doctrine of caveat emptor. First, however, we shall turn to the definition of "good faith and fair dealing."

#### A. *Defining the Duty of Good Faith and Fair Dealing*

There is no uniformly recognized definition of the duty of good faith and fair dealing that can be utilized in the negotiation context. For instance, the Uniform Commercial Code (UCC) defines "good faith" as "honesty in fact in the conduct or transaction concerned."<sup>17</sup> The Restatement (Second) of Contracts, however,

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extent codified; (3) is scholastic in nature; (4) is the law of professors; (5) is abstract thinking in institutions and works with concepts (which often develop a life of their own); and (6) focuses the interpretive process on the identification of what the abstract norms intend to say about an unknown and unforeseen problem. The common law, intended as the Anglo-American law: (1) is characterized by a prophecy of what judges will do based on precedents, and is empirical, casuistic and skeptical of generalizations; (2) has developed through a continuing tradition, advancing from case to case on the notion that as life is unpredictable so is the law, and case law responds, therefore, more adequately to the needs of society; (3) is forensic; (4) is the law of judges; (5) is concrete thinking in cases, relations, rights and duties; and (6) is pictorial and based on experience of life. See OLIVER W. HOLMES, *THE COMMON LAW* 11 (1881) (observing that "[t]he life of the law has not been logic; it has been experience"); W.W. BUCKLAND & ARNOLD D. MCNAIR, *ROMAN LAW & COMMON LAW, A COMPARISON IN OUTLINE*, xiv (2d ed. 1952) (suggesting that "it may be a paradox, but it seems to be the truth that there is more affinity between the Roman jurist and the common lawyer than there is between the Roman jurist and his modern civilian successor [because] [b]oth the common lawyer and the Roman jurist avoid generalizations and, so far as possible, definitions"); cf. KONRAD ZWIEGERT & HEIN KÖTZ, 1 *EINFÜHRUNG IN DIE RECHTSVERGLEICHUNG* 75-76 (1971) (noting also that the civil law is moving towards a greater emphasis on case law, while the common law is moving towards increased statutory systematization).

<sup>17</sup> UCC § 1-201(19) (1989). This definition is expanded to include "honesty in fact and the observance of reasonable commercial standards of fair dealing in the trade" when a merchant is involved. *Id.* § 2-103(1)(b). According to the UCC, a merchant is:

A person who deals in goods of the kind or otherwise by his occupation holds himself out as having knowledge or skill peculiar to the practices

provides a more expansive definition of good faith than does the UCC.<sup>18</sup> According to the Second Restatement good faith means more than honesty, and it proscribes conduct that violates community standards as defined by the court or jury.

Moreover, legal commentators have differed with regard to the manner in which good faith and fair dealing should be defined. Accordingly, the doctrine of good faith and fair dealing has been defined variously as requiring reasonableness or fair conduct,<sup>19</sup> reasonable standards of fair dealing,<sup>20</sup> decency as well as fairness and reasonableness,<sup>21</sup> fairness,<sup>22</sup> and community standards of fairness, decency and reasonableness.<sup>23</sup> Despite this plethora of definitions, Professor Robert S. Summers has argued that it is inappropriate to ascribe any particular definition to the term "good faith and fair dealing."<sup>24</sup> He contended that the concept of good faith and fair dealing was an "excluder" in that it simply excluded certain bad faith behavior.

As a majority of commentators seem to recognize, however, it is probably better that the definition of good faith and fair dealing remains amorphous so that the doctrine can be applied on a case-by-case basis. Nonetheless, some commentators have criticized expansive definitions of good faith and fair dealing as being too vague.<sup>25</sup> Although the concept of good faith and fair dealing will

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or goods involved in that transaction to whom such knowledge or skill may be attributed by his employment of an agent or broker or other intermediary who by his occupation holds himself out as having such knowledge or skill.

*Id.* § 2-104(1).

<sup>18</sup> Comment a to Restatement (Second) of Contracts § 205 states that: Good faith performance or enforcement of a contract emphasizes faithfulness to an agreed common purpose and consistency with the justified expectations of the other party; it excludes a variety of types of conduct characterized as involving "bad faith" because they violate community standards of decency, fairness or reasonableness.

RESTATEMENT (SECOND) OF CONTRACTS § 205 cmt. a (1979).

<sup>19</sup> Holmes, *supra* note 15, at 451.

<sup>20</sup> C. FRIED, *CONTRACT AS PROMISE* 83 (1981).

<sup>21</sup> E. Allan Farnsworth, *Good Faith Performance And Commercial Reasonableness Under The Uniform Commercial Code*, 30 U. CHI. L. REV. 666, 671 (1963) [hereinafter *Good Faith Performance*].

<sup>22</sup> Robert A. Hillman, *Policing Contract Modifications under the UCC: Good Faith and the Doctrine of Economic Duress*, 64 IOWA L. REV. 849, 877 (1979).

<sup>23</sup> Richard Thigpen, *Good Faith Performance Under Percentage Leases*, 51 MISS. L.J. 315, 320 (1981).

<sup>24</sup> *General Contract Law*, *supra* note 15, at 206.

<sup>25</sup> See, e.g., Clayton P. Gillette, *Limitations On The Obligations Of Good Faith*, 1981 DUKE L.J. 619, 621 (1981). See Christianne Dubreuil, *L'assurance: un contrat de bonne foi à l'étape de la formation et de l'exécution* 1992 MCGILL L.J. 1087, 1089 (1992).

require additional exposition when applied to negotiations, such imprecision in its definition is not unworkable and is common in the law.

### B. *The Historical and Cultural Context*

In social life, long before the intervention of legal systems, individuals dealt with each other with scrupulous fairness, as imposed by ancient and rigid customs. Good faith in dealings and negotiation practices was the element of binding value in these ancestral societies, and served as the religious basis for maintaining the word given.<sup>26</sup> As civilization progressed, however, the individual acquired a greater freedom through contract.<sup>27</sup> Nevertheless, good faith and fairness remained the highest criterion for evaluating contractual obligations.<sup>28</sup>

The primordial recognition that parties have an obligation to act in good faith and to deal fairly in their relations with one another, and the notion that contracts had to be entered into and performed in good faith (*oportere ex fide bona*)<sup>29</sup> were well known in

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<sup>26</sup> See EMILIO BETTI, *TEORIA GENERALE DEL NEGOZIO GIURIDICO*, Torino 1955, at 41 & n.4. An interesting example was given by Herodotus when he described how the savages handled negotiations preceding conclusion of a contract:

The Carthaginians also relate the following: There is a country in Libya, and a nation, beyond the Pillars of Heracles, which they are wont to visit, where they no sooner arrive but forthwith they unlade their wares, and, having disposed them after an orderly fashion along the beach, leave them, and, returning aboard their ships, raise a great smoke. The natives, when they see the smoke, come down to the shore, and, laying out to view so much gold as they think the worth of the wares, withdraw to a distance. The Carthaginians upon this come ashore and look. If they think the gold enough, they take it and go their way; but if it does not seem to them sufficient, they go aboard the ship once more, and wait patiently. Then the others approach and add to their gold, till the Carthaginians are content. Neither party deals unfairly by the other: for they themselves never touch the gold till it comes up to the worth of their goods, nor do the natives ever carry off the goods till the gold is taken away.

I THE GREEK HISTORIANS 292 (Francis R.B. Godolphin ed. & George Rawlinson trans. Random House 1942). See also Betti, *supra*, at 41 & n.4 (providing a similar account attributed to the Venetian sailor of the 15th century, Alvise da Ca' da Mosto).

<sup>27</sup> ARTHUR L. CORBIN, *CORBIN ON CONTRACTS* (1952). In a well known passage, Professor Corbin explained that this change from "status to contract" means the individual acquired greater freedom expressed as "increasing forbearance by organized society to forbid his bargains and increasing readiness to enforce them, thus making his condition in the world more dependent on his own free-willed action than on the action of his ancestors." *Id.* at 1166.

<sup>28</sup> BETTI, *supra* note 26, at 42.

<sup>29</sup> See Gai - Inst. 4, 62-63, in ARANGIO-RUIZ/GUARINO, *BREVIARIUM IURIS ROMANI* 68

Roman law.<sup>30</sup> In the classical time, enforcement of good faith took place through the *judicia bonae fidei*. If a defendant in one of these contracts cases was unsuccessful in justifying his nonperformance, he would be obligated to pay the plaintiff whatever the court believed was owed *ex bona fide*, i.e., in accordance with the requirements of good faith.<sup>31</sup> The court was bound to decide what the defendant ought to have done had he performed the contract in good faith using the express as well as the implied terms. But by the time of Justinian, with the abandonment of the *formulae* (forms of action), the notion had become inherent to the contract itself (*contractus bonae fidei*).<sup>32</sup>

The idea of bona fides, conceived as "loyalty and fairness," was the basis for trade in the *ius gentium*. Although one of the most easily perceived aspects of bona fides was its negation of bad faith, it was well recognized that the scope of bona fides was much broader, "*manat latissime*"; the duty "permeates throughout," according to the great Roman jurist Quintus Mucius Scaevola.<sup>33</sup>

The opinion of the Roman statesman, orator, and stoic philosopher, Cicero, has been frequently referred to as setting forth the

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(Milano 1962). Typical contracts subject to the *iudicium bonae fidei* were, e.g., the sale of goods, lease, bailment, agency, and partnership.

<sup>30</sup> BIONDI, ISTITUZIONI DI DIRITTO ROMANO 457 (Milano 1972). See also LONGO, MANUALE ELEMENTARE DI DIRITTO ROMANO, 77 (Torino 1939) ("these contracts are based on a spirit of honesty and loyalty"). For further references, see Benatti, *supra* note 2, at 1. Roman law evolved over a long period of time and, although any classification is somewhat arbitrary, the following time frames have been suggested: (i) archaic period (from the most ancient times to the 5th century B.C., 753-367 B.C.); (ii) Republican period (to the end of the Republic, 367 B.C.-27 A.D.); (iii) classical period (to the 3rd century A.D., 27-284 A.D.); (iv) post-classical period (to the 6th century, 284-527 A.D.); and (v) the period of Justinian (527-565 A.D.). Biondi, *id.*, at 5. During the Republican period, *ius civile* came to signify the law that applied exclusively in the Roman *civitas*, as opposed to *ius gentium* which signified the law applicable in Rome and to other people.

<sup>31</sup> *Good Faith Performance*, *supra* note 21, at 669 (quoting F.H. LAWSON, A COMMON LAWYER LOOKS AT THE CIVIL LAW 124-25 (1953)).

<sup>32</sup> See D. 2, 14, 7 (Ulpianus, IV *ad edictum*) ("*solemus enim dicere pacta conventa inesse bonae fidei iudicii*"), Arangio-Ruiz/Guarino, *supra* note 29 at 674-75. In Roman law, as in the medieval Common Law, no one could bring an action without a form of action (writ). This had as a consequence that the jurists did not think in terms of substantive law (claims) but rather in terms of "adjective" law ("Remedy comes before Right"). Thus it is understandable that only after abolishment of the forms of action did the concept of good faith become a requirement of the substantive law rather than an instrument of procedure. For the common law, see F.W. MAITLAND, THE FORMS OF ACTION AT COMMON LAW 1 (1971) ("So great is the ascendancy of the Law of Actions . . . that substantive law has at first the look of being gradually secreted in the interstices of procedure.") (quoting MAINE, EARLY LAW AND CUSTOM).

<sup>33</sup> Franco Pastori, GLI ISTITUTI ROMANISTICI COME STORIA E VITA DEL DIRITTO 740-41 (3d ed. Milano 1992).



requirements of good faith disclosures in commercial sales transactions.<sup>34</sup> Cicero believed that good faith prohibited a seller of a commodity from concealing facts affecting the market price of the commodity, even though the seller made no affirmative misrepresentations.<sup>35</sup>

The jurists of the post-classical time believed that the contractual good faith requirements applied to the precontractual phase, though the remedy could only be sought through a contractual action (*e.g.*, the *actio ex emptio*), which is understandable because of the still strong influence of the classical tradition of prescribed causes of action.<sup>36</sup>

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<sup>34</sup> *E.g.*, *Laidlaw v. Organ*, 15 U.S. (2 Wheat.) 178, 185 n.2 (1817); 3A ARTHUR L. CORBIN, CORBIN ON CONTRACTS § 654A(D), at 86 (1951 & West Supp. 1992); Saul Litvinoff, *Vices Of Consent, Error, Fraud, Duress And Epilogue On Lesion*, 50 LA. L. REV. 1, 59 (1989).

<sup>35</sup> Cicero provides an example that illustrated his opinion on the duty of disclosure in commercial transactions:

Let it be set down as an established principle, then, that what is morally wrong can never be expedient . . . . But . . . cases often arise in which expediency may seem to clash with moral rectitude . . . . The following are problems of this sort: suppose, for example, a time of dearth and famine at Rhodes, with provisions at fabulous prices; and suppose that an honest man has imported a large cargo of grain from Alexandria and that to his certain knowledge also several other importers have set sail from Alexandria, and that on the voyage he has sighted their vessels laden with grain bound for Rhodes; is he to report the fact to the Rhodians or is he to keep his own counsel and sell his own stock at the highest market price? I am assuming the case of a virtuous, upright man, and I am raising the question how a man would think and reason who would not conceal the facts from the Rhodians if he thought that it was immoral to do so, but who would be in doubt whether such silence would really be immoral.

M.T. CICERO, DE OFFICIIS III, 319 (Walter Miller trans. 1938).

Cicero stated, upon this question, the sentiments of two stoic philosophers, Diogenes and Antipater. Diogenes thought that the merchant might lawfully withhold the knowledge which he had of the vessels on the point of arriving, and sell his corn at the current price (*aliud est celare, aliud tacere*). Antipater, his disciple, whose decision Cicero apparently adopted, thought, to the contrary, that this dissimulation was contrary to good faith: all the facts should be disclosed, that the buyer may not be uninformed of any detail which the seller knows (*omnia patefacienda, ut ne quid omnino, quod venditor norit, emptor ignoret*). *Id.* at 319, 321; see also *Laidlaw*, 15 U.S. (2 Wheat.) at 185 n.2 (quoting POTHIER, TRAITÉ DU CONTRAT DE VENTE, Art. III, No. 241).

<sup>36</sup> The *actio ex emptio* was the cause of action available to the buyer against the seller. The duties arising from the sale of goods were subject to *oportere ex fide bona*, meaning that both the seller and the buyer had to conduct themselves according to good faith, and any breach of this duty would be subject to the *iudicium bonae fidei*, with broad "equitable" discretion of the court. The use of the *actio ex emptio* for breaches of the duty of good faith in the context of the sale of goods contributed to the confusion (that has lasted to this day) that a "contractual" ("sale") action could give rise only to a contractual liability for breach. See Biondi, *supra* note 30, at 489. See also Benatti,

Thereafter, no significant development occurred until the 18th and 19th centuries. In the civil law, Jhering "discovered," in 1861, *culpa in contrahendo*.<sup>37</sup> The concept of good faith disclosures also found its way into the English common law, where it made its most explicit appearance in the area of insurance law. The notion of good faith and fair dealing to measure disclosures was used in an English case of the 18th century, *Carter v. Boehm*,<sup>38</sup> which became the leading case to articulate this duty of disclosure in contract formation. The case concerned an insurance contract indemnifying the owner of an island for its loss from foreign take-over. The carrier sought to avoid payment by claiming that certain material facts, regarding the insecurity of the island and the insured's fear of an invasion, were not disclosed at the time the contract was made.

According to Lord Mansfield, a contract for insurance is voidable if there is a non-disclosure of a material fact, since the risk run is different from the risk insured.<sup>39</sup> Lord Mansfield enunciated the following principle of all contracts and dealings: "Good faith forbids either party from concealing what he privately knows, to draw the other into a bargain, from his ignorance of that fact, and his believing the contrary."<sup>40</sup>

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*supra* note 2, at 2 (providing an excellent summary of this concept and further references).

<sup>37</sup> See generally Benatti, *supra* note 2, at 3-9. See also Kessler & Fine, *supra* note 15, at 401. "*Culpa in contrahendo*" means "fault in negotiating." Kessler & Fine noted that Jhering, a German legal scholar of the 19th Century "advanced the thesis that damages should be recoverable against the party whose blameworthy conduct during negotiations for a contract brought about its invalidity or prevented its perfection." Kessler & Fine, *supra* note 15, at 401.

<sup>38</sup> 97 Eng. Rep. 1162 (K.B. 1766).

<sup>39</sup> *Id.* at 1164.

<sup>40</sup> This broad duty, however, was not without limitations. Lord Mansfield continued: "But either party may be innocently silent, as to grounds open to both, to exercise their judgment upon." *Id.* Further, an insured did not need to reveal what the insurer should know, or could reasonably discover. *Id.* at 1165. The reason for placing the burden of knowledge on the insurer was to prevent an insurer from writing a contract that he knew he could later void. *Id.* at 1169. The insurer could promise indemnity and collect the premium, and then deny payment should the circumstance insured against occur, or, should the circumstance not occur, profit from the paid premium.

Lord Mansfield presented the central question as "whether there was, under all the circumstances at the time the policy was underwritten, a fair representation; or a concealment; fraudulent, if designed; or though not designed, varying materially the object of the policy, and changing the risque understood to be run." *Id.* at 1165. Lord Mansfield reviewed the facts and held that there was no concealment in *Carter v. Boehm* because the underwriter was in a better position than the insured to judge the safety of the island, and the insured's fears of invasion were the reasons for purchasing the policy and were not based on any facts not known or not ascertainable to the

Despite Lord Mansfield's early application of good faith to precontractual disclosures, the common law evolved in the 19th Century so that notions of good faith and fair dealing were either divorced from contract negotiations and disclosure requirements, or required very little in the way of candor. Early in the 19th century, the United States Supreme Court opined that a buyer who had exclusive information, which was about to be made public and that would substantially affect the price of a commodity, was not required to inform the seller as long as the buyer did nothing to deceive the seller.<sup>41</sup>

Likewise, the English bench ruled that in sales transactions, "whatever may be the case in a court of morals, there is no legal obligation on the vendor to inform the purchaser that he is under a mistake, not induced by the act of the vendor."<sup>42</sup> Nevertheless, good faith and fair dealing increasingly became a part of the common law of contract performance and enforcement. Furthermore, late nineteenth century courts also began to apply standards of good faith and fair dealing to measure disclosure requirements in contract formation, although application of the doctrine of caveat emptor inhibited the significance of this later trend.

To set the stage for an assault on the doctrine of caveat emptor in arm's length transactions, it is helpful to examine modern doctrines and trends in American law indicating that our soci-

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underwriter. *Id.* at 1166-69. This early appearance of good faith disclosure during negotiation of a contract remained, for a long time, restricted to marine insurance contracts. Holmes, *supra* note 15, at 426-35.

<sup>41</sup> *Laidlaw v. Organ*, 15 U.S. (2 Wheat.) 178 (1817). For a discussion of *Laidlaw*, see *infra* notes 183-98.

<sup>42</sup> *Smith v. Hughes*, (1871) L.R. 6 Q.B. 597, 607. This case dealt with a sale of oats. On appeal, the court assumed that the buyer of the oats believed he was purchasing "old oats" even though the oats were not old, but new, and the seller was aware that the buyer was mistaken about the age of the oats. The seller did nothing to bring about this mistake or to correct it, but gave the buyer a sample of the oats prior to the sale. Chief Judge Cockburn explained that "[t]he question was not what a man of scrupulous morality or nice honour would do under such circumstances." *Id.* at 603. Chief Judge Cockburn relied on Justice Story for the applicable legal principle: "[t]he general rule, both of law and equity, in respect to concealment, is that mere silence with regard to a material fact . . . will not avoid a contract, although it operate as an injury to the party from whom it is concealed." *Id.* at 604 (citation omitted). The court also noted that with regard to intrinsic facts, those relating to the nature or quality of the item, mere silence was not actionable as long as the condition of the item may be discovered by the other party in the exercise of proper diligence. *Id.* (citation omitted). As for extrinsic facts (environmental or market conditions), neither party was bound to disclose them. *Id.* at 660 (citation omitted). See *Peek v. Gurney*, (1873) L.R. 6 H.L. 377, 403 (asserting that "[m]ere non-disclosure of material fact, however morally censurable . . . form[s] no ground for an action . . . for misrepresentation.").

ety's concepts of the law are changing, and that notions of good faith and morality are increasingly being recognized as necessary ingredients for the determination of legal obligations. First, it is now widely recognized that there is a duty of good faith implied in every contract. Second, although the UCC and the Restatement (Second) of Contracts appear to limit use of the doctrine of good faith and fair dealing to contract performance and enforcement, in fact, both the UCC and the Restatement indicate that the requirement of good faith and fair dealing may apply to precontractual negotiations. Third, the requirement of good faith and fair dealing is increasingly being used in statutes. Fourth, the notion that the duty of good faith is a duty imposed by law is gaining acceptance. Fifth, in numerous areas of the law, morality and ethical standards are playing a significant role in forming and applying the law. Finally, the doctrine of caveat emptor has been abandoned or mollified in many transactions because it has been deemed to be inconsistent with modern ethics and practices. Each of these trends will be discussed *seriatim*.

C. *The Development of the Duty of Good Faith as a Duty Implied in Every Contract*

To uphold the duty of good faith performance in his dealings, a party is required to conform his behavior to reasonable established trade practices and norms. In 1893, the New York Court of Appeals announced that courts, when interpreting contracts, should infer that the contracting parties fully contemplated good faith in performance.<sup>43</sup> This inference of good faith was to be a

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<sup>43</sup> Genet v. President of Delaware & Hudson Canal Co., 32 N.E. 1078 (N.Y. 1893); Hilleary v. Skokum Root Hair-Grower Co., 23 N.Y.S. 1016 (C.P. 1893). Earlier cases from New York's highest court also referred to the duty of good faith and fair dealing. See, e.g., Marsh v. Masterson, 5 N.E. 59, 63 (N.Y. 1886) (ruling that defendant, who had a contract employing plaintiff to work as a mason, was "bound to act in good faith"); Uhrig v. Williamsburg City Fire Ins. Co., 4 N.E. 745, 746 (N.Y. 1886) (examining an arbitration clause for the appraisal of property subject to an insurance policy, the court ruled that "it was duty of each party to act in good faith to accomplish the appraisalment"). Earlier in the 19th century, the United States Supreme Court also referred to the contract duty of good faith. Chicago, Rock Island & Pac. R.R. v. Howard, 74 U.S. (7 Wall.) 392, 413 (1868). The *Howard* court noted: [C]orporations as much as individuals are bound to good faith and fair dealing, and the rule is well settled that they cannot, by their acts, representations or silence, involve others in onerous engagements and then turn round and disavow their acts and defeat just expectations which their own conduct has superinduced.

*Id.*; see also Bush v. Marshall, 47 U.S. (6 How.) 284, 291 (1848) (declaring that a vendee owes vendor a duty of "good faith and fair dealing").

guide for the courts in determining the meaning of the contract terms. The focus subsequently shifted, however, to the parties' duties in performance of contractual obligations. In *Industrial & General Trust, Ltd. v. Tod*,<sup>44</sup> for example, the bondholders of an insolvent railway formed a re-organization committee with complete discretion to create and adopt a plan of reorganization.<sup>45</sup> In carrying out its mandate, the committee allowed the property to be foreclosed prior to the submission of a reorganization plan.<sup>46</sup> Despite the wide powers granted to the committee, the court found that the committee had violated its duty to act in good faith.<sup>47</sup> Although the committee's actions were not fraudulent or "willfully wrong," their actions violated the underlying agreement with the bondholders and, therefore, violated the duty to act in good faith.<sup>48</sup>

The current framework of the doctrine in New York was put forward in *Kirke La Shelle Co. v. Paul Armstrong Co.*<sup>49</sup> In *Kirke La Shelle*, a party to a theatrical licensing agreement attempted to sell the production's movie rights. The court, which prohibited the sale of the movie rights, reasoned that production of a movie would make the theatrical rights worthless. In finding a breach of the duty of good faith when one party purposefully devalues the other party's contractual rights, the court ruled that:

[I]n any contract there is an implied covenant that neither party

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<sup>44</sup> 73 N.E. 7 (N.Y. 1905).

<sup>45</sup> *Id.*

<sup>46</sup> *Id.*

<sup>47</sup> *Id.* at 10.

<sup>48</sup> *Id.* at 10-11. The New York Court of Appeals continued to refine the doctrine over the next ten years. In interpreting an insurance agreement, the court stated that "there is a contractual obligation of universal force which underlies all written agreements. It is the obligation of good faith in carrying out what was written." *Brassil v. Maryland Casualty Co.*, 104 N.E. 622 (N.Y. 1914); *see also* *Lyon v. Lyon*, 233 P. 988, 990 (Cal. Dist. Ct. App. 1925) ("It is assumed that every party to a contract acts in good faith in performing their contractual duties. A violation of the duty of good faith must be shown by extrinsic evidence."); *Wigand v. Bachmann-Bectel Brewing Co.*, 118 N.E. 618, 620 (N.Y. 1918) (finding that a duty of good faith required company to pay independent contractor despite dissolution of company because independent contractor had right to assume long term relationship). This duty of good faith required parties to perform their contractual obligations in a reasonable time and in a reasonable manner. *Ratzlaff v. Trainor-Desmond Co.*, 183 P. 269, 271 (Cal. Dist. Ct. App. 1919); *People ex rel. Wells & Newton Co. v. Craig*, 133 N.E. 419, 426 (N.Y. 1921); *Simon v. Etgen*, 107 N.E. 1066, 1067 (N.Y. 1915).

<sup>49</sup> 188 N.E. 163 (N.Y. 1933). *Kirke La Shelle* is widely cited as the first declaration of the modern duty of good faith and fair dealing. *Centronics Corp. v. Genicom Corp.*, 562 A.2d 187, 191 (N.H. 1989); Steven J. Burton, *Breach Of Contract And The Common Law Duty To Perform In Good Faith*, 94 HARV. L. REV. 369, 379-80 nn.42-43 (1980); Corbin, *supra* note 34, at § 654A (D).

shall do anything which shall have the effect of destroying or injuring the rights of the other party, to receive the fruits of the contract, which means that in every contract there exists an implied covenant of good faith and fair dealing.<sup>50</sup>

A significant number of other jurisdictions did not follow the *Kirk La Shelle* decision, however,<sup>51</sup> until the California Supreme Court elaborated on the doctrine of good faith and fair dealing in *Comunale v. Traders & General Insurance Co.*<sup>52</sup> and *Mattei v. Hopper*.<sup>53</sup> By that time, the UCC had also adopted the duty of good faith. Subsequently, during the late 1960s and early 1970s, a large number of courts began to accept the concept of a duty of good faith and fair dealing as necessary to protect the expectations of parties to a contract. Presently, courts in the vast majority of American jurisdictions agree that a general obligation of good faith and fair dealing is implied in every contract.<sup>54</sup> This contractual duty of good faith and fair dealing arises as

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<sup>50</sup> *Kirk La Shelle*, 188 N.E. at 167.

<sup>51</sup> For the most part, only New York courts referred to the duty of good faith and fair dealing during the two decades following the *Kirk La Shelle* case. *E.g.*, *Mutual Life Ins. Co. v. Tailored Woman, Inc.*, 128 N.E.2d 401, 403 (N.Y. 1955); *M O'Neal Supply Co. v. Petroleum Heat & Power Co.*, 19 N.E.2d 676, 678 (N.Y. 1939); *Price v. Spielman Motor Sales Co.*, 26 N.Y.S.2d 836, 839 (N.Y. App. Div. 1941); *Lutz v. Bayberry Huntington, Inc.*, 148 N.Y.S.2d 762, 767 (N.Y. Sup. Ct. 1956); *Mezz v. Swim Products Co.*, 138 N.Y.S.2d 643, 646 (N.Y. Sup. Ct. 1955); *Halstead v. General Ry. Signal Co.*, 51 N.Y.S.2d 372, 374 (N.Y. Sup. Ct. 1945); *Vineyard v. Martin*, 29 N.Y.S.2d 935, 938 (N.Y. Sup. Ct. 1941). A few California cases also referred to the covenant of good faith and fair dealing implied in every contract. *Brown v. Superior Court*, 212 P.2d 878, 881 (Cal. 1949); *Bergum v. Weber*, 288 P.2d 623, 625 (Cal. Ct. App. 1955); *Matzen v. Horwitz*, 228 P.2d 841, 845 (Cal. Ct. App. 1951); *Wilson v. Wilson*, 216 P.2d 104, 108 (Cal. Ct. App. 1950); *Brawley v. Crosby Research Found.*, 166 P.2d 392, 397 (Cal. Ct. App. 1946).

<sup>52</sup> 328 P.2d 198 (Cal. 1958). For a more complete discussion of *Comunale*, see *infra* notes 102-04 and accompanying text.

<sup>53</sup> 330 P.2d 625 (Cal. 1958).

<sup>54</sup> *E.g.*, *Hilley v. Allstate Ins. Co.*, 562 So.2d 184, 190 (Ala. 1990); *Guin v. Ha*, 591 P.2d 1281, 1291 (Alaska 1979); *Savoca Masonry Co., Inc. v. Homes & Son Const. Co., Inc.*, 542 P.2d 817, 821 (Ariz. 1975); *Wilgus v. Salt Pond Inv. Co.*, 498 A.2d 151, 159 (Del. 1985); *Crooks v. Chapman Co.*, 185 S.E.2d 787, 789 (Ga. Ct. App. 1971); *Idaho First Nat'l Bank v. Bliss Valley Foods, Inc.*, 824 P.2d 841, 862 (Idaho 1991); *Martindell v. Lake Shore Nat'l Bank*, 154 N.E.2d 683, 690 (Ill. 1958); *Daniels v. Army Nat'l Bank*, 822 P.2d 39, 43 (Kan. 1991); *Ranier v. Mount Sterling Nat'l Bank*, 812 S.W.2d 154, 156 (Ky. 1991); *Food Fair Stores, Inc. v. Blumberg*, 200 A.2d 166, 174 (Md. 1964); *Kerrigan v. City of Boston*, 278 N.E.2d 387, 393 (Mass. 1972); *Burkhardt v. City Nat'l Bank of Detroit*, 226 N.W.2d 678, 680 (Mich. Ct. App. 1975); *Morris v. Macione*, 546 So. 2d 969, 971 (Miss. 1984); *Faust & Fordon, Inc. v. Greenbaum*, 421 S.W.2d 809, 813 (Mo. Ct. App. 1967); *U.V. Inds., Inc. v. Danielson*, 602 P.2d 571, 581 (Mont. 1979); *K Mart Corp. v. Ponsock*, 732 P.2d 1364, 1370 (Nev. 1987); *Griswold v. Heat, Inc.*, 229 A.2d 183, 187 (N.H. 1967); *Palisades Properties, Inc. v. Brunetti*, 44 N.J. 117, 130, 207 A.2d 522, 531 (1965); *Watson Truck & Supply Co., Inc. v. Males*, 801 P.2d 639, 642 (N.M. 1991); *Weyerhaeuser Co. v. Godwin Bldg. Supply Co.*, 253 S.E.2d 625, 627-28 (N.C. Ct. App. 1979); *Miles v. N. J. Motors, Inc.*, 338 N.E.2d 784, 787-88 (Ohio Ct.

soon as the contract is executed, even though there may be a subsequent closing.

The general recognition of the duty of good faith and fair dealing has been substantiated by the dozens of commentators who, in the last thirty years, have written articles in many different areas of the law concerning this duty.<sup>55</sup> The two most influential commentators on

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App. 1975); *Western Natural Gas Co. v. Cities Serv. Gas Co.*, 507 P.2d 1236, 1241 (Okla.), *appeal dismissed and cert. denied*, 409 U.S. 1052 (1972); *Perkins v. Standard Oil Co.*, 383 P.2d 107, 112 (Or. 1963) (en banc); *Ide Farm & Stable, Inc. v. Cardi*, 297 A.2d 643, 645 (R.I. 1972); *Commercial Credit Corp. v. Nelson Motors, Inc.*, 147 S.E.2d 481, 484 (S.C. 1966); *Garrett v. BankWest, Inc.*, 459 N.W.2d 833, 841 (S.D. 1990); *TSC Indus., Inc. v. Tomlin*, 743 S.W.2d 169, 173 (Tenn. Ct. App. 1987); *Zion's Properties, Inc. v. Holt*, 538 P.2d 1319, 1321 (Utah 1975); *H.P. Hood & Sons v. Heins*, 205 A.2d 561, 566 (Vt. 1964); *Miller v. Othello Packers, Inc.*, 410 P.2d 33, 34 (Wash. 1966) (per curiam); *In re Chayka v. Santini*, 176 N.W.2d 561, 564 (Wis. 1970); *see also In re Stevenson Ass'n, Inc.*, 777 F.2d 415, 421 (8th Cir. 1985) (applying Minnesota law); *Makofsky v. Cunningham*, 576 F.2d 1223, 1226 (5th Cir. 1978) (applying Louisiana law); *Rees v. Bank Bldg. & Equip. Corp. of America*, 332 F.2d 548, 551-52 (7th Cir.) (applying Missouri law), *cert. denied*, 379 U.S. 932 (1964); *National Safe Corp. v. Benedict & Myrick, Inc.*, 371 So. 2d 792, 795 (La. 1979) (applying LA. CIV. CODE ANN. art. 1901 (West 1987)). *Contra Childers v. Pumping Sys., Inc.*, 968 F.2d 565, 568-69 (5th Cir. 1992) ("Texas law does not imply a covenant of good faith and fair dealing in every contract."); *English v. Fischer*, 660 S.W.2d 521, 522 (Tex. 1983).

<sup>55</sup> Many articles, most of which deal with the contractual duty of good faith and fair dealing, have been written concerning the duty: Eric G. Andersen, *Good Faith in the Enforcement of Contracts*, 73 IOWA L. REV. 299 (1988); Neal Batson, *The Lender's Obligation of Good Faith and Fair Dealing and Other Implied Provisions in Commercial Transactions*, Practising Law Institute (1990); John P. Bermingham, *Extending Good Faith: Does the UCC Impose a Duty of Good Faith Negotiation Under Changed Circumstances?*, 61 ST. JOHN'S L. REV. 217 (1987); Steven J. Burton, *More on Good Faith Performance of a Contract: A Reply to Professor Summers*, 69 IOWA L. REV. 497 (1984); Steven J. Burton, *Good Faith Performance of a Contract Within Article 2 of the Uniform Commercial Code*, IOWA L. REV. 1 (1981); Steven J. Burton, *Breach of Contract and the Common Law Duty to Perform in Good Faith*, 94 HARV. L. REV. 369 (1980); Hon. H. Walter Croskey, *Bad Faith In California: Its History, Development And Current Status*, 26 TORT & INSURANCE L.J. 561 (1991); Robert Dugan, *Good Faith And The Enforceability of Standardized Terms*, 22 WM. & MARY L. REV. 1 (1980); Russell A. Eisenberg, *Good Faith Under The Uniform Commercial Code - A New Look At An Old Problem*, 54 MARQ. L. REV. 1 (1971); E. Allen Farnsworth, *Precontractual Liability And Preliminary Agreements: Fair Dealing And Failed Negotiations*, 87 COLUM. L. REV. 217 (1987); Gillette, *supra* note 25 at 619; Patricia K. Gillette, *The Implied Covenant of Good Faith and Fair Dealing: Are Employers the Insurers of the Eighties?*, 11 EMPLOYEE RELATIONS L.J. 438 (1985); Dr. Tariq Hassan, *The Principle Of Good Faith In The Formation Of Contracts*, 5 SUFFOLK TRANSNAT'L L.J. 1 (1980); Hillman, *supra* note 22; Holmes, *supra* note 16; Kessler & Fine, *supra* note 15; Guy O. Kornblum, *Recent Cases Interpreting the Implied Covenant of Good Faith and Fair Dealing*, 30 DEFENSE L.J. 411 (1981); Christina L. Kunz, *Frontispiece on Good Faith: A Functional Approach Within The UCC*, 16 WM. MITCHELL L. REV. 1105 (1990); Gerard Mantese, *The UCC and Keeping the (Good) Faith*, MICH. BAR J., March 1991, at 270; Ralph A. Newman, *The Renaissance Of Good Faith In Contracting in Anglo-American Law*, 54 CORNELL L. REV. 553 (1969); Rafael M. Powell, *Good Faith In Contracts*, 9 CURRENT LEGAL PROBLEMS 16 (1956); B.J. Reiter, *Good Faith In Contracts*, 17 VAL. U. L. REV. 705 (1983); Rochelle B. Spandorf, et al., *Implications of the Covenant of Good Faith: Its Extension to Franchising*, 5 FRANCHISE L.J. 3

American contract law, Corbin and Williston, have also recognized and discussed the duty of good faith and fair dealing.<sup>56</sup>

The duty of good faith and fair dealing has become so widely accepted that it has been recognized in areas where there has been a traditional reluctance to apply the duty. For example, the concept has been applied in employment-at-will contracts.<sup>57</sup> Likewise, a duty of

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(1985); *General Contract Law*, *supra* note 15; Robert S. Summers, *The General Duty Of Good Faith—Its Recognition And Conceptualization*, 67 CORNELL L. REV. 810 (1982); Thigpen, *Good Faith Performance Under Percentage Leases*, *supra* note 23; Steven W. Thomas, *Utmost Good Faith In Reinsurance: A Tradition In Need of Adjustment*, 41 DUKE L.J. 1548 (1992); Daniel E. Toomey, et al., *Good Faith and Fair Dealing: The Well-Nigh Irrefragable Need for a New Standard in Public Contract Law*, 20 CONTRACT L.J. 87 (1990); Glen E. Tremper, *Commercial Bad Faith: Tort Recovery For Breach Of Implied Covenant In Ordinary Commercial Contracts*, 48 MONT. L. REV. 349 (1987); Raymond Wallenstein, *Breach Of The Implied Covenant Of Good Faith And Fair Dealing In Commercial Contracts: A Wrong in Search Of A Remedy*, 20 U. WEST L.A. L. REV. 113 (1989); Jeffrey Willis, *The Substantive Law Of Lender Liability*, 26 TORT & INS. L.J. 742 (1991). Numerous student notes and comments concerning the duty of good faith and fair dealing have also been published. See Theresa V. Agee, Note, *Breach of an Insurer's Good Faith Duty to Its Insured: Tort or Contract?*, 1988 UTAH L. REV. 135 (1988); Kelly H. Anderson, Case-note, 27 LAND & WATER L. REV. 173 (1992); Mathew J. Barrett, Note, "*Contort*": *Tortious Breach of Applied Covenant of Good Faith and Fair Dealing in Non-insurance, Commercial Contracts—Its Existence and Desirability*, 60 NOTRE DAME L. REV. 510 (1985); Michael H. Cohen, Note, *Reconstructing Breach of the Implied Covenant of Good Faith and Fair Dealing as a Tort*, 73 CAL. L. REV. 1291 (1985); James H. Cook, Comment, *Seaman's Direct Buying Service, Inc. v. Standard Oil Co.: Tortious Breach of the Covenant of Good Faith and Fair Dealing in a Non-insurance Commercial Contract Case*, 71 IOWA L. REV. 893 (1986); David M. Erickson, Case Note, 26 DRAKE L. REV. 883 (1976-77); Patricia A. Milon, Recent Developments, *Implied Covenants of Good Faith and Fair Dealing: Loose Cannons of Liability for Financial Institutions*, 40 VAND. L. REV. 1197 (1987); Harold D. Jones, Case Note, 21 TEX. TECH. L. REV. 801 (1990); Rayne Rasty, Note, *Extending Good Faith and Fair Dealing To Employment Contracts: A Proposal*, 22 TEX. TECH. L. REV. 211 (1991); Cary Smith, Note, *Breach of Good Faith as an Expansive Basis for Lender Liability Claims: An Idea Whose Time Has Come - And Gone?*, 42 RUTGERS L. REV. 177 (1989); Carolyn S. Smith, Note, 42 OKLA. L. REV. 607 (1989).

<sup>56</sup> CORBIN *supra* note 34, § 654A; 5 SAMUEL WILLISTON, A TREATISE ON THE LAW OF CONTRACTS, § 670, at 159 (3d ed. 1961); *see also* 17 AM. JUR. 2d *Contracts* § 380 (2d ed. 1991).

<sup>57</sup> *Foley v. Interactive Data Corp.*, 765 P.2d 373, 389-90 (Cal. 1988) (the covenant of good faith and fair dealing is implied in all contracts, even employment-at-will contracts, but tort damages are not available for breach of the duty); *Morris v. Coleman Co.*, 738 P.2d 841, 849 (Kan. 1987); *Fortune v. National Cash Register Co.*, 364 N.E.2d 1251, 1255-56 (Mass. 1977); *Monge v. Beebe Rubber Co.*, 316 A.2d 549, 552 (N.H. 1974). Other courts have rejected application of the duty of good faith to employment-at-will contracts believing that the duty is incompatible with such contracts. *See Spann v. Springfield Clinic*, 577 N.E.2d 488, 492 (Ill. App. Ct. 1991); *Morris v. Coleman Co.*, 738 P.2d 841, 851 (Kan. 1987); *Suburban Hosp., Inc. v. Dwiggins*, 596 A.2d 1069, 1076-77 (Md. 1991); *D'Angelo v. Gardner*, 819 P.2d 206, 211-12 (Nev. 1991); *Pyle v. Ledex, Inc.*, 551 N.E.2d 205, 212 (Ohio Ct. App. 1988); *Avey v. Hillcrest Medical Ctr.*, 815 P.2d 1215, 1217 (Okla. Ct. App. 1991); *Casas v. Wornick Co.*, 818 S.W.2d 466, 468-69 (Tex. Ct. App. 1991); *Hatfield v. Rochelle Coal Co.*, 813 P.2d 1308, 1309 (Wyo. 1991). Only one of the aforementioned courts has rejected the duty of good



good faith and fair dealing to consummate a transaction has been applied to precontractual negotiations when there has been a letter of intent or other agreement to negotiate.<sup>58</sup> Finally, the duty of good faith and fair dealing has been implied in public contracts, despite the strong governmental interest in protecting its representatives, which leads courts to almost always presume "good faith" conduct on their behalf.<sup>59</sup>

*D. The Uniform Commercial Code and the Restatement (Second) of Contracts*

The duty of good faith and fair dealing as applied to the enforcement and performance of contracts in the UCC and the Restatement (Second) of Contracts demonstrates that good faith and fair dealing is a workable legal concept that should not cause uncertainty when applied to contract negotiations. Although the UCC and the Restatement (Second) of Contracts imply a duty of good faith and fair dealing only in contract performance, one cannot infer from this that there is no precontractual duty of good

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faith in all employment contracts. *Hatfield*, 813 P.2d at 1309. Two other cases recognized the duty in general employment contracts. *Julian v. Christopher*, 575 A.2d 735, 739 (Md. 1990); *D'Angelo*, 819 P.2d at 211-12.

<sup>58</sup> See *infra* notes 584-85 and accompanying text.

<sup>59</sup> Courts have long held that whenever the government was a party to a contract, its performance under the contract was presumed to be in good faith. *E.g.*, *Squirrel Creek Assocs. v. United States*, 11 Cl. Ct. 212, 218 (1986); *Kalver Corp. v. United States*, 543 F.2d 1298, 1302 (Ct. Cl. 1976); *Knotts v. United States*, 121 F. Supp. 630, 631 (Ct. Cl. 1954); *Struck Constr. Co. v. United States*, 96 Ct. Cl. 186 (1942). Accordingly, it has been quite difficult to demonstrate that the government has not satisfied the presumption of good faith and fair dealing. *E.g.*, *Kalver Corp.*, 543 F.2d at 1302 (an incorrect reading of a contract by government officials is not tantamount to bad faith); *Struck Const. Co.*, 96 Ct. Cl. 186 (bad faith only found after determining that the government's conduct was "designedly oppressive"). Although some recent cases continue this trend, *e.g.*, *Embrey v. United States*, 17 Cl. Ct. 617, 626 (1989) (the court held that the "plaintiff must present specific evidence of intent to retaliate against or injure plaintiff to support an allegation of bad faith"), other recent decisions have shown that the courts are beginning to follow more modern rules of good faith and fair dealing, *Malone v. United States*, 849 F.2d 1441, 1445 (Fed. Cir. 1988) (principles of RESTATEMENT (SECOND) OF CONTRACTS § 205 cmt. d applied to government contract); *Maxima Corp. v. United States*, 847 F.2d 1549, 1556 (Fed. Cir. 1988) ("the need for mutual fair dealing is no less required in contracts to which the government is a party, than in any other commercial arrangement"); *Industrial Constructors Corp. & Firemen's Fund Ins. Co. v. United States*, Nos. 472-85C and 140-86C, slip op. at 48 (Cl. Ct. Jan. 1990) ("[T]he duty of fair dealing should be applied at least as strictly to government employees and agencies as it is applied to private parties."). At least one relatively early decision of the United States Court of Claims also supports this later view. *Commerce Int'l Co. v. United States*, 338 F.2d 81, 85 (Ct. Cl. 1964) (the government has the same obligation as all other contracting parties "to carry out its bargain reasonably and in good faith"). See generally Toomey, *supra* note 55, at 87.

faith and fair dealing. The Restatement (Second) of Contracts and, to a lesser extent, the UCC, contemplated the potential application of the duty of good faith and fair dealing to contract negotiations and did not intend, by negative inference, to foreclose such application. In any event, the general recognition in the UCC and the Second Restatement that parties must perform their contracts in good faith evidences the continuing evolution of business ethics towards recognizing that standards of good faith and fair dealing should measure all dealings, even those between businessmen, and even those of a precontractual nature.

### 1. The UCC

The UCC, which every state has adopted,<sup>60</sup> has confirmed the viability of the doctrine of good faith performance. Specifically, UCC section 1-203 provides that: "Every contract or duty within this Act imposes a duty of good faith in its performance or enforcement."<sup>61</sup> At least one court, however, has held that there is a duty of good faith during negotiations.<sup>62</sup> The UCC refers to good faith

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<sup>60</sup> The following states adopted the UCC on the date indicated: Alabama 1966, Alaska 1963, Arizona 1967, Arkansas 1961, California 1965, Colorado 1966, Connecticut 1961, Delaware 1967, Florida 1967, Georgia 1964, Hawaii 1967, Idaho 1967, Illinois 1962, Indiana 1964, Iowa 1966, Kansas 1965, Kentucky 1960, Louisiana (although Louisiana has not adopted the UCC as such, articles 1, 3, 4, 5, 7, and 8 have been adopted in substance as Title 10 Commercial Laws of the Louisiana Revised Statutes, Chapters 1, 3, 4, 5, 7, and 8 effective January 1, 1975; article 9 was adopted by Act No. 528 of 1988 effective July 1, 1989, with the effective date extended to January 1, 1990 by Act No. 12 of the 1989 extraordinary session), Maine 1964, Maryland 1964, Massachusetts 1958, Michigan 1964, Minnesota 1966, Mississippi 1968, Missouri 1965, Montana 1965, Nebraska 1965, Nevada 1967, New Hampshire 1961, New Jersey 1963, New Mexico 1962, New York 1964, North Carolina 1967, North Dakota 1966, Ohio 1962, Oklahoma 1963, Oregon 1963, Pennsylvania 1954-1960, Rhode Island 1962, South Carolina 1968, South Dakota 1967, Tennessee 1964, Texas 1966, Utah 1965, Vermont 1966, Virginia 1966, Washington 1967, West Virginia 1964, Wisconsin 1965, and Wyoming 1962. See Uniform Commercial Code Reporting Service (Clark Boardman Callaghan 1991).

<sup>61</sup> The definition of "good faith" in UCC section 1-203 explicitly refers only to performance or enforcement of contracts. See *Rigby Corp. v. Boatmen's Bank & Trust Co.*, 713 S.W.2d 517, 525 (Mo. Ct. App. 1986).

<sup>62</sup> *Connecticut Nat'l Bank v. Anderson*, No. 0053810, 1991 WL 204359 (Conn. Super. Ct. Oct. 1, 1991). The court reasoned that because section 1-201(19) of the UCC defined good faith in terms of conduct or transaction, the duty of good faith is required in precontractual dealings, notwithstanding the language in code section 1-203. A similar result was reached in a case involving the negotiations for the sale of a used car. *Underwood v. Monte Asti Buick, Co.*, 20 UCC Rep. Serv. 657, 661 (Pa. Com. Pl. 1976). A car dealer sold, as new, a car that had been seriously damaged and repaired. The court rescinded the contract of sale, ruling that: "The purchase of motor vehicles by naive and nonmechanic oriented consumers is, of necessity, based upon the reliance of the buyer on the good faith of the dealer or seller." *Id.* In addition the court explained that "[t]he duty placed on the seller was not limited to stated repre-

in at least 54 of its 400 sections, and it is specifically referred to in each of its nine substantive articles.<sup>63</sup>

The UCC does not have a general requirement of objective good faith for all dealings.<sup>64</sup> Under the UCC, merchants are held

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sentations but may also include concealment or nondisclosure of a *material* fact relating to the vehicle, particularly where the buyer is not competent or able to determine the defect from inspection." *Id.* at 661. The court did not define more generally, however, what would constitute a material fact. Major damage, amounting to 25% of the value of the car, was a material fact. While it cannot be inferred from this decision that a more knowledgeable buyer would be protected by this extended duty of good faith, especially in light of the court's emphasis on plaintiff's inexperience and lack of competence, it is still noteworthy that the concept of good faith and fair dealing has been held applicable to precontractual negotiations.

<sup>63</sup> The following sections from the UCC refer to "good faith": (1) three sections from article 1 on general provisions (1-201(19), 1-203, 1-208); (2) 14 sections from article 2 on sales (2-103(1)(b), 2-305(2), 2-306(1), 2-311(1), 2-323(2)(b), 2-328(4), 2-402(2), 2-403(1), 2-506(2), 2-603(3), 2-615(a), 2-706(1), 2-706(5), 2-712(1)); (3) 11 sections from article 3 on commercial paper (3-302(1)(b), 3-404(1), 3-406, 3-410(3), 3-417(1), 3-417(2), 3-417(4), 3-418, 3-419(3), 3-506(1), 3-802(2)); (4) five sections from article 4 on bank deposits and collections (4-103(1), 4-207(1), 4-401(2), 4-406(1), 4-503(b)); (5) two sections from article 5 on letters of credit (5-109(1) and 5-114(2)(b)); (6) one section from article 6 on bulk transfers (6-110(2)); (7) ten sections from article 7 on warehouse receipts, bills of lading, and other documents of title (7-203, 7-209(3)(a), 7-210(5), 7-301(1), 7-308(4), 7-404, 7-501(4), 7-504(2)(c), 7-508, 7-601(2)); (8) five sections from article 8 on investment securities (8-302(1), 8-306(3), 8-311(a), 8-318, 8-406(1)(b)); and (9) three sections from article 9 on secured transactions, sales of accounts, and chattel paper (9-206(1), 9-208(2), 9-504(4)).

<sup>64</sup> The 1949 draft of the UCC, however, imposed an objective obligation of good faith applicable to all contracts and dealings within the Code: "Unless otherwise agreed, in this Act . . . 'Good faith' means honesty in fact in the conduct or transaction concerned. Good faith includes good faith toward all prior parties and observance by a person of the reasonable commercial standards of any business or trade in which he is engaged." *General Contract Law*, *supra* note 15, at 207 (quoting UCC § 1-201(18) (May 1949 Draft)). In 1950, the committee on the Proposed Commercial Code of the section on Corporation, Banking and Business Law of the American Bar Association recommended that the general definition of good faith should be restricted to the subjective duty of honesty in fact. *Id.* at 208-09 (quoting Malcolm, *The Proposed Commercial Code*, 6 BUS. LAW. 113, 128 (1951)). The committee reasoned that the average businessman or lawyer would define good faith as honesty in fact rather than commercial reasonableness. The drafters of the Code followed the committee's recommendations, removing the latter portion of the draft provision in 1952, and leaving the present definition of good faith set forth in section 1-201(19): "'Good faith' means honesty in fact in the conduct or transaction concerned." UCC § 1-201(19) (1989). As noted above, this subjective obligation of good faith was made applicable to contracts and duties within the UCC by section 1-203. Although some sections of the UCC make an objective obligation of good faith applicable in certain situations, the general requirement remains that the parties behave honestly in fact.

Many courts have considered the UCC definition of good faith as "honesty in fact." The consensus is that the mental state of the party who allegedly performed the action in bad faith determines "honesty in fact." Regardless of the negligence or imprudence of the action, if the action was performed honestly, it was in good faith. *See, e.g., Frantz v. First Nat'l Bank*, 584 P.2d 1125, 1127 (Alaska 1978); *Watseka First Nat'l*

Bank v. Ruda, 552 N.E.2d 775, 781 (Ill. 1990); Breslin v. New Jersey Investors, Inc., 70 N.J. 466, 471-72, 361 A.2d 1, 3-4 (1976); Lawton v. Walker, 343 S.E.2d 335 337-38 (Va. 1986); *see also* Farmers Coop. Elevator, Inc. v. State Bank, 236 N.W.2d 674, 678 (Iowa 1975) (citing numerous other authorities). In most jurisdictions, the duty of subjective good faith applies to all contractual dealings within the UCC. Although there have been attempts to apply commercial reasonableness to all UCC cases, the subjective formulation of good faith remains dominant. For example, a bona fide purchase of goods requires subjective good faith. So long as the purchaser honestly believes what he is buying is legitimately owned by the seller, his purchase is not in bad faith. *See* Balon v. Cadillac Auto. Co., 303 A.2d 194, 196 (N.H. 1973); Tumber v. Automation Design and Mfg. Corp., 130 N.J. Super. 5, 12, 324 A.2d 602, 606 (Law Div. 1974). Similarly, the duty of subjective good faith applies to bona fide purchases of securities and other instruments under section 8-302(1). *See, e.g.,* Eldon's Super Fresh Stores, Inc. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 207 N.W.2d 282, 287 (Minn. 1973); *Lawton*, 343 S.E.2d at 337. Banks must fulfill the subjective obligation in the course of their operations as well. *See, e.g.,* Frantz, 584 P.2d at 1127 (observing that a bank, in immediately crediting a check that later was revealed to be bad, did not have to adhere to a standard of commercial reasonableness, and that only subjective honesty was required); *Watsika First Nat'l Bank*, 552 N.E.2d at 779, 781-82 (ruling that a loan acceleration must be done as a result of the creditor's honest belief that he is in financial trouble, but noting that § 1-205 [course of dealing and usage of trade] added an objective dimension to the analysis); Sievert v. First Nat'l Bank, 358 N.W.2d 409, 414 (Minn. Ct. App. 1984) (refusing to classify a bank as a merchant, the court declined to impose a standard of commercial reasonableness upon a bank negotiating a loan refinancing, and held that the applicable standard was subjective good faith); J.R. Hale Contracting Co., Inc. v. United New Mexico Bank, 799 P.2d 581, 591 (N.M. 1990) (declaring that a loan acceleration must be done with a good faith belief in its necessity, and was also subject to a reasonableness inquiry). Secured transactions under section 9-307 of the Code also require adherence to honesty in fact. *See, e.g.,* Foy v. First Nat'l Bank, 693 F. Supp. 747, 758 (N.D. Ind. 1988); Frank Davis Buick AMC-Jeep, Inc. v. First Alabama Bank, 423 So. 2d 855, 858 (Ala. 1982); Massey-Ferguson, Inc. v. Holland, 434 N.E.2d 295, 298 (Ill. App. Ct. 1982). In his 1963 article on the subject of good faith performance, Professor E. Allan Farnsworth criticized the drafters of the UCC, claiming that the drafters' failure to make the objective formulation of good faith generally applicable "so enfeebled [it] that it could scarcely qualify at this point as an 'overriding' or 'super-eminent' principle." *Good Faith Performance*, *supra* note 21, at 674. Some courts have recognized the potential for harm that can result from conduct that would not violate subjective good faith but would be considered commercially unreasonable. In one case, a court found that there was a general duty of objective good faith applicable to all transactions under the Code, section 1-201(19) notwithstanding. *In re Martin Specialty Vehicles, Inc.*, 87 B.R. 752 (Bankr. D. Mass. 1988) (citing *Fortune v. National Cash Register*, 364 N.E.2d 1251, 1256 (Mass. 1977)) (ruling that Massachusetts courts would find a generally applicable duty of objective good faith even under UCC § 1-203), *rev'd on other grounds*, 97 B.R. 721 (D. Mass. 1989). Another court has recognized that other provisions of the Code, such as section 1-205, can add elements of objectivity to the test through a course of dealings analysis. *First Nat'l Bank v. Lewco Sec. Corp.*, 860 F.2d 1407, 1415-16 (7th Cir. 1988) (ruling that the notice standard for bona fide purchase of securities under §§ 1-205 and 8-302 required a commercially reasonable inquiry into the legitimacy of the securities). Yet another court has turned to the jury trial process to provide objectivity, relying on the jury's determination of party credibility to test the subjective honesty of parties, thus preventing "arbitrary or capricious" acceleration of loan payments. *Watsika First Nat'l Bank*, 552 N.E.2d at 781. One court has also held that "objective evidence" may be used to prove that the subjective standard has not been met. *Bank One*

to the duty of objective good faith as well as the duty of subjective good faith.<sup>65</sup> The motivation behind requiring merchants to adhere to a higher standard of good faith is that they have expertise with respect to the customs and standards of their trade.<sup>66</sup>

The objective standard of good faith has been applied in many contexts. For example, it has been used to police "requirements contracts" so that speculation, hoarding and attempted avoidance of contractual obligations are discouraged.<sup>67</sup> Where merchants are attempting to prove their status as bona fide purchasers or holders in due course, the objective standard has also been used rather than the subjective standard, which is used for less expert purchasers.<sup>68</sup> The commercial reasonableness requirement has been ap-

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v. Grantham, Inc., Nos. 90-G-1555, 90-G-1556, 1991 WL 206733, at \*7 (Ohio App. Sept. 30, 1991), *vacated and remanded by*, 588 N.E.2d 127 (Ohio 1992).

<sup>65</sup> See, e.g., *Eastern Air Lines, Inc. v. McDonnell Douglas Corp.*, 532 F.2d 957, 977 (5th Cir. 1976); *Swift v. J.I. Case Co.*, 226 So. 2d 379, 381 (Fla. Dist. Ct. App. 1972); *Oloffson v. Commer*, 296 N.E.2d 871, 875 (Ill. App. Ct. 1973); *Courtesy Enter. v. Richards Lab.*, 457 N.E.2d 572, 577 (Ind. Ct. App. 1983); *Kiser v. Lemco Indus., Inc.*, 536 S.W.2d 585, 589 (Tex. App. 1976). Missouri appears to be an exception, finding a breach of good faith only upon a showing of at least constructive fraud or design to mislead. *Bunge Corp. v. Recker*, 519 F.2d 449, 452 (8th Cir. 1975) (applying Missouri Law).

In addition to honesty in fact, merchants are required to observe "reasonable commercial standards of fair dealing in the trade." UCC § 2-103(1) (1989). This additional duty applies to all sales transactions (transactions covered by Article 2 of the UCC), whether or not the actual UCC provision in question contains an explicit good faith requirement. E.g., *Courtesy Enter.*, 457 N.E.2d at 576-77 (citing the objective good faith standard as the impetus behind requiring a reasonable time for notice of breach of a warranty, even though the actual provision concerning such notice, UCC Section 2-607, did not explicitly mention good faith); *Eastern Air Lines*, 532 F.2d at 997 ("[T]he buyer's good faith is the governing criterion under § 2-607."); *Oloffson*, 296 N.E.2d at 875 (noting that the definition of the words "commercially reasonable time" in UCC § 2-160 must be read in relation to the objective good faith requirement of § 2-103). What constitutes adherence to reasonable commercial standards necessarily varies with the facts of the situation and the area of commerce concerned. *Courtesy Enter.*, 457 N.E.2d at 577; *Eastern Air Lines*, 532 F.2d at 978 ("Therefore, the fact that dissatisfaction may once have been communicated to the seller should not preclude an inquiry into the buyer's good faith as evidenced by his entire course of conduct").

<sup>66</sup> For the definition of a merchant, see *supra* note 17. Courts that have considered the issue of whether a party was a merchant have pointed to experience and expertise with respect to the good or dealing in question as the most important factors for determining merchant status. E.g., *Agristor Leasing v. Hansen*, 41 UCC 1660, 1633-34 (D. Minn. 1985); *Eichenberger v. Wilhelm*, 244 N.W.2d 691, 697 (N.D. 1976); *Pecker Iron Works, Inc. v. Sturdy Concrete Co.*, 410 N.Y.S.2d 251, 253-54 (N.Y. 1978); *Valley Iron and Steel Co. v. Thorin*, 562 P.2d 1212, 1215 (Or. 1977) (In Banc).

<sup>67</sup> E.g., *Homestake Mining Co. v. Washington Pub. Power Supply Sys.*, 476 F. Supp. 1162 (N.D. Cal. 1979); *Neumiller Farms, Inc. v. Cornett*, 368 So. 2d 272, 275 (Ala. 1979); *Eastern Air Lines*, 532 F.2d at 976.

<sup>68</sup> E.g., *Swift v. J.I. Case Co.*, 266 So. 2d 379, 381 (Fla. Ct. App. 1972); *Brokke v. Williams*, 766 P.2d 1311-12 (Mont. 1989); *Touch of Class Leasing v. Mercedes-Benz*

plied by analogy to franchising as well.<sup>69</sup>

## 2. The Restatement (Second) of Contracts

The Restatement (Second) of Contracts also applies the duty of good faith and fair dealing to the performance and enforcement of all contracts. Although that duty was expressly applied only in contract performance or enforcement, application of the duty to measure disclosure requirements prior to the consummation of the contract has not been foreclosed.

The American Law Institute acknowledged that all contracts incorporate a duty of good faith and fair dealing when the Institute decided to adopt section 205 of the Restatement (Second) of Contracts.<sup>70</sup> The First Restatement of Contracts did not, however, contain such a section. The duty of good faith and fair dealing was first embodied in Tentative Draft no. 5, section 231 (Draft section 231) of the Second Restatement of Contracts. The language of Draft section 231 was identical with that adopted in 1979 as Restatement section 205.<sup>71</sup>

The official version of the Restatement made relatively minor modifications in this language to emphasize the fact that negotiations in bad faith were not within the contemplated scope of section 205. Comment c to section 205 provides: "This Section, like Uniform Commercial Code § 1-203, does not deal with good faith in the formation of a contract. Bad faith in negotiation, although not within the scope of this Section, may be subject to sanctions."<sup>72</sup>

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Credit of Canada, Inc., 248 N.J. Super. 426, 443, 591 A.2d 661, 669-70 (App. Div. 1991).

<sup>69</sup> Zapatha v. Dairy Mart, Inc., 408 N.E.2d 1370, 1375 (Mass. 1980).

<sup>70</sup> See Restatement (Second) of Contracts § 205 ("Every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement."). *Id.* Other sections of the Restatement (Second) of Contracts also refer to "good faith" and "fair dealing." For example, Section 241(e) provides that "the extent to which the behavior of [a] party failing to perform . . . comports with standards of good faith and fair dealing" is a significant factor in determining whether that party's breach is material. RESTATEMENT (SECOND) OF CONTRACTS § 241(e) (1979).

<sup>71</sup> The only relevant change in language between Draft Section 231 and Section 205 is found in the official comments appended to those sections. Comment c, *Good Faith in Negotiation of Draft § 231*, reads:

This Section, like Uniform Commercial Code § 1-203, does not deal with good faith in the formation of a contract, but bad faith in negotiation is also subject to sanctions. Particular forms of bad faith bargaining are the subjects of rules as to capacity to contract, mutual assent and consideration and of rules as to invalidating causes such as fraud or duress.

RESTATEMENT (SECOND) OF CONTRACTS § 231 (Tentative Draft No. 5 (1966)).

<sup>72</sup> RESTATEMENT (SECOND) OF CONTRACTS § 205 cmt. c (1979).

The comment to section 205 further states that where a statute does not impose a duty to bargain in good faith, "remedies for bad faith in the absence of agreement are found in the law of torts or restitution."<sup>73</sup>

Section 205 was included in the Second Restatement under the topic entitled, *Considerations of Fairness and the Public Interest*. The official Restatement, however, does not include a rationale for section 205 or a reason why section 205 was limited to contract performance and enforcement. It is possible that section 205 does not deal with the application of the duty of good faith and fair dealing to the negotiation of a contract because this was seen as an area of tort, not contract law.<sup>74</sup> The drafters of the Second Restatement may also have been reluctant to delve into the area of negotiations because of a perception that a precontractual duty of good faith was not yet well-recognized.

The Reporter's note to section 205 references two law review articles, one by Professor Farnsworth,<sup>75</sup> and the other by Professor Summers,<sup>76</sup> which explore the meaning and historical application of "good faith" in contract law.<sup>77</sup> The reference to Professor Summers's article, in particular, is interesting because Summers argued that the duty of good faith and fair dealing applied to precontractual negotiations.<sup>78</sup>

The thesis of the Farnsworth article was that an objective standard, as reflected in the UCC's reference to commercial reasonableness, should be adopted to evaluate good faith.<sup>79</sup> Professor Farnsworth concluded that, "the lesson is there, and the [UCC's] concepts of good faith performance and commercial reasonable-

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<sup>73</sup> *Id.*

<sup>74</sup> The language in comment c to section 205 supports this interpretation.

<sup>75</sup> *Good Faith Performance*, *supra* note 21.

<sup>76</sup> *General Contract Law*, *supra* note 15.

<sup>77</sup> RESTATEMENT (SECOND) OF CONTRACTS § 205 (1979) (Reporter's note).

<sup>78</sup> *General Contract Law*, *supra* note 15, at 220-32.

<sup>79</sup> *Good Faith Performance*, *supra* note 21, at 671-74. According to Professor Farnsworth, the UCC used the term "good faith" in two senses. In the first sense, "a party is advantaged only if he acted with innocent ignorance or lack of suspicion. This meaning of "good faith" is very close to that of lack of notice." *Id.* at 668. In the second sense, the UCC used the term:

[T]o describe performance or enforcement rather than purchase. In this sense, 'good faith' has nothing to do with a state of mind—with innocence, suspicion, or notice. Here the inquiry goes to decency, fairness or reasonableness in performance or enforcement. This sense of the term may be characterized as 'good faith performance' . . . and is the sense in which 'good faith' is used in the general obligation of good faith.

*Id.*

ness await development, even beyond the bounds of the [UCC], at the hands of resourceful lawyers and creative judges."<sup>80</sup> Perhaps in response to this call, section 205, as adopted, refers to UCC §§ 1-201(19) and 2-103(1)(b) as examples of the meaning of good faith comprehended by the section.<sup>81</sup>

The second article referred to in the Restatement, written by Professor Summers, recognized a common law meaning of good faith that pre-dated and had a scope beyond that found in the UCC.<sup>82</sup> Summers maintained that good faith, as revealed in common law jurisprudence of contract, applied a "minimal standard rather than a high ideal."<sup>83</sup> His thesis was that court decisions that apply general contract law reveal the term "good faith" as "a phrase which has no general meaning or meanings of its own, but which serves to exclude many heterogeneous forms of bad faith," and that "the duties judges have imposed in the name of contractual good faith are more varied and numerous [than the scope of UCC application]."<sup>84</sup>

Professor Summers argued that, although the drafters of the UCC thought of good faith "as a positive concept, with a general, definable meaning of its own," it was not beneficial to attempt to articulate a single "good faith" concept in the common law of contract.<sup>85</sup> Viewed as an "excluder," the article argued that courts imposed a good faith requirement in a broad range of contexts.<sup>86</sup>

The Summers article cited pre-Restatement cases that either

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<sup>80</sup> *Id.* at 679.

<sup>81</sup> RESTATEMENT (SECOND) OF CONTRACTS § 205 cmt. a (1979).

<sup>82</sup> *General Contract Law*, *supra* note 15, at 196.

<sup>83</sup> *Id.* at 195.

<sup>84</sup> *Id.* at 196, 197.

<sup>85</sup> *Id.* at 207. Professor Summers further noted:

To summarize, general definitions of good faith either spiral into the Charybdis of vacuous generality or collide the Scylla of restrictive specificity. Moreover, the analyst who puts general definitions aside and tries to focus on the form of bad faith which the given judge intends to exclude by use of the term is likely to get closer to that judge's meaning, for good faith functions as an 'excluder,' and judges are more interested in what they are proscribing than in characterizing what is generally allowed.

*Id.* at 206-07.

<sup>86</sup> Professor Summers explained that:

Cases have been discovered which, if taken as a whole rather than by states, require good faith at every stage of the contractual process, from preliminary negotiation through performance and discharge, and in nearly all kinds of contracts. This is not to say that all cases agree as to when a duty of good faith should be imposed, for they do not. Nor, is it to say that the jurisdictions are more or less uniform in the extent to which they require good faith. On some questions . . . for example,



directly or indirectly support the imposition of some type of good faith standard in negotiations that relate to: negotiating without serious intent, abusing the privilege to withdraw a proposal or an offer, entering a deal and not intending to perform or recklessly disregarding prospective inability to perform, and taking advantage of another in driving a bargain. The article also included a seller's nondisclosure of known infirmities in goods as an area where a good faith standard has application, but cited no cases that impose such a requirement.<sup>87</sup>

By its nature, this older, common law view of good faith as an "excluder" should be understood primarily as a functional tool for judges. Therefore, its application is not rigid, but rather, incorporates the idea of evolution that is at work in the common law as a whole. As such, even if section 205, as originally drafted, was not intended to apply to contract negotiations, the common law process envisioned in the common law definition of good faith, which section 205 embraced, does not prohibit the good faith concept from application during contract negotiations. As already noted, Professor Summers argued that courts could extend the doctrine for application to contract negotiations.<sup>88</sup> Unfortunately, some courts relying upon section 205, comment c, have specifically refused to apply the duty of good faith and fair dealing to precontractual negotiations.<sup>89</sup> This conclusion, however, overreads the comment. Although comment c states that section 205 does not apply to the negotiation phase, neither that comment nor the text of section 205 precludes application of a precontractual duty of good faith. Moreover, section 161(b) of the Second Restatement specifically provides for good faith disclosures in the making of a

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whether contract negotiations must be conducted in good faith—case law is scant.

*Id.* at 216.

<sup>87</sup> *Id.* at 228-30.

<sup>88</sup> *Id.* at 203, 220-21, 228-30.

<sup>89</sup> *E.g.*, Local 900, Union of Paperworkers Int'l v. Boise Cascade, 713 F. Supp. 26, 29 (D. Me. 1989); Carrols Corp. v. Canton Joint Venture, No. 88-2115-1, 1990 WL 99047, at \*7 (Ohio Comm. Pl. June 27, 1990) (rejecting argument that there is an implied duty of good faith and fair dealing in precontractual negotiations by noting, in part, that Section 205 of the RESTATEMENT (SECOND) OF CONTRACTS limited application of the doctrine of the duty of good faith and fair dealing to contract performance and enforcement); Four Mines Gold, Inc. v. 71 Const., Inc., 809 P.2d 236, 239 (Wyo. 1991) (citing RESTATEMENT (SECOND) OF CONTRACTS § 205 cmt. c (1979)) (concluding that the implied covenant of good faith and fair dealing "does not deal with the formation of a contract"); Tolbert v. First Nat'l Bank, 823 P.2d 965, 969 (Or. 1991) (relying in part on comment c to the RESTATEMENT (SECOND) OF CONTRACTS § 205, the court declared that the duty of good faith and fair dealing did not "extend to the formation of the contract") (footnote omitted).

contract under certain circumstances.<sup>90</sup>

### E. Statutory Good Faith Requirements

The increasing usage of the duty of good faith and fair dealing is also evidenced by the imposition of the duty through legislation such as the Federal Automobile Dealers Franchise Act, better known as the Automobile Dealers' Day in Court Act (ADDA).<sup>91</sup> Under the ADDA, a dealer may bring suit against a manufacturer if the manufacturer failed "to act in good faith in performing or complying with any of the terms or provisions of the franchise, or in terminating, canceling, or not renewing the franchise . . . ."<sup>92</sup> The

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<sup>90</sup> RESTATEMENT (SECOND) OF CONTRACTS § 161(b) (1979). See *infra* Section IV. E. 2 for a discussion of the good faith concepts adopted by both The Restatement (Second) of Contracts and Restatement (Second) of Torts.

<sup>91</sup> 15 U.S.C. §§ 1221-1225 (1982). Another example of a statutory requirement of good faith is found in the National Labor Relations Act (NLRA), 29 U.S.C. § 158(d) (1988) providing that:

[T]o bargain collectively is the performance of the mutual obligation of the employer and the representative of the employees to meet at reasonable times and confer in good faith with respect to wages, hours, and other terms and conditions of employment . . . but such obligation does not compel either party to agree to a proposal or require the making of a concession.

Despite the language of the statute, no *per se* test of good faith bargaining exists. *United Packinghouse, Food & Allied Workers' Int'l Union v. N.L.R.B.*, 416 F.2d 1126, 1131 (1969) (quotation omitted), *cert. denied*, 396 U.S. 903 (1969). The bargaining, nevertheless, presupposes that the parties attempt to enter into a collective bargaining agreement. *N.L.R.B. v. Insurance Agents Int'l Union*, 361 U.S. 477, 484-86 (1960). Tension still exists between the principles that the parties must attempt to solve their differences and that the parties need not make concessions. There are many examples of bad faith. An employer is guilty of bad faith bargaining when it insists on terms which no reasonable union could accept. *Tomco Communications, Inc.*, 220 N.L.R.B. 636, 637-38 (1975). Taking a position in an effort to destroy or cripple the union also constitutes bad faith. *United Steelworkers of America v. N.L.R.B.*, 390 F.2d 846, 849-50 (1967), *cert. denied*, 391 U.S. 904 (1968). Moreover, the parties must make a serious attempt to reach agreement, not merely go through the formalities. *Continental Ins. Co. v. N.L.R.B.*, 495 F.2d 44, 47-48 (2d Cir. 1974). The union, in addition to having a duty to bargain fairly with the employer, also has a duty of fair representation to its employees. A union breaches this duty of fair representation if its actions are arbitrary, discriminatory, or otherwise in bad faith. *Vaca v. Sipes*, 386 U.S. 171, 190-91 (1967).

<sup>92</sup> 15 U.S.C. § 1222. The ADDA defined good faith as:

[T]he duty of each party to any franchise, and all officers, employees, or agents thereof to act in a fair and equitable manner toward each other so as to guarantee the one party freedom from coercion, intimidation, or threats of coercion or intimidation from the other party: *Provided*, That recommendation, endorsement, exposition, persuasion, urging or argument shall not be deemed to constitute a lack of good faith.

15 U.S.C. § 1221(e). The definition is more limited than the general good faith standard. *Autohaus Brugger, Inc. v. Saab Motors, Inc.*, 567 F.2d 901, 911 (9th Cir. 1978),

legislative history of the ADDA indicates that Congress was prompted to enact the law, at least in part, by the failure of courts to impose a duty of good faith on automobile manufacturers.<sup>93</sup> Some states also regulate the franchise relationship through restrictions upon the franchisor and a requirement that the parties act in good faith.<sup>94</sup>

#### F. *The Nature of the Duty of Good Faith*

For the last few decades, courts in the United States have been wrestling with the nature of the duty of good faith. Some courts have argued that the duty is simply contractual in nature and arises only with a contract, while others have posited that the duty is imposed by law. Accordingly, the obligation of good faith and fair dealing has become the object of a tug-of-war between those who

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*cert. denied*, 436 U.S. 946 (1978); *Frank Meador Buick, Inc. v. General Motors Acceptance Corp.* (*In re Frank Meador Buick, Inc.*), 13 B.R. 841, 844 (W.D. Va. 1981). Actual or threatened intimidation determines the presence or absence of good faith. *Francis Chevrolet Co. v. General Motors Corp.*, 460 F. Supp. 1166, 1169 (E.D. Mo. 1978), *aff'd*, 602 F.2d 227 (8th Cir. 1979). Thus, "an indispensable element of a cause of action under the Act is a lack of good faith in which coercion, intimidation, or threats thereof exist . . . ." *Conroy Datson Ltd. v. Nissan Motor Corp.*, 506 F. Supp. 1051, 1055 (N.D. Ill. 1980).

<sup>93</sup> See H.R. No. 2850, 84th Cong. 2d Sess. 4599 (1956). Some courts have found that every franchise contract contains an implied covenant of good faith and fair dealing. *E.g.*, *Photovest Corp. v. Fotomat Corp.*, 606 F.2d 704, 727-28 (7th Cir. 1979), *cert. denied*, 445 U.S. 917 (1980). One court, however, has held that the obligation of good faith and fair dealing does not extend to precontractual negotiations involving a franchise agreement. *Bonfield v. AAMCO Transmission, Inc.*, 717 F. Supp. 589, 593-94 (N.D. Ill. 1989).

<sup>94</sup> 62B AM. JUR. 2d *Private Franchise Contracts* § 292 (1990). The state of Washington enacted the most comprehensive type of franchise statute. It provides that the franchisor and franchisee "shall deal with each other in good faith." WASH. REV. CODE § 19.100.180(1) (1991). The statute also sets forth a list of unfair or deceptive trade practices, all of which protect the franchisee. *Id.* § 19.100.180(2)(a-j). Among other things, Washington's franchise statute protects the franchisee's right to join an association of franchisees, safeguards the franchisee's ability to purchase goods from suppliers other than the franchisor, protects the franchisee's business contacts and governs the termination or renewal of the franchise. Washington's statute therefore protects the franchisee once the business relationship is established.

Moreover, outside Washington, attempts have been made to pass legislation that would expand the duty of good faith in franchises. The Unfair Franchise and Business Opportunities Act has been proposed, but the Act has encountered problems because of its inclusion of a duty of good faith. 62B AM. JUR. 2d *Private Franchise Contracts* § 6 (1990). The North American Securities Administrators' Association has proposed a Model Act that would impose a good faith standard on the general performance of the franchise agreement, but the duty of good faith apparently arises only when the agreement is in place. *Id.* § 294. Legislatures have passed franchise statutes because many of the established remedies, such as breach of contract and fraud, which are adequate for normal business transactions, do not solve the problem of franchise contracts. *Id.* § 292.

seek its restriction to the realm of contract law, the breach of which will require contract damages only, and those who envision the duty as the source of a tort remedy, with consequential damages, punitive damages and attorney's fees available.<sup>95</sup>

The breach of the duty, in the insurance context or otherwise, led, initially, to recovery of contract damages only, and was not viewed as a source for an action in tort independent of the contract.<sup>96</sup> Courts soon recognized the need to protect the rights of an insured in the face of liability insurers who controlled the insured's defense, but refused to settle claims, thus exposing the insured to judgments in excess of the amount covered by the insurer.<sup>97</sup> The tort evolved slowly, however. In *Brassil v. Maryland Casualty Co.*, the New York Court of Appeals held that a good faith duty existed in all insurance transactions.<sup>98</sup>

A more significant move toward allowing recovery in tort for breach of the implied covenant occurred in *Hilker v. Western Automobile Insurance Co.*<sup>99</sup> The court in *Hilker* did not explicitly recognize a tort, but found that a "good faith" duty attached to the insurer when the insurer bargained for full control over the insured's defense.<sup>100</sup> The court allowed the insured to recover from the insurer an amount in excess of the policy, where plaintiff obtained a judgment against the insured in excess of the insured's policy and the insurer previously refused to settle plaintiff's claim for an amount within the policy limit. The court utilized a negligence standard in determining that the insurer had breached the covenant of good faith by failing to exercise "that degree of care and diligence which a man of ordinary care and prudence would exercise" in deciding whether to settle the claim.<sup>101</sup>

The use of tort remedies for breach of the duty of good faith in the United States is usually traced to *Comunale v. Traders & General Insurance Co.*<sup>102</sup> In *Comunale*, plaintiff sued his insurance company for, among other things, refusing to accept a reasonable

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<sup>95</sup> Croskey, *supra* note 55, at 562-64.

<sup>96</sup> *Rumford Falls Paper Co. v. Fidelity & Cas. Co.*, 43 A. 503, 506-07 (Me. 1899).

<sup>97</sup> Alan R. Miller & Jordan M. Lewis, *The Impact Of The Good Faith Requirement Upon The Parties*, 26 TORT AND INS. L.J. 602, 603-05 (1991).

<sup>98</sup> *Brassil v. Maryland Cas. Co.*, 104 N.E. 622, 624 (N.Y. 1914). The court did not recognize a tort, but allowed an insured to recover the cost of appealing a judgment against him in excess of his policy, where the insurer had previously refused to settle for an amount within the policy limit. *Id.*

<sup>99</sup> 235 N.W. 413 (Wis. 1930).

<sup>100</sup> *Id.* at 414; see also Jones, *supra* note 55, at 804.

<sup>101</sup> *Hilker*, 235 N.W. at 415.

<sup>102</sup> 328 P.2d 198 (1958).

settlement offer. In holding the insurer liable for the subsequent court judgment, including the amount in excess of the policy limit, the California Supreme Court stated that "[t]here is an implied covenant of good faith and fair dealing that neither party will do anything which will injure the right of the other to receive the benefits of the agreement."<sup>103</sup> In *Comunale*, the California Supreme Court explicitly held that a breach of the implied covenant of good faith could sound in both tort and contract, at least with regard to an insured's actions against his liability insurer.<sup>104</sup>

*Comunale* and its creation of a third-party tort claim—a claim by the insured against his insurer for refusal to settle a claim by another party against the insured—was relatively uncontroversial until it was extended to first party claims—claims brought by the insured against the insurer for refusal to pay the insured's claim. In *Gruenberg v. Aetna Insurance Co.*, the California Supreme Court expanded the coverage of this tort to include an insurer's wrongful refusal to settle first party claims.<sup>105</sup> The court explained that the law implied an action in tort separate from the contract, and this action existed independent of the contract: "[T]he insurer's duty is unconditional and independent of the performance of plaintiff's contractual obligations."<sup>106</sup> Most states trace creation of their first-

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<sup>103</sup> *Id.* at 200.

<sup>104</sup> *Id.* at 202. Subsequently, the same court went even further, holding that an insured could not only recover damages exceeding policy limits incurred in the form of an excess judgment, but all damages due to emotional distress arising from injury to property interests. *Crisci v. Security Ins. Co.*, 426 P.2d 173, 179 (Cal. 1967). Some jurisdictions require substantial economic injury beyond the policy amount arising from the insurer's refusal to settle or pay a claim in good faith before allowing collection of emotional distress or other extra-contractual damages. *Anderson v. Continental Ins. Co.*, 271 N.W.2d 368, 378 (Wis. 1978). At least in California, proof of substantial economic harm is not necessary, and the court will evaluate emotional distress claims on a case-by-case basis. *Delos v. Farmers Ins. Group, Inc.*, 155 Cal. Rptr. 843, 853-54 (Cal. Ct. App. 1979); Thomas A. Diamond, *The Tort Of Bad Faith Breach Of Contract: When, If At All, Should It Be Extended Beyond Insurance Transactions?*, 64 MARQ. L. REV. 425, 426-27 & nn.5-7 (1981). Additionally, an insurer found to have acted with malice or reckless disregard as to the validity of a claim in refusing to pay a claim will be liable for punitive damages. *Egan v. Mutual of Omaha Ins. Co.*, 598 P.2d 452, 457 (Cal. 1979); *Anderson*, 271 N.W.2d at 376, 379. The implied covenant of good faith, however, may be breached without proof of the positive malicious misconduct essential for recovering punitive damages. *Neal v. Farmers Ins. Exch.*, 582 P.2d 980, 986 n.5 (Cal. 1978).

<sup>105</sup> *Gruenberg v. Aetna Ins. Co.*, 510 P.2d 1032, 1037 (1973).

<sup>106</sup> *Id.* at 1040 (footnote omitted). Similarly, the *Egan* court cited high public expectations, insurance companies superior bargaining power and the need for public trust in private insurance companies performing an essentially public function as its rationale for recognizing this tort. *Miller & Lewis*, *supra* note 97, at 606; *Egan*, 598 P.2d at 457. The need to discourage insurance companies from attempting to avoid payment of claims through wrongful or threatened cancellation also contributed to

party insurance tort to *Gruenberg*.<sup>107</sup> Some states, however, have rejected this tort claim.<sup>108</sup> In 1984, the California Supreme Court caused an uproar when it hinted in dicta that tort remedies may be available for other commercial contracts.<sup>109</sup> The tentativeness of the dicta divided the legal community.<sup>110</sup>

Those advocating the use of tort remedies for contract breaches marshalled two simplistic but forceful arguments. The first argument cited the punitive aspects of the tort remedy as a

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the willingness of California's courts to find a tort in the breach of an implied covenant. *Spindle v. Travelers Ins. Cos.*, 136 Cal. Rptr. 404, 408 (Cal. Ct. App. 1977).

<sup>107</sup> Carolyn S. Smith, Note, *supra* note 55, at 611. Support for recognition of "first party" claims is more controversial. As of 1990, twenty-eight jurisdictions recognized first party tort actions, twelve rejected it, seven generally rejected it but allowed some recovery of extra-contractual damages and two have left the question unanswered. *Jones, supra* note 55, at 809-10. Typically, a court evaluates the reasonableness of the insurer's conduct under the circumstances in refusing to pay a claim to determine whether a breach of the covenant occurred. Factors generally considered are: whether the claim was adequately investigated, whether the policy was fairly interpreted and, whether the insurer's conduct was free of abusive or coercive actions.

<sup>108</sup> For example, the Utah Supreme Court limited recovery in first party actions to contract damages after determining that, "there is no sound theoretical difference between a first-party insurance contract and any other contract . . . that justifies permitting punitive damages for the breach of one and not the other." *Beck v. Farmer's Ins. Exch.*, 701 P.2d 795, 800 (Utah 1985). The court permitted extra-contractual recovery, however, allowing for "general damages," defined as "those flowing naturally from the breach [as well as] consequential damages, *i.e.*, those reasonably within the contemplation of, or reasonably foreseeable by the parties at the time the contract was made." *Id.* at 801. Although the court found this approach analytically superior to permitting recovery in tort, the court stated that emotional distress damages could be recovered as "foreseeable," as well as any damages incurred through violation of the "reasonable expectations" of the parties. *Id.* at 802. Some commentators have noted that such a "reasonable expectations" standard "rejects traditional contract law standards." *Miller & Lewis, supra* note 97, at 605. The Utah Court's resort to "reasonable expectations," therefore, is ironic given the court's desire to preserve the purity of contract doctrine when interpreting insurance contracts.

<sup>109</sup> In *Seaman's Direct Buying Serv. Inc. v. Standard Oil Co.*, the court observed that while an implied covenant of good faith and fair dealing has been well settled, the same cannot be said about a tort action for breach of the covenant. 686 P.2d 1158 (Cal. 1984). The court noted, however, that a tort action for a breach of the covenant has been available in certain circumstances, such as an insurance contract, because an insurance contract consists of a "'special relationship' between the insurer and insured, characterized by elements of public interest, adhesion, and fiduciary responsibility." *Id.* Other relationships, according to the court, may also qualify for similar legal treatment. *Id.* at 1166 (footnote omitted).

<sup>110</sup> One commentator noted:

A court that avoids ruling on the extension of the cause of action for bad faith to commercial contract cases by recognizing a new cause of action for 'stonewalling', citing an inapposite decision from an intermediate appellate court of a sister state, can only be described as out of balance.

Wallenstein, *supra* note 55, at 121 n.50 (citation omitted).

possible tool to deter wrongful conduct and enforce business ethics.<sup>111</sup> The second argument was rooted in contract compensation theory. It contended that contract damages, while designed to make the non-breaching party whole, seldom render adequate compensation.<sup>112</sup> Many argue that tort damages are necessary to solve this undercompensation problem.<sup>113</sup>

The critics of tort remedies for breach of commercial contracts also advanced their own forceful arguments. Commentators pointed out that tort remedies are economically inefficient and poorly designed to meet the acknowledged under-compensation problem.<sup>114</sup> Most importantly, commentators noted that tort damages undermine the system of "efficient breach" that forms the basis of contract law.<sup>115</sup>

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<sup>111</sup> Barrett, *supra* note 55, at 523.

<sup>112</sup> Tremper, *supra* note 55, at 366 & n.99. Damages for breach of contract are ordinarily restricted to those that were foreseeable and contemplated by the parties at the time of the contract's execution. *Hadley v. Baxendale*, 156 Eng. Rep. 145 (1854). Some observers have advocated the use of tort law in cases of limitation of damages available in breach of contract cases. One commentator pointed out that the expanded use of the covenants of good faith and fair dealing implied in every contract could provide a vehicle to impose tort duties. Tremper, *supra* note 55, at 350. Implied or imposed duties are outside those contained in the contract, and an array of tort remedies, such as consequential damages, emotional distress, punitive damages and attorneys fees, are available. Croskey, *supra* note 55, at 362-63.

<sup>113</sup> Tremper, *supra* note 55, at 368.

<sup>114</sup> *Id.* at 369.

<sup>115</sup> *Id.* at 370-71. Legal scholars who guided the initial development of contract law believed that liability for breach of contract should not exceed the sum of the promises given for consideration. Richard E. Speidel, *The Borderland Of Contract*, 10 N. KY. L. REV. 163, 166 (1983). This rule limited the remedial powers of the judicial system to the four corners of the bargained-for agreement and provided a measure of predictability that was essential to the "efficient breach" contract system. *Id.* at 172. At the same time, most states created the implied covenant of good faith and fair dealing to address unexpected contract problems. *Foley v. Interactive Data Corp.*, 765 P.2d 373, 389 (Cal. 1988). Because the implied covenant served a gap filling function, courts have treated the covenant as an adjunct obligation of the contract whose breach is compensable by ordinary contract damages. Wallenstein, *supra* note 55, at 115 (footnote omitted).

Immediately following the *Seaman* court's dicta, there was a wave of sentiment that tort remedies were soon to be available for breach of ordinary commercial contracts. Barrett, *supra* note 55, at 522. This sense of immediacy dissipated as few courts moved to adopt *Seaman's* tort. Tremper, *supra* note 55, at 355 (footnote omitted). In fact, the California Supreme Court intentionally impeded the trend towards contract tort remedies in *Foley v. Interactive Data Corp.*, 765 P.2d 373 (1988). *Foley* involved an effort to extend the *Gruenberg* insurance tort into the area of employment contracts. In addressing this attempt, the California Supreme Court declared that the covenant of good faith and fair dealing originated with the aim of "making effective the agreement's promises," not fulfilling social policy. *Id.* at 389. The court distinguished some appellate decisions for their "uncritical incorporation of the insurance model into the employment context, without careful consideration of the fundamen-

Any attempt to characterize the duty of good faith as merely contractual and thus to deny the existence of the duty when there is no contract is unsustainable because the duty of good faith exists before any contract is ever entered into. It is a duty imposed by law, and is outside the contractual freedom of the parties. The duty of good faith belongs to the prevailing practices of the community of people and their notions as to what constitutes the general welfare.<sup>116</sup> It is a duty permanently present whenever human beings deal with each other. A breach of this duty is contrary to public policy and *contra bonos mores* as these concepts are understood by the community. A man of probity and intelligence knows that the practices and opinions of his fellow men, "practices and opinions in the midst of which he was born and by which his own mind and conscience have been formed and educated"<sup>117</sup> would not let breaches of good faith prevail.

Marcel Planiol, a most distinguished French scholar, thus described imposed duties in a celebrated comment to *Epoux de Molènes v. Patry*:

[T]he contractual liability is added to the liability imposed by law, which it can neither eliminate nor substitute, the reason being that the law comes before any contract. The legal obligation pre-exists, and the contracting parties can only add to it;

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tal policies underlying the development of tort and contract law." *Id.* at 393. The court then remarked that:

[A]n allegation of breach of the implied covenant of good faith and fair dealing is an allegation of breach of an "ex contractu" obligation, *namely one arising out of the contract itself*. The covenant of good faith is read into contracts in order to protect the express covenants or promises of the contract, not to protect some general public policy interest not directly tied to the contract's purposes. *The insurance cases thus were a major departure from traditional principles of contract law.*

*Id.* at 394 (emphasis added). This, in a nutshell, was a forceful rejection of the extension of tort remedies to employment contracts. Furthermore, the court clearly held that the rightful place for the covenant of good faith and fair dealing, barring an unusual exception, was within the realm of contract law. *Foley* thus indicated that, at least in California, the trend towards the application of tort remedies to commercial contracts has been reversed for now.

Farnsworth described the "rise and fall" of the tort remedy for bad faith breach as perhaps "the most astonishing development" in the field of contract law in the 1980's. E. Allan Farnsworth, Essay, *Developments In Contract Law In The 1980's: The Top Ten*, 41 CASE W. RES. L. REV. 203, 204 (1990). While Farnsworth did not proclaim the death of the bad faith tort, he noted that *Foley* would probably check its expansion in the 1990's. *Id.* at 206 (footnote omitted). Farnsworth did note, however, that "the specter of bad faith breach promises to haunt contract law until future cases determine its fate." *Id.*

<sup>116</sup> CORBIN, *supra* note 27, at 1157.

<sup>117</sup> *Id.* at 1158.



but a pre-existing legal obligation cannot become a contractual one just because private parties have somehow reproduced it in, and committed to, their contract.<sup>118</sup>

As a requirement based on public policy, the duty of good faith establishes the standard of conduct which is exacted from everybody in order to discourage dishonesty, and encourage loyalty, fairness and openness, thus fostering trade and commerce, rewarding honesty and candor and condemning deceit of whatever kind.<sup>119</sup> Considerations of meticulous characterization in contract or tort, and sharp systematic distinctions within the two orders of liability, are not important. There may be good reasons in some cases not to allow tort remedies for violation of the duty of good faith when a contract exists. This Article does not address that topic. Nevertheless, what matters is that some remedy is always available for a breach of the duty of good faith.

Thus, while the cases and legal commentators are not in agreement on whether breach of the duty of good faith and fair dealing should be considered to lie in tort or contract, at least when a contract is involved, the dispute does not affect the thesis of this Article that there is a tort duty of good faith disclosure in the negotiations leading up to the sale of a business or the consummation of other business transactions. Because there is no contract during the negotiation stage, there is no reason why tort remedies for breach of the duty of good faith should not be available.

The recognition that there is a duty imposed by law, independent of contract, to exercise good faith in transactions with others, supports the conclusion that the duty applies to both the precontractual and the contractual phase.<sup>120</sup> What differs between a breach of the duty

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<sup>118</sup> Cour d'Appel de Paris 17 Jan. 1905, D.P. 1907 2 97: "*la responsabilité conventionnelle vient s'ajouter à la responsabilité établie par la loi et ne peut ni l'éliminer, ni se substituer à elle, par la raison que la loi est antérieure à tous les contrats. L'obligation légale préexiste, et les parties contractantes peuvent seulement y ajouter quelque chose; mais une obligation légale préexistante ne devient pas contractuelle par cela seul que des particuliers l'ont reproduite et versée, en quelque sorte, dans leur contrat.*" Louis Josserand (writing, as did Planiol in the above passage, in the context of *cumul*, i.e., concurrence of claims) attacked Planiol's position because he thought that it represented too severe a threat on contractual freedom. In Josserand's own words, "endemic chaos is systematically introduced in the contractual relations of private law in the name of public policy." ("*Si bien qu'en définitive, c'est le régime contractuel qui va s'effondrer, qui va faire faillite, de par la volonté unilatérale de l'un de ceux qui l'avaient établi et librement accepté: au nom de l'ordre public, c'est le désordre à l'état endémique qui est porté systématiquement dans les rapports contractuels du droit privé.*"). Note to Req. 14 Dec. 1926, D.P. 1927 I 105, at 107.

<sup>119</sup> See, e.g., Benatti, *supra* note 2, at 308-09 (discussing Italian law). See also *infra* notes 588-611 and accompanying text (discussing the duty of good faith under Italian law).

<sup>120</sup> The traditional definition of a tort, sufficient to allow recovery of consequential and punitive damages, is that a violation has occurred of a duty that arises independ-

when there is a contract, and a breach in the precontractual stage, is the remedy. In the contractual context, contract remedies are awarded (although concurrent tort remedies should not be ruled out), and in the precontractual context, tort remedies should be awarded.

### G. *The Application of Ethical Standards in the Marketplace*

As Corbin has stated, "bargains are judged by the folkways and mores of the time."<sup>121</sup> The days of *laissez-faire* economics and *caveat emptor*, for instance, in which courts often noted that the law was not coextensive with ethics and morality,<sup>122</sup> but only proscribed certain egregious behavior, have gone.

A number of trends are commonly referenced in order to substantiate this legal change in the ethics of the marketplace. The doctrine of promissory estoppel, for example, advances moral and ethical principals in the marketplace.<sup>123</sup> Promissory estoppel is the basis for enforcement of a promise, even when it is not binding as a contract under certain circumstances, "if injustice can be avoided only by enforcement of the promise."<sup>124</sup> Another example is the observation that courts have become increasingly receptive to characterize what had heretofore been considered conventional com-

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ent of contract. *Palmer v. Nationwide Mut. Ins. Co.*, 945 F.2d 1371, 1375 (6th Cir. 1991); *Cincinnati Gas & Elec. Co. v. General Elec. Co.*, 656 F. Supp. 49, 61 (S.D. Ohio 1986); *Cotton v. Otis Elevator Co.*, 627 F. Supp. 519 (S.D. W. Va. 1986).

<sup>121</sup> CORBIN, *supra* note 27, at 1157. Corbin went on to add: "The mores of a people, those generally prevailing practices and opinions as to what promotes welfare and survival, also slowly change with the time and circumstance . . . Courts and administrative officers, as well as legislators, cannot fail to be affected by these changes in times and opinions." *Id.* at 1162.

In tune with this observation, it is noteworthy to point out that the mores of society, the prevailing practices and opinions, including commercial transactions, as to what promotes human welfare and survival, are increasingly turning to moral and ethical standards. *See id.* Similarly, for the law of Quebec, *see, e.g.,* Brigitte Lefebvre, *La bonne foi dans la formation du contrat* 1992 MCGILL L.J. 1053, 1055 (1992) ("*Depuis les dernières décennies, le droit des obligations est en pleine évolution, marqué par une nouvelle philosophie basée sur la notion de justice contractuelle.*"). Lefebvre emphasizes the supremacy of contractual justice over contractual freedom. *See id.* at 1068 ("*On constate donc que le législateur québécois cherche à promouvoir la justice contractuelle au détriment de la liberté contractuelle.*").

<sup>122</sup> *E.g., Goodwin v. Agassiz*, 186 N.E. 659, 661 (Mass. 1933) ("Law in its sanctions is not as extensive with morality. It cannot undertake to put all parties to every contract on an equality as to knowledge, experience, skill and shrewdness.").

<sup>123</sup> G. Richard Shell, *Substituting Ethical Standards For Common Law Rules In Commercial Cases: An Emerging Statutory Trend*, 82 Nw. U. L. REV. 1198, 1206 (1988); Daniel A. Farber & John H. Matheson, *Beyond Promissory Estoppel: Contract Law and the "Invisible Handshake"*, 52 U. CHI. L. REV. 903, 906 (1985).

<sup>124</sup> RESTATEMENT (SECOND) OF CONTRACTS § 90 (1979).

mercial relationships as fiduciary or confidential in nature, so that the parties involved in such relationships have heightened ethical and moral duties to each other.<sup>125</sup>

The UCC's and the Second Restatement's use of unconscionability also reflects the increasing morality of the marketplace.<sup>126</sup> Section 2-302 of the UCC, which deals with the "Unconscionable Contract or Clause," reflects the "UCC's sensitivity to the ethical dimension in business dealings."<sup>127</sup> The duty of good faith as adopted by the UCC, the Restatement (Second) of Contracts, and by the common law, also injects ethical norms into business relationships.<sup>128</sup> Likewise, the recognition of a tort for breach of the implied covenant of good faith and fair dealing, which is now widely accepted in the area of insurance law,<sup>129</sup> and perhaps other areas of the law,<sup>130</sup> as well as the allowance of punitive damages

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<sup>125</sup> Shell, *supra* note 123, at 1207-08.

<sup>126</sup> *Id.* at 1208-09.

<sup>127</sup> *Id.* at 1208. Section 208 of the Restatement (Second) of Contracts has also adopted the doctrine of unconscionability. RESTATEMENT (SECOND) OF CONTRACTS § 208 (1979). While principles of unconscionability are most often applied to consumer contracts, commentators have noted a recent trend towards applying the rule in cases between businesses. Shell, *supra* note 123, at 1209 & n.60. See David Frisch, et al., *Uniform Commercial Code Annual Survey: General Provisions, Sales, Bulk Transfers, and Documents of Title*, 42 BUS. LAW. 1213, 1225-28 (1987); Steven Goldberg, *Unconscionability In A Commercial Setting: The Assessment Of Risk In A Contract To Building Nuclear Reactors*, 58 WASH. L. REV. 343, 346-47 (1983); Ellen R. Jordan, *Unconscionability at The Gas Station*, 62 MINN. L. REV. 813, 815-17 (1978); Jane P. Mallor, *Unconscionability In Contracts Between Merchants*, 40 SW. L.J. 1065, 1074-84 (1986).

<sup>128</sup> Shell, *supra* note 123, at 1209. The duty reflects the incorporation of an ethics standard more common to tort actions than contract law. Speidel, *supra* note 114, at 181.

<sup>129</sup> For example, an insurer found to have acted with malice or reckless disregard as to the validity of a claim in refusing to pay a claim will be liable for punitive damages. *Egan v. Mutual of Omaha Ins. Co.*, 598 P.2d 452, 457 (Cal. 1979); *Anderson v. Continental Ins. Co.*, 271 N.W.2d 367, 374 (Wisc. 1978). The implied covenant of good faith, however, may be breached without proof of the positive malicious misconduct essential for recovering punitive damages. *Neal v. Farmers Ins. Exch.*, 582 P.2d 980, 986 n.5 (Cal. 1978). Support for recognition of tort claims brought by an insured against his insurer for not paying the insured's claim is more controversial. See *supra* notes 107-08. Typically, a breach of the covenant is determined by evaluating the reasonableness of the insurer's conduct under the circumstances in refusing to pay a claim.

See *supra* notes 102-04 and accompanying text (discussing the court's decision in *Commune v. Traders & Gen. Ins. Co.*).

<sup>130</sup> Recognition of a tort for breach of the covenant of good faith and fair dealing was also temporarily extended by two states to the area of lender liability. See, e.g., *Commercial Cotton Co. v. United California Bank*, 209 Cal. Rptr. 551, 554 (Cal. Ct. App. 1985) (finding that the relationship of bank to depositor is quasi-fiduciary, thus giving rise to tort liability); *First Nat'l Bank in Libby v. Twombly*, 689 P.2d 1226, 1230 (Mont. 1984) ("[W]hen the duty to exercise good faith is imposed by law rather than the contract itself, . . . the breach of that duty is tortious."). Most commentators

and supercompensatory remedies for egregious conduct and "bad faith" breaches of contract, are indicative of the infusion of moral standards into the marketplace.<sup>131</sup>

#### *H. Rise and Decline of Caveat Emptor*

The conviction by some that the duty of good faith and fair dealing does not apply to negotiations, including disclosures made during contract formation, has marred the development of this duty. The dichotomy may be explained as the result of the common law emphasis on freedom of contract, i.e., the right to choose with whom one might wish to deal and to choose the terms of the deal, coupled with the general position that no wrong can be committed by inaction. The caveat emptor doctrine embodies the foregoing principles.

Caveat emptor means "let the buyer beware" and requires a purchaser to examine and judge for himself.<sup>132</sup> The history of the body of legal, economic, religious and social principles encapsulated in the Latin phrase caveat emptor defies any straightforward

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agree, however, that California and Montana have since moved away from their position on tort liability. See EDWARD F. MANNINO, *LENDER LIABILITY BANKING AND LITIGATION*, § 5.03[4], at 5-29 and 5-31 (1992). Recently, the Nevada Supreme Court recognized the covenant of good faith and fair dealing in general employment contracts (other than at-will) and ruled that the tort of bad faith was committed "when an employer, acting in bad faith, discharges an employee who has established contractual rights of continued employment and who has developed a relationship of trust, reliance and dependency with the employer." *D'Angelo v. Gardner*, 819 P.2d 206, 211 (Nev. 1991). The California Supreme Court in 1980 hinted in dicta that breaching the implied covenant of good faith in employment contracts might sound in tort as well as contract. *Tameny v. Atlantic Richfield Co.*, 610 P.2d 1330, 1337 n.12 (Cal. 1980). The court, however, subsequently noted the risk involved in intruding into the expectations of parties to commercial contracts by allowing the tort remedy. See *supra* note 115 (discussing the implications of extending tort law causes of action). Most jurisdictions, however, do not recognize a breach of the implied covenant of good faith as a tort outside the insurance context. *Jones, supra* note 55, at 809. The Ohio Supreme Court, when explaining why the implied duty of good faith and fair dealing as an independent tort has been generally restricted to the insurance area, noted that holding an insurer to the duty of good faith was reasonable because of the relative bargaining strength of the insurer, and the insured's vulnerability to oppressive insurer tactics. *Hoskins v. Aetna Life Ins. Co.*, 452 N.E.2d 1315, 1319 (Ohio 1983). The Utah Supreme Court also declined to recognize a good faith tort in the first party insurance context, in part, because it believed doing so would require the court to make the doctrine available to litigants in any contract dispute. *Beck v. Farmer's Ins. Exch.*, 701 P.2d 795, 800 (Utah 1985). Even in California, extension of the doctrine has been limited and controversial; courts have rejected its application to a variety of circumstances in the past five years. *Croskey, supra* note 55, at 568.

<sup>131</sup> Shell, *supra* note 123, at 1209-12.

<sup>132</sup> See *supra* note 8 for the definition of caveat emptor.

and simple explanation.<sup>133</sup> Widely presumed to be an ancient principle because of its Latin embodiment, *caveat emptor* actually emerged in 16th century England.<sup>134</sup> Prior to that time, extremely limited opportunities for trade resulted in a seller's general unwillingness to offend customers who were inextricably linked with him in the social hierarchy.<sup>135</sup> The customer was entitled to great deference. Religious teachings held that "[i]n ecclesiastical polity there was no place for the notion that the seller was not responsible for the goodness of his wares"<sup>136</sup> because "the possessors of the keys to heaven might force men to conform to their admission requirements."<sup>137</sup> In addition to the direct and no-nonsense lessons on the dangers of avarice found in sermons and confessionals, Church manuals of the Middle Ages provided strict guidelines for market conduct that included requirements for warranties of quality.<sup>138</sup> On the secular front, complex regulations were initially enacted to control trade behavior at the traveling fairs.<sup>139</sup> More

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<sup>133</sup> Walton H. Hamilton, *The Ancient Maxim Caveat Emptor*, 40 YALE L.J. 1133, 1135-36 (1931). Hamilton noted:

The refusal of public authority, through legislature and judiciary, to accord effective protection to the purchaser, has been crystallized into the compact expression *caveat emptor*. Although the words are supposed to constitute a principle of the law of sales, the rules which govern the vending of goods are far too detailed and specific to be set down so succinctly. They change in meaning with the course of events, and different judges may read words narrowly or broadly to secure variable results. Moreover, *caveat emptor* has been a matter of judicial opinion, a value if you will, a principle if you must, which directs even the rules of laws to its own ends. Its power of compulsion resides in the individualistic common-sense to which it belongs, and the expression of this common-sense has been limited to no legal domain.

*Id.*

<sup>134</sup> The term *caveat emptor* seems to have first appeared in print in 1534, when it was used in the context of horse trading. Charles T. LeViness, *Caveat Emptor Versus Caveat Venditor*, 7 MD. L. REV. 177, 182 (1943) ("Wrote Fitzherbert in his boke of Husbandrie: 'If he be tame and have ben rydden upon, then caveat emptor.'").

<sup>135</sup> *Id.* at 178. In feudal times, where society was rigidly controlled and authority was split between church and lords, freedom of trade was practically non-existent. In the Middle Ages, however, just as today, the phrase "the customer is always right" described the deferential treatment given to the buyer. *Id.* See Donald P. Rothschild, *The Magnuson-Moss Warranty Act: Does It Balance Warrantor and Consumer Interests?*, 44 GEO. WASH. L. REV. 335, 337 (1976) (noting that merchants, who had direct contact with their neighbors in the marketplace, would generally attempt to safeguard a quality product).

<sup>136</sup> Hamilton, *supra* note 133, at 1141.

<sup>137</sup> *Id.* at 1139.

<sup>138</sup> Rothschild, *supra* note 135, at 337.

<sup>139</sup> The regulations on fairs included those requiring that "[g]oods were to be sold only in shops which had frontage. No merchandise could be sold which was not publicly exhibited to all." LeViness, *supra* note 134, at 179.

regulations were later created when traveling fairs yielded to rapidly developing market towns and centers.<sup>140</sup> All of these regulations strove to protect both parties from deceptions of any sort.

Eventually, however, the combination of increased geographic mobility, changing economic and social demographics, the rise of trade and the weakened grip of the Church on society contributed with other factors to the advent of caveat emptor. The longstanding principles and practices of the Middle Ages gave way to the "buyer beware" philosophy for several reasons. First, caveat emptor developed

because of the failure of the administrative and court machinery to keep the fraud and abuses of the manufacturers and sellers at a minimum. Thus, the purchaser, of necessity had to protect himself against them and notice of that necessity was given by the pervasiveness of the doctrine of caveat emptor.<sup>141</sup>

Second, the creation of established marketplaces, in turn, created a powerful merchant class that used its growing power selfishly to discourage regulations favoring consumers.<sup>142</sup> Third, the rise of the ideal of individualism in the 18th century also facilitated the rise of caveat emptor. During this age of *laissez-faire*, people adopted caveat emptor not merely as a maxim of trade, but also as a basis for political theory and personal behavior.<sup>143</sup>

Caveat emptor with its appeal to self-reliance proved immensely attractive to the rugged individualism of 19th Century Americans. LeVinesse explains:

The growth of the railroad, the Westward Ho' movement, and the emergence of our infant industrial system influenced the courts to extol individualism in business, as in private life. . . .  
*Caveat emptor* not only was a sound legal precept, it was the patri-

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<sup>140</sup> With London as the chief market center by the fifteenth century, detailed regulations arose for market towns, most notably of which was the doctrine of the "market overt." A sale in the open market, as opposed to purchases made in private homes or back alleys, carried a warranty of title. *Id.*

<sup>141</sup> ALPHONSE M. SQUILLANTE & JOHN R. FONSECA, 2 WILLISTON ON SALES § 15-12, at 364 (4th ed. 1974).

<sup>142</sup> Rothschild, *supra* note 135, at 338 (footnote omitted).

<sup>143</sup> LeViness, *supra* note 134, at 183. LeViness also states:

With the advent of the Eighteenth Century the spirit of individualism was intense and there was a growing trend to *laissez-faire*. The great Blackstone, whose writings so influenced the circuit riders in young America, provided an out for the merchant "against defects that are plainly and obviously the object of one's senses," and attributed liability to the seller only for a "defect that cannot be discovered by sight and is a matter of skill or collateral proof."

*Id.* (quoting WILLIAM BLACKSTONE, COMMENTARIES ON THE LAWS OF ENGLAND 165-66 (American ed. 1772)).

otic thing. How could a man shift for himself on the frontier unless he could survive in the marts of commerce?<sup>144</sup>

Consequently, the doctrine quickly entrenched itself in American jurisprudence.<sup>145</sup>

By the beginning of the twentieth century, however, social and legal reform movements had targeted all sorts of *laissez-faire* policies in an effort to replace society's "law of the jungle" approach with a more ordered and cooperative approach. Typical of these reform efforts was the movement advocating clean advertising and honest labeling.<sup>146</sup> Other significant legislative actions since the turn of the century which were directed toward, or resulted in, limiting the frequently harsh results of caveat emptor include the Uniform Sales Act,<sup>147</sup> the Uniform Commercial Code,<sup>148</sup> the Securities Act of 1933,<sup>149</sup> the Truth in Lending Act,<sup>150</sup> the Equal Credit Opportunity

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<sup>144</sup> *Id.* at 184.

<sup>145</sup> *Barnard v. Kellogg*, 77 U.S. (10 Wall.) 383, 388 (1871), is frequently cited as indicative of judicial attitudes of the period. In *Barnard*, the United States Supreme Court, noting the nearly universal acceptance of caveat emptor, held that given the doctrine's widespread acceptance, "such a rule, requiring the purchaser to take care of his own interests, has been found best adapted to the wants of trade in the business transactions of life." See also *Laidlaw v. Organ*, 15 U.S. (2 Wheat.) 178, 195 (1817) (finding that a purchaser of goods is not required to disclose to the seller facts about the sale affecting the price of the goods, particularly when the information is accessible to both parties). English courts also followed the doctrine of caveat emptor. *Smith v. Hughes*, L.R. 6 Q. B. 597, 607 (1871) (pointing out that "there is no legal obligation on the vendor to inform the purchaser that he is under a mistake, not induced by the act of the vendor").

<sup>146</sup> This movement resulted in the passage of false advertising statutes in 42 states and in the creation of the Federal Trade Commission at the federal level. The newly-created Commission directed its authority toward stopping unfair advertising claims of, *inter alia*, "patent medicines," alcoholic products and weight loss pills. The Supreme Court, however, reigned in the reformist fervor of the Commission in *Federal Trade Comm'n v. Raladam Co.*, 283 U.S. 643 (1931), where the Court limited the Commission to its original purpose of "enforcing the Sherman Act, the Clayton Act and breaking up unfair trade practices which amount to a destruction of competition." *LeViness*, *supra* note 134, at 194.

<sup>147</sup> UNIF. SALES ACT, 3A U.L.A. 452 (1906). The Uniform Sales Act was the first attempt at standardizing state practices regarding the sale of consumer goods.

<sup>148</sup> The Uniform Commercial Code greatly formalized the public policy doctrines and warranties concerning the sale of chattels.

<sup>149</sup> 15 U.S.C. §§ 77a-77aa (1988). The Securities Act of 1933 was the first important Federal legislation to control the issuance of, and transactions in, securities. The Act protects the investing public by requiring the issuer of securities to make certain disclosures through the filing of a registration statement with the Securities and Exchange Commission. The registration statement is available to the public and contains information about the security, the issuer and the underwriter. The Act also requires that purchasers be provided with a prospectus containing essential information from the registration statement.

<sup>150</sup> 15 U.S.C. §§ 1601-1067(c) (1988). The Truth in Lending Act (TILA) is Subchapter I of the Consumer Credit Protection Act. It is aimed at increasing disclosure

Act,<sup>151</sup> the Real Estate Settlement Procedures Act,<sup>152</sup> the Interstate Land Sales Full Disclosures Act,<sup>153</sup> the Truth in Negotiations Act,<sup>154</sup> and the Magnuson-Moss Warranty Federal Trade Commission Improvement Act (the Magnuson-Moss Act).<sup>155</sup> Nonetheless, caveat emptor remains viable in a number of areas. Not surprisingly, the doctrine has fallen from favor with greater frequency in those areas in which lay persons are involved—whether it be buying consumer goods or buying a home. Caveat emptor's only legal stronghold remains those areas in which professionals are involved in reaching commercial agreements.

Between the combined effects of the Uniform Commercial Code and the Magnuson-Moss Act, the role of caveat emptor in personal

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of credit costs to borrowers. The TILA, however, is not the primary source of disclosure requirements. Rather, the TILA provides for regulations to be promulgated by the Board of Governors of the Federal Reserve. *Id.* § 1604. The Board has issued Regulation Z, Truth in Lending, which governs disclosure requirements in credit transactions. 12 C.F.R. § 226.1 (1992). Regulation Z is aimed at providing the consumer sufficient information to enable him to make fully informed credit decisions.

<sup>151</sup> 15 U.S.C. §§ 1691(a)-(f) (1988 & Supp. III 1992). The Equal Credit Opportunity Act (ECOA) is Subchapter IV of the Consumer Credit Protection Act. The ECOA mandates that an applicant for credit is entitled to disclosures explaining the reasons why credit has been denied or revoked.

<sup>152</sup> 12 U.S.C. §§ 2601-2617 (1982 & Supp. IV 1992). The Real Estate Settlement Procedures Act (RESPA) mandates the use of a standard form for the statement of settlement costs in federally related mortgage loans. *Id.* § 2603. RESPA also requires the Secretary of H.U.D. to prepare and distribute booklets that explain the nature and costs of real estate settlements. *Id.* § 2604. The purpose of RESPA is to ensure that consumers "are provided with greater and more timely information on the nature and costs of the settlement process and are protected from unnecessarily high settlement charges." *Id.* § 2601.

<sup>153</sup> 15 U.S.C. §§ 1701-1720 (1988). The Interstate Land Sales Full Disclosure Act requires, among other things, a statement of record describing those with interests in the land, all conditions and plans with respect to the land, and the types of sales and transactions contemplated. *Id.* § 1705(1)-(12).

<sup>154</sup> 10 U.S.C. § 2306a (1988). The Truth in Negotiations Act, originally enacted in 1962, provides that prime contractors and subcontractors involved in certain government contracts must disclose to the government accurate, complete, and current, cost and pricing data. Contractors are required to deliver the relevant information to the government and make the significance of the information to the negotiation process known. *E.g.*, *Singer Co. v. United States*, 576 F.2d 905, 914 (Ct. Cl. 1978).

<sup>155</sup> 15 U.S.C. §§ 2301-2312 (1988). In 1976, Congress passed the Magnuson-Moss Warranty Federal Trade Commission Improvement Act, which prescribed the first comprehensive federal standards for consumer product warranties. The act attempts to balance free market dealing with consumer protection by providing a definition of "full" warranties, but does not require that warranties be offered. A business may claim "full" warranties only if minimum standards are met; other types of warranties must be termed "Limited." Importantly, this legislation was heralded as the end of caveat emptor in consumer warranty transactions. *See* Christopher Smith, *The Magnuson-Moss Warranty Act: Turning the Tables on Caveat Emptor*, 13 CAL. W. L. REV. 391, 391-92 (1977).



property transactions has been virtually eliminated.<sup>156</sup> The introduction of strict liability for injuries arising from defective products has also all but eliminated caveat emptor in this field. The doctrine is still applied, albeit unevenly, in product liability cases involving used products.<sup>157</sup> Some states such as California<sup>158</sup> and Oregon<sup>159</sup> have not yet resolved the question, while others such as New Jersey<sup>160</sup> have held that the doctrine may apply to product liability of used products.

Real property law, on the other hand, has traditionally not extended many protections to the buyer.<sup>161</sup> Even today, the protections are not as great as those afforded personal property.<sup>162</sup> Numerous

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<sup>156</sup> See BARKLEY CLARK, *WARRANTIES IN THE SALE OF GOODS* (1980); Smith, *supra* note 155, at 391-92; Barkley Clark & Michael Davis, *Beefing Up Product Warranties: A New Dimension in Consumer Protection*, 23 KAN. L. REV. 567 (1975); Andrew M. Baker et al., Special Project, *Article Two Warranties In Commercial Transactions*, 64 CORNELL L. REV. 30 (1978).

<sup>157</sup> See James S. Kats, Comment, *Used Products and Strict Liability: Where Public Safety and Caveat Emptor Intersect*, 19 CAL. W. L. REV. 330, 330-31 (1983) (footnotes omitted).

<sup>158</sup> See *LaRosa v. Superior Ct.*, 176 Cal. Rptr. 224, 237 (Cal. Ct. App. 1981); *Tauber-Arons Auctioneers Co., Inc. v. Superior Ct.*, 161 Cal. Rptr. 789, 798-99 (Cal. Ct. App. 1980); *Green v. City of Los Angeles*, 115 Cal. Rptr. 685, 697 (Cal. Ct. App. 1974).

<sup>159</sup> See *Tillman v. Vance Equip. Co.*, 596 P.2d 1299, 1303-04 (Or. 1979).

<sup>160</sup> See *Ortiz v. Farrell Co.*, 171 N.J. Super. 109, 115, 407 A.2d 1290, 1292 (Law Div. 1979); *Turner v. Int'l Harvester Co.*, 133 N.J. Super. 277, 285, 336 A.2d 62, 67 (Law Div. 1975).

<sup>161</sup> Caveat emptor was once the universal rule in the sale of real estate. A seller did not have a duty to disclose latent defects in the property that were unknown to the buyer. An example of the doctrine's application was shown in *Swinton v. Whitinsville Sav. Bank*, 42 N.E.2d 808 (Mass. 1942). In *Swinton*, a buyer unknowingly purchased a termite infested house and sought thereafter to rescind the contract based upon the seller's fraudulent concealment of the defect. The court, however, rejected the buyer's claim and entered judgment for the seller. In reaching this decision, the court stated:

The law has not yet, we believe, reached the point of imposing upon the frailties of human nature a standard so idealistic as this [a duty by a seller of real estate to disclose any nonapparent defect in the subject of the sale which materially reduces its value and which the buyer fails to discover] . . . . The rule of nonliability for bare nondisclosure has been stated and followed by this court . . . .

*Id.* at 808-09 (citations omitted).

<sup>162</sup> Caveat emptor generally does not require disclosures from sellers during negotiations for the sale of real property unless there is a special circumstance such as a partial disclosure amounting to a misrepresentation, a volunteering of information, a specific inquiry, a failure to correct a previously made assertion now known to be incorrect, or a special relationship of confidence and trust between the parties. These exceptions to the rule have themselves, by virtue of their universal appeal, served as an artificial barrier to the recognition of obligations that precede as well as accompany contract performance. See, e.g., *Wedig v. Brinster*, 469 A.2d 783, 788 (Conn. App. Ct. 1983) (volunteered information); *Lock v. Schreppler*, 426 A.2d 856, 862 (Del. Super. Ct. 1981) (volunteered information); *Indiana Bank & Trust Co. v. Perry*, 467 N.E.2d 428, 431 (Ind. Ct. App. 1984) (volunteered information); *Fageas v. Sherrill*, 147 A.2d 223, 226 (Md. 1958) (special relationship); *Swinton*, 42 N.E.2d 808, 808

jurisdictions have, however, retreated from strict principles of caveat emptor in real estate transactions.<sup>163</sup> Most states have recognized an implied warranty of habitability between the buyer and the seller in the sale of new homes.<sup>164</sup> While these warranties do not represent

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(Mass. 1942) (special relationship); *Ware v. Scott*, 257 S.E.2d 855, 858 (Va. 1979) (prior representation); *Ollerman v. O'Rourke Co., Inc.*, 288 N.W.2d 95, 107 (Wis. 1980) (buyer relied on knowledge of vendor). See generally Powell, *supra* note 15. As one commentator has noted:

The law offers greater protection to the purchaser of a seventy-nine cent dog leash than to the purchaser of a \$40,000 home. If the dog leash is defective the purchaser can easily obtain a refund or a new leash, or even sue to recover damages if the defective leash resulted in the loss of his pet. The purchaser of the home, on the other hand, is often without recourse when the spring rains filter through his basement walls.

Frederick C. Wamhoff, Note, *Property—Caveat Emptor—Duty to Disclose Limited to Commercial Vendors*, 64 MARQ. L. REV. 547, 548 (1981).

<sup>163</sup> Courts have developed several approaches to ameliorate caveat emptor's harshness in the real estate context. The first inroad on the rule of caveat emptor has been to impose an implied warranty of habitability from a home builder to the purchaser of that home. A second retreat from caveat emptor is found in the seller's tort duty to disclose known defects to potential buyers of real property. Omar S. Parker, Jr., *Caveat Emptor Is Further Eroded By Health, Environmental Worries*, NAT'L L.J., Nov. 14, 1988, at 26. In addition, some courts have expressed a willingness to grant relief not only where there is evidence of fraudulent misrepresentation during negotiations, but also where the nondisclosure resulted from innocent misrepresentation. *Shore Builders v. Dogwood, Inc.*, 616 F. Supp. 1004, 1012 (D. Del. 1985); *Asleson v. West Branch Land Co.*, 311 N.W.2d 533, 543-44 (N.D. 1981). See Frona M. Powell, *Relief for Innocent Misrepresentation: A Retreat From the Traditional Doctrine of Caveat Emptor*, 19 REAL EST. L.J. 130, 130 (1990) (noting that the unwillingness of many courts to allow rescission for an "innocent misrepresentation," even when a "relatively sophisticated purchaser" fails to find the defects, signals a shift away from the doctrine of caveat emptor and the recognition of a new business ethics in the sale of real property). Also, real estate brokers are increasingly being denied the protection of caveat emptor when brokers make misrepresentations about the property. Clarence E. Hagglund & Britton D. Weimer, *Caveat Realtor: The Broker's Liability for Negligent and Innocent Misrepresentations*, 20 REAL EST. L.J. 149, 149 (1991) (observing that while the doctrine of caveat emptor often protects a broker from liability to buyers, courts have recently imposed liability on a broker for "negligent misrepresentations" and also have employed a strict scrutiny standard to evaluate a broker's "innocent misrepresentations" to a buyer).

<sup>164</sup> *Alaska Pacific Assurance Co. v. Collins*, 794 P.2d 936, 177 (Alaska 1990); *Richards v. Powercraft Homes, Inc.*, 678 P.2d 427, 430 (Ariz. 1984); *Coney v. Stewart*, 562 S.W.2d 619, 620 (Ark. 1978); *Pollard v. Saxe & Yolles Dev. Co.*, 525 P.2d 88, 91 (Cal. 1974) (in bank); *Carpenter v. Donohoe*, 388 P.2d 399, 408 (Colo. 1964); *Vernali v. Centrella*, 266 A.2d 200, 201-02 (Conn. 1970); *Smith v. Berwin Builders Inc.*, 287 A.2d 693, 695 (Del. Super. Ct. 1972); *Gable v. Silver*, 264 So. 2d 418, 419 (Fla. 1972); *Bethlahmy v. Bechtel*, 415 P.2d 698, 710-11 (Idaho 1966); *Petersen v. Hubschman Constr. Co., Inc.*, 389 N.E.2d 1154, 1158 (Ill. 1979); *Theis v. Heuer*, 280 N.E.2d 300, 306 (Ind. 1972); *Kirk v. Ridgway*, 373 N.W.2d 491, 496 (Iowa 1985); *Crawley v. Terhune*, 437 S.W.2d 743, 745 (Ky. 1969); *Degeneres v. Burgess*, 486 So. 2d 769, 773 (La. Ct. App. 1986); *Banville v. Huckino*, 407 A.2d 294, 297 (Me. 1979); *Krol v. York Terrace Bldg., Inc.*, 370 A.2d 589, 595-96 (Md. Ct. Spec. 1977); *Weeks v. Slavick Builders, Inc.*, 180 N.W.2d 503, 506-07 (Mich. Ct. App. 1970); *Tereault v. Palmer*, 413 N.W.2d 283, 285 (Minn. Ct. App. 1987); *Brown v. Elton Chalk, Inc.*, 358 So. 2d 721, 722 (Miss.

complete protection of the modern home buyer, they do represent an erosion of caveat emptor in this area.<sup>165</sup> Nevertheless, caveat emptor

1978); *Smith v. Old Warson Dev. Co.*, 479 S.W.2d 795, 796 (Mo. 1972) (en banc); *Chandler v. Madsen*, 642 P.2d 1028, 1032 (Mont. 1972); *Norton v. Burleaud*, 342 A.2d 629, 630 (N.H. 1975); *Schipper v. Levitt & Sons, Inc.*, 44 N.J. 70, 93, 207 A.2d 314, 326 (1965); *DeRoche v. Dame*, 430 N.Y.S.2d 390, 392, *appeal dismissed*, 413 N.E.2d 366 (N.Y. 1980); *Hartley v. Ballou*, 209 S.E.2d 776, 782 (N.C. 1974); *Dobler v. Malloy*, 214 N.W.2d 510, 516 (N.D. 1973); *Jeanguneat v. Jackie Hames Constr. Co.*, 576 P.2d 761, 764 (Okla. 1978); *Yepsen v. Burgess*, 525 P.2d 1019, 1022 (Or. 1974) (in bank); *Elderkin v. Gaster*, 288 A.2d 771, 177 (Pa. 1972); *Padula v. J.J. Deb-Cin Homes, Inc.*, 298 A.2d 529, 532 (R.I. 1973); *Rutledge v. Dodenhoff*, 175 S.E.2d 792, 795 (S.C. 1970); *Waggoner v. Midwestern Dev., Inc.*, 154 N.W.2d 803, 807 (S.D. 1967); *Dixon v. Mountain City Constr. Co.*, 632 S.W.2d 538, 542 (Tenn. 1982); *Humber v. Morton*, 426 S.W.2d 554, 555 (Tex. 1968); *Rothberg v. Olenik*, 262 A.2d 461, 467 (Vt. 1970); *House v. Thorton*, 457 P.2d 199, 204 (Wash. 1969); *Gamble v. Main*, 300 S.E.2d 110, 115 (W. Va. 1983); *Maltberg v. Nu Way Builders, Inc.*, No. 84-921 (Wis. Ct. App. Mar. 26, 1985); *Tavares v. Horstman*, 542 P.2d 1275, 1276-77 (Wyo. 1975). See generally *Caryn M. Chittenden*, Comment, *From Caveat Emptor to Consumer Equity—The Implied Warranty of Quality Under The Uniform Common Interest Ownership Act*, 27 WAKE FOREST L. REV. 571, 579-80 (1992) (noting the rise in implied warranties of habitability in new homes).

<sup>165</sup> See William D. Grand, *Implied and Statutory Warranties in the Sale of Real Estate: The Demise of Caveat Emptor*, 15 REAL EST. L.J. 44, 55 (1986) (noting that courts have retreated from the doctrine of caveat emptor to recognize a cause of action for "breach of an implied warranty to build and construct in a reasonably good and workmanlike manner"). This action, according to Grand, applies to the sale of common and residential real property. *Id.* Some states have explicitly rejected caveat emptor as inappropriate for modern house buying practices. See *Humber v. Morton*, 426 S.W.2d 554, 562 (Tex. 1968) ("The caveat emptor rule as applied to new houses is an anachronism patently out of harmony with modern home buying practices."). In *Johnson v. Davis*, the Florida Supreme Court rejected the doctrine of caveat emptor in the sale of homes. *Johnson v. Davis*, 480 So. 2d 625, 629 (Fla. 1985). Relying on case law from other jurisdictions, the court found that a seller had a duty to disclose facts that materially affect property value for both new and used real property. *Id.* (citations omitted). According to one commentator, the *Davis* court had taken "a minority position, but [it] appears to be a growing minority." Ray Reynold, *Caveat Emptor Dead for Florida House Sales*, NAT'L L.J., Nov. 25, 1985, at 3. Many states rejecting the doctrine's application to the sale of residential property have chosen to impose a duty to disclose on the seller of the property where the seller knows of latent material defects affecting the value of the property of which the buyer is not aware or which could not be discovered through reasonable diligence. *Hill v. Jones*, 725 P.2d 1115, 1118 (Ariz. Ct. App. 1986); *Karoutas v. Homefed Bank*, 283 Cal. Rptr. 809, 811 (1991); *Lingsch v. Savage*, 29 Cal. Rptr. 201, 210 (1963); *Cohen v. Vivian*, 349 P.2d 366, 368 (Colo. 1960); *Wilhite v. Mays*, 232 S.E.2d 141, 143 (Ga. Ct. App. 1976), *aff'd*, 235 S.E.2d 532 (Ga. 1977); *Posner v. Davis*, 395 N.E.2d 133, 137-38 (Ill. App. Ct. 1979); *Loghry v. Capel*, 132 N.W.2d 417, 419 (Iowa 1965); *Jenkins v. McCormick*, 339 P.2d 8, 11 (Kan. 1959); *Nei v. Burley*, 446 N.E.2d 674, 676-77 (Mass. 1983); *Williams v. Benson*, 141 N.W.2d 650, 655 (Mich. Ct. App. 1966); *Flakus v. Schug*, 329 N.W.2d 859, 863 (Neb. 1983), *overruled on other grounds*, *Nielsen v. Adams*, 388 N.W.2d 840, 846 (Neb. 1986); *Oates v. Jag, Inc.* 333 S.E.2d 222, 226 (N.C. 1985); *Brooks v. Ervin Const. Co.*, 116 S.E.2d 454, 457 (N.C. 1960); *Holcombe v. Zinke*, 365 N.W.2d 507, 511-12 (N.D. 1985); *Miles v. McSwegin*, 388 N.E.2d 1367, 1369 (Ohio 1979); *von Brauchitsch v. Cravens*, 604 P.2d 379, 380-81 (Okla. Ct. App. 1979); *Quashnock v. Frost*, 445 A.2d 121, 124-25 (Pa. Super. Ct. 1982); *Cushman v. Kirby*, 536 A.2d 550, 552 (Vt. 1987); *Obde v.*

is still applied in home sales in Maine,<sup>166</sup> New York,<sup>167</sup> Ohio<sup>168</sup> and Virginia.<sup>169</sup> Some states have continued to apply the doctrine to used, as opposed to new, home sales.<sup>170</sup>

Despite advances away from caveat emptor in the residential property context, fewer jurisdictions have conferred the same protec-

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Schlemeyer, 353 P.2d 672, 674-75 (Wash. 1960); Thacker v. Tyree, 297 S.E.2d 885, 888 (W.Va. 1982). *Contra* Ray v. Montgomery, 399 So. 2d 230, 232-33 (Ala. 1980); Reed v. King, 193 Cal. Rptr. 130, 132 (1983); Cohen v. Blessing, 192 S.E.2d 204, 206 (S.C. 1972); May v. Hopkinson, 347 S.E.2d 508, 513 (S.C. Ct. App. 1986). Termite infestation, structural defects, roach infestation and soil defects are among the material facts that courts have deemed to affect property values. *Hill*, 725 P.2d at 1119; *Jenkins*, 339 P.2d at 10-11; Weintraub v. Krobatsch, 64 N.J. 445, 455-56, 317 A.2d 68, 74-75 (1974). Other courts have gone so far as to require disclosure of all material defects that make the land less valuable or desirable. Puget Sound Serv. v. Dalarna Management Corp., 752 P.2d 1353, 1355-56 (Wash. Ct. App. 1988); Easton v. Strassburger, 199 Cal. Rptr. 383, 387-88 (Cal. Ct. App. 1984); *Reed*, 193 Cal. Rptr. at 132. Some courts have recognized that the duty to disclose material facts about the real estate arises because good faith and fair dealing demand it. *E.g.*, Johnson v. Davis, 480 So. 2d 625, 628 (Fla. 1985) (stating that "[t]he law appears to be working toward the ultimate conclusion that full disclosure of all material facts must be made whenever elementary fair conduct demands it."); Bethlahmy v. Bechtel, 415 P.2d 698, 706 (Idaho 1966) (quotation omitted).

<sup>166</sup> Stevens v. Bouchard, 532 A.2d 1028, 1030 (Me. 1987) (determining that caveat emptor applies to home sales in the absence of a fiduciary relationship of trust between the parties).

<sup>167</sup> Stambovsky v. Ackley, 572 N.Y.S.2d 672, 677 (N.Y. App. Div. 1992); Baker v. Runza, (N.Y. Sup. Ct. 1990) *reported in*, N.Y.L.J., Aug. 15, 1990, at 17. The *Baker* court explained:

A seller of real property is under no duty to disclose facts pertaining to the conditions of the premises when the parties deal at arm's length . . . . It is the buyer's obligation to satisfy himself as to the quality of his bargain pursuant to the doctrine *caveat emptor*. This doctrine still applies in New York State to real estate transactions.

*Id.*

<sup>168</sup> Layman v. Binns, 519 N.E.2d 642, 645 (Ohio 1988). Absent vendor fraud, caveat emptor precludes a buyer's recovery for structural problems in a house where "the condition complained of is open to observation" and where this buyer "had the full and unimpeded opportunity to examine the premises." Recently, however, the continued application of caveat emptor to transfers of used residences has been largely abandoned in Ohio, by statute. OHIO REV. CODE ANN. § 5302.30 (Anderson 1992). This law, effective July 1, 1993, requires the seller of residential real property to fill out a disclosure form setting forth material matters related to the condition of the residence, and to provide this form to the transferee. *Id.*

<sup>169</sup> Starks v. Albemarle County, 716 F. Supp. 934, 937 (W.D. Va. 1989) (where seller of home merely failed to disclose flood-prone nature of property and did not defraud purchaser or divert him from investigation, the court adopted caveat emptor as the controlling rule); Kuczmanski v. Gill, 302 S.E.2d 48, 51 (Va. 1983) (stating that in the absence of active fraud or misrepresentation, caveat emptor will apply).

<sup>170</sup> Commercial Credit Corp. v. Lisenby, 579 So. 2d 1291, 1294 (Ala. 1991). Williamson v. Realty Champion, 551 So. 2d 1000, 1002 (Ala. 1989); Dee v. Peters, 591 N.E.2d 115, 116 (Ill. App. Ct. 1992) (fiduciary requirement was required between sellers before duty to disclose arose, so seller of used house was not obligated to disclose defects.).

tions on buyers of commercial property.<sup>171</sup> But even in the area of commercial property sales there has been a trend away from caveat emptor.<sup>172</sup> For example, in *Tusch Enterprises v. Coffin*, the purchaser of duplexes sought compensation for structural defects in the property.<sup>173</sup> The court concluded that the seller, who had soil defects on the land where the duplexes stood, had a duty to disclose that the buildings were constructed on fill dirt.<sup>174</sup> Likewise, in *Green Spring Farms v. Spring Green Farm Associates Ltd. Partnerships*, the court rejected strict application of caveat emptor and found that the seller of a dairy farm had a duty to disclose to potential purchasers all material facts

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<sup>171</sup> A stark example of this disparate treatment is found in Florida. In *Johnson v. Davis*, the Florida Supreme Court dispensed with caveat emptor in the sale of homes. *Johnson v. Davis*, 480 So. 2d 625 (Fla. 1985). In 1991, however, a Florida court of appeals unambiguously stated that:

Nowhere does the [*Johnson*] court conclude that the duty of disclosure is present in the sale of commercial property . . . . Nowhere does *Johnson* address or change the long line of case law establishing *caveat emptor* as the rule in the sale of commercial property. *Johnson* simply does not impose a duty of disclosure in a commercial setting.

*Futura Realty v. Lone Star Bldg. Ctrs. (Eastern), Inc.*, 578 So. 2d 363, 364-65 (Fla. Dist. Ct. App. 1991). Similarly, the Supreme Court of Alabama, in *DeAravjo v. Walker*, 589 So. 2d 1292, 1293 (Ala. 1991), held that caveat emptor applied to the sale of unimproved land.

In *Gill v. Marquoit*, the purchaser sought to recover the purchase price of land because the seller failed to disclose that the land was susceptible to flooding. *Gill v. Marquoit*, 525 P.2d 1030, 1031 (Or. 1974). The court concluded that the sellers were under no duty to disclose the defect because the purchasers were expected to learn of the defect on their own. *Id.* at 1032. According to *Gill*, the vendor has a duty to disclose that the land for sale is not suitable for the purchaser's intended use if:

(i) the seller knows or has reason to know that the purchaser is buying the land for a specific use and that such use is not feasible because of the character of the land; (ii) the seller knows or has reason to know that the purchaser does not know of the character of the land rendering it unsuitable; and (iii) the purchaser does not have equal opportunities for obtaining information which he may be expected to utilize.

*Id.* (footnotes omitted).

Some courts also place a greater burden on commercial purchasers in inspecting the property, which, in effect, diminishes the duty to disclose. In *Puget Sound Serv. Corp. v. Dalarna Management Corp.*, the buyer brought suit against the seller alleging the seller's fraudulent concealment of defects in the building. *Puget Sound Serv. Corp. v. Dalarna Management Corp.*, 752 P.2d 1353, 1355 (Wash. Ct. App. 1988). The court held that the vendor had no duty to affirmatively report the defects to the purchaser because the purchaser should have made inquiries to the seller. *Id.* at 1356. The court further stated that the problem would have been "readily ascertained" if the purchaser had made such inquiries. *Id.*

<sup>172</sup> See Powell, *supra* note 163, at 130, for one author's conclusion that defects ought to be disclosed in sales of residential or commercial real estate where good faith and fair dealing would require the disclosure.

<sup>173</sup> 740 P.2d 1022, 1025 (Idaho 1987).

<sup>174</sup> *Id.* at 1028.

that purchasers would be in poor position to discover.<sup>175</sup>

Perhaps the most heavily litigated area involving caveat emptor today is the right of a purchaser of contaminated land to recover from the previous owner responsible for the contamination under the 1980 Comprehensive Environmental Response, Compensation and Liability Act (CERCLA). Generally, most jurisdictions have agreed that previous owners who pollute cannot invoke caveat emptor as a defense against any possible financial liability.<sup>176</sup> In 1988, for example, the Third Circuit held, in *Smith Land & Improvement Corp. v. Celotex Corp.*,<sup>177</sup> that caveat emptor was not available as a defense against liability for indemnification of cleanup costs incurred under CERCLA, but that the doctrine could be considered in mitigation of any amounts owed.<sup>178</sup> Some courts have refused to hold the seller responsible for contaminated land, however, when the purchaser had an opportunity to investigate.<sup>179</sup>

Although caveat emptor is still followed in execution sales, tax sales, and judicial sales,<sup>180</sup> the doctrine has been rejected in security sales,<sup>181</sup> and has been abandoned and limited elsewhere as noted

<sup>175</sup> 492 N.W.2d 392 (Wis. Ct. App. 1992). See *infra* notes 552-54 and accompanying text for additional discussion of the *Green Springs Farms* decision.

<sup>176</sup> See *United States v. Kramer*, 757 F. Supp. 397, 428 (D.N.J. 1991); *Hanlin Group, Inc. v. Int'l Minerals & Chems. Corp.*, 759 F. Supp. 925, 933 (D. Me. 1990); *Westwood Pharmaceuticals, Inc. v. Nat'l Fuel Gas Distribution Corp.*, 737 F. Supp. 1272, 1277 (W.D.N.Y. 1990), *aff'd*, 964 F.2d 85 (2d Cir. 1992); *Sunnen Prods. Co. v. Chemtech Indus., Inc.*, 658 F. Supp. 276, 278 (E.D. Mo. 1987); *T & E Indus., Inc. v. Safety Light Corp.*, 123 N.J. 371, 387, 587 A.2d 1249, 1257-58 (1991).

<sup>177</sup> 851 F.2d 86 (3d Cir. 1988).

<sup>178</sup> *Id.* at 89-90. See Kathleen D. Lindenberger, Note, 37 J. URB. & CONTEMP. L. 273 (1990).

<sup>179</sup> *Stuart v. American Sec. Bank*, 494 A.2d 1333, 1338-39 (D.C. Cir. 1985). See *Wilson Auto Enters., Inc. v. Mobil Oil Corp.*, 778 F. Supp. 101, 104-05 (D.R.I. 1991).

<sup>180</sup> Caveat emptor is still applied in execution sales: "Applying the doctrine of *caveat emptor* to third-party purchasers of goods and chattels at execution sales and to purchasers at void execution sales serves no purpose other than to maintain an oppressive judicial tradition." Jeremy Gilman, Note, *Rethinking The Role Of Caveat Emptor In Execution Sales*, 32 CASE W. RES. L. REV. 735, 775 (1982). The doctrine is also still applied to other sales. See, e.g., *Gauger v. State*, 815 P.2d 501, 506 (Kan. 1991) (tax sales); *Stuart v. American Sec. Bank*, 494 A.2d 1333 (D.C. Cir. 1985) (foreclosure sales); *French Energy v. Alexander*, 818 P.2d 1234, 1238-39 (Okla. 1991).

<sup>181</sup> The historical acceptance of caveat emptor in the securities field was immediately and decisively abandoned following the 1929 stock market crash. In describing the series of legislative acts that resulted from the crash and the subsequent depression, the United States Supreme Court, in *SEC v. Capital Gains Research Bureau, Inc.*, explained that: "The Investment Advisors Act of 1940, along with earlier efforts to curtail securities abuses, was intended to substitute full disclosure for the doctrine of *caveat emptor* in order to bring about more stringent business ethics." 375 U.S. 180, 186 (1963) (citations omitted). Occasional deregulation efforts notwithstanding, caveat emptor is still not applied in the securities arena. See also *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462 (1977); *Wilko v. Swan*, 346 U.S. 427 (1953); *Resort Car Rental*

above. The diminishing influence of caveat emptor demonstrates that the ethics of the marketplace are changing.

### *I. Conclusion*

As times and circumstances change, doubts arise as to the soundness of old practices and opinions. Old truths become falsehoods, society prohibits bargains that were not prohibited, and refuses to enforce bargains that would formerly be enforced. The law is becoming increasingly receptive toward using standards of morality and ethics to judge transactions between commercial parties. There has been a slow but steady trend away from caveat emptor towards an application of higher standards of good faith, fair dealing, and morality to all contracts and transactions. The doctrine of caveat emptor is being abandoned and the rule that negotiations must be conducted with openness and in good faith is being affirmed. This accords with the notion advanced in this Article that the duty of good faith and fair dealing is a requirement of public policy.<sup>182</sup>

## IV. THE DUTY OF DISCLOSURE DURING NEGOTIATIONS

### *A. Introduction*

Generally, there is no liability for silence unless there is a duty to disclose. A duty to disclose has been recognized in at least seven circumstances: (1) all material facts that have been actively concealed must be disclosed; (2) prior statements that are later discovered to be or turn out to be false must be corrected; (3) all material facts must be disclosed if anything is said; (4) all material facts must be disclosed when there is a fiduciary or confidential relationship between the parties; (5) superior material information concerning a transaction must be disclosed when the other party cannot reasonably discover the information and is under a mistaken belief with regard to it; (6) all material facts must be disclosed in the formation of insurance and suretyship contracts; and (7) all material facts must be disclosed as required by statute.

Even if a duty to disclose exists, however, a plaintiff asserting another's breach of the duty will not be able to recover unless the plaintiff can demonstrate justifiable reliance. Many courts have

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Sys., Inc. v. Chuck Ruwart Chevrolet, Inc., 519 F.2d 317 (10th Cir. 1975); Spilker v. Shayne Lab., Inc., 520 F.2d 523 (9th Cir. 1975); Dupuy v. Dupuy, 511 F.2d 641 (5th Cir. 1975); Herpich v. Wallace, 430 F.2d 792 (5th Cir. 1970).

<sup>182</sup> See *supra* Section III. B and F for a discussion of the historical and legal development of the good faith and fair dealing standard.

held that justifiable reliance does not exist if the plaintiff could have discovered the facts through a reasonable investigation. Nonetheless, the modern trend has been to mollify or abandon this duty of investigation. The trend away from the duty of investigation is based upon changing ethical standards, the diminishing influence of caveat emptor and the belief that a party who has a duty to disclose should not be able to avoid that duty as a result of the other party's negligence or indolence.

*B. The Traditional Rule—Right to Remain Silent*

Perhaps the most renowned and oft-cited case in American common law to support the argument that silence is not a misrepresentation is *Laidlaw v. Organ*.<sup>183</sup> The arguments presented in that case on the duty to disclose and the disposition of those arguments, although in dicta, are relevant for the issues dealt with in this Article.

The War of 1812 between the United States and England formally ended on December 24, 1814, with the signing of the Treaty of Ghent. News did not travel so quickly in 1814 and 1815 with the unfortunate result that the bloodiest and most celebrated battle of that war occurred on January 9, 1815, the Battle of New Orleans. On the night of February 18, 1815, news of the Treaty of Ghent was finally communicated by the British fleet which was blockading New Orleans, to three individuals.<sup>184</sup> This news was first disseminated in New Orleans in a handbill made public at 8:00 a.m. the following day, February 19.<sup>185</sup> Prior to public disclosure of the treaty, the plaintiff in *Laidlaw* had already learned of it.<sup>186</sup> Consequently, before knowledge of the treaty became widely known, plaintiff purchased a significant quantity of tobacco from defendant, a New Orleans commission merchant.<sup>187</sup> Prior to the sale, defendant asked plaintiff whether there was any news "which was calculated to enhance the price or value" of the tobacco<sup>188</sup> but plaintiff remained silent in the face of that question.<sup>189</sup> In making the purchase, plaintiff took advantage of the depressed price of

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<sup>183</sup> 15 U.S. (2 Wheat.) 178, 195 (1817). *Laidlaw* involved the silence of the buyer.

<sup>184</sup> *Id.* at 182-83.

<sup>185</sup> *Id.* at 183.

<sup>186</sup> The brother of one of the three individuals who first learned of the Treaty of Ghent told plaintiff about the Treaty. *Id.* at 183. The man who told plaintiff this information was also interested in one-third of the profits from the deal plaintiff struck with defendant. *Id.* See the situation described by Cicero, *supra* note 35.

<sup>187</sup> *Id.*

<sup>188</sup> *Id.*

<sup>189</sup> *Id.*



tobacco caused by the British blockade of New Orleans.<sup>190</sup> As soon as word of the Treaty of Ghent became widely known, the market price of tobacco jumped 30 to 50%.<sup>191</sup> Defendant then refused to transmit the tobacco to plaintiff.

Plaintiff sued defendant for the delivery of the tobacco. The court directed a verdict in favor of plaintiff.<sup>192</sup> Defendant then appealed to the United States Supreme Court. The arguments presented to the Court articulated two opposing views on the precontractual duty to disclose material information about a business transaction in good faith. Counsel for petitioner, defendant below, stated:

Suppression of material circumstances within the knowledge of the vendee, and not accessible to the vendor, is equivalent to fraud, and vitiates the contract. . . . The parties treated on an unequal footing, as the one party had received intelligence of the peace of Ghent, at the time of the contract, and the other had not. . . . In answer to the question whether there was any news calculated to enhance the price of the article, the vendee was silent. This reserve, when such a question was asked, was equivalent to a false answer, and as much calculated to deceive as the communication of the most fabulous intelligence.<sup>193</sup>

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<sup>190</sup> The blockade had prevented exports of tobacco, thus causing a surplus of tobacco which decreased its market value.

<sup>191</sup> *Id.*

<sup>192</sup> *Id.* at 184.

<sup>193</sup> *Id.* at 184-90. Counsel for petitioners cited only one authority to support his arguments, POTHIER, TRAITÉ DU CONTRAT DE VENTE, Paris-Orléans, 1772, Nos. 233 to 241. *Id.* at 185 n.2 (hereinafter POTHIER). Robert-Joseph Pothier is best known for his work on Roman law, PANDECTAE IUSTINIANEE IN NOVUM ORDINEM DIGESTAE, Paris, 1748-52. In Article II, No. 233 of Pothier's work, he stated:

[N]éanmoins dans les contrats intéressés, du nombre desquels est le contrat de vente, la bonne foi ne défend pas seulement tout mensonge, mais toute réticence de tout ce que celui avec qui nous contractons a intérêt de savoir touchant la chose qui fait l'objet du contrat. La raison est que la justice & l'équité dans ces contrats consistent dans l'égalité; tout ce qui tend à la blesser est donc contraire à l'équité. Il est évident que toute réticence de la part d'un des contractants, de tout ce que l'autre auroit intérêt de savoir touchant la chose qui fait l'objet du contrat, blesse cette égalité car dès que l'un a plus de connoissance que l'autre touchant cette chose, il a plus d'avantage que l'autre à contracter; il fait mieux ce qu'il fait que l'autre, & par conséquent l'égalité ne se trouve plus dans le contrat. En faisant l'application de ces principes au contrat de vente, il s'ensuit que le vendeur est obligé de déclarer tout ce au'il sait touchant la chose vendue à l'acheteur qui a intérêt de le savoir; & qu'il pèche contre bonne foi qui doit regner dans ce contrat, lorsqu'il lui en dissimule quelque chose. ([I]n interested contracts, among which is the contract of sale, good faith not only forbids the assertion of falsehood, but also all reservation concerning that which the person with whom we contract has an interest in knowing, touching the thing which is the object of the contract. The reason is that equity and justice, in these contracts, consists in equality. It is evi-

Counsel for respondent, plaintiff below, responded that legal obligations were not coextensive with ethics, as evidenced by the existence of the caveat emptor doctrine:

The only real question in the cause is, whether the sale was invalid because the vendee did not communicate information which he received precisely as the vendor might have got it had he been equally diligent or equally fortunate? And, surely, on this question there can be no doubt. Even if the vendor had been entitled to the disclosure, he waived it by not insisting to an answer to his question; and the silence of the vendee could easily have been interpreted as a negative answer to the vendor's question. In principle, however, the vendee was not bound to disclose any information unknown to the vendor. Even admitting that his conduct was unlawful, in *foro conscientiae*, does this admission prove that it was so in the civil forum? Human laws are imperfect in this respect, and the sphere of morality is more extensive than the limits of civil jurisdiction. The maxim of *caveat emptor* could never have crept into the law if the province of ethics had been coextensive with it. There was, in the present case, no circumvention or manoeuvre practiced by the vendee, unless rising early in the morning, and obtaining by superior diligence and alertness that intelligence by which the price of commodities was regulated, be such. It is a romantic equality that is contended for on the other side. Parties never can be precisely equal in knowledge, either of facts or the inferences from such facts, and both must concur in order to satisfy the rule contended for.<sup>194</sup>

Counsel for petitioner replied that good faith required disclosure:

The information was monopolized by the messengers from the British fleet, and not imparted to the public at large until it was too late for the vendor to save himself. The rule of law and of ethics is the same. It is not a romantic, but a practical and legal

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dence that any reservation, by one of the contracting parties, concerning any circumstance which the other has an interest in knowing, touching the object of the contract, is fatal to this equality: from the moment the one acquires a knowledge of this object superior to the other, he has an advantage over the other in contracting; he knows better what he is doing than the other; and, consequently, equality is no longer found in the contract. In applying these principles to the contract of sale, it follows that the vendor is obliged to disclose every circumstance in his knowledge touching the thing which the vendee has an interest in knowing, and that he sins against that good faith which ought to reign in this contract if he conceals any such circumstance from him.).

*Id.*

<sup>194</sup> *Id.* at 193-94.

rule of equality and good faith that is proposed to be applied.<sup>195</sup>

In a one paragraph opinion delivered by Chief Justice Marshall, the Court reversed and held for petitioner ruling that the lower court should not have directed a verdict, but should have submitted the issue to the jury to decide.<sup>196</sup> At the same time, however, the Court in *dicta* opined on the larger question expressing its concern that a duty of disclosure could not be adequately defined:

The question in this case is, whether the intelligence of extrinsic circumstances, which might influence the price of the commodity, and which was exclusively within the knowledge of the vendee, ought to have been communicated by him to the vendor? The court is of the opinion that he was not bound to communicate it. It would be difficult to circumscribe the contrary doctrine within proper limits, where the means of intelligence are equally accessible to both parties. But at the same time, each party must take care not to say or do anything tending to impose upon the other.<sup>197</sup>

With this pronouncement, which addressed the failure of disclosure on the side of the buyer, application of notions of good faith to precontractual disclosures was arrested, except in the area of insurance and suretyship law, and the doctrine of caveat emptor continued its ascent in American jurisprudence.

Consistent with the principle enunciated by *Laidlaw*, courts continue to rule that silence is not considered a misrepresentation for purposes of fraud unless there is a legally recognized duty to speak.<sup>198</sup> While outright fraudulent misstatements are prohibited,<sup>199</sup> parties to business transactions traditionally have not been required to disclose all material information unknown to the other party before the transaction is consummated.

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<sup>195</sup> *Id.* at 194.

<sup>196</sup> *Id.* at 195.

<sup>197</sup> *Id.*

<sup>198</sup> *E.g.*, *Simpson Timber Co. v. Palmberg Constr. Co.*, 377 F.2d 380, 385 (9th Cir. 1967); *Bank of Red Bay v. King*, 482 So. 2d 274, 284 (Ala. 1985); *In re Marriage of Travlos*, 578 N.E.2d 1267, 1273 (Ill. App. Ct. 1991); *Greene v. Gulf Coast Bank*, 593 So. 2d 630, 632 (La. 1992); *Wilson v. Donegal Mut. Ins. Co.*, 598 A.2d 1310, 1316 (Pa. Super. Ct. 1991); *Sutfin v. Southworth*, 539 A.2d 986, 988 (Vt. 1987).

<sup>199</sup> The elements of common law fraud are (1) material misrepresentation of presently existing or past fact, (2) made with knowledge of its falsity or reckless disregard for its truth (scienter), (3) with the intention that the other party rely, and (4) resulting in justifiable reliance by the party to its detriment. 37 AM. JUR. 2d *Fraud and Deceit* § 12 (1968).

### C. *The Exceptions to the Rule—Duty to Speak*

The seven generally accepted exceptions to the rule that a party may remain silent have been used in an ever widening array of circumstances, so much so, that the exceptions have almost subsumed the rule of nondisclosure. It would be incorrect to say, however, that the rule of nondisclosure no longer has any vitality. It still does. But the exceptions are so broad that a resourceful judge can almost always find a way to fit the facts of a case within the confines of one of the exceptions. It is one of the points of this Article that judges, in fact, often do precisely that.

#### 1. Active concealment

The first exception to the general rule of nondisclosure is that active concealment or the intentional suppression of material information is actionable.<sup>200</sup> Concealment, to be actionable, requires something more than mere silence or failure to volunteer information.<sup>201</sup> Concealment usually occurs when one party actively attempts to hide the true facts from the other party by use of some trick or artifice intended to prevent discovery of the concealed fact or inquiry into it.<sup>202</sup>

#### 2. Duty to correct prior statement

It is well established that a party has a duty to correct a previous material representation if the party later learns that the representation is no longer true and it has not yet been acted upon.<sup>203</sup>

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<sup>200</sup> *Zanbetiz v. Trans World Airlines, Inc.*, 219 N.E.2d 98, 102 (Ill. App. Ct. 1966); *Barylski v. Andrews*, 439 S.W.2d 536, 539 (Mo. Ct. App. 1969); *Moser v. Spizzirro*, 295 N.Y.S.2d 188, 188-89 (N.Y. App. Div. 1968), *aff'd*, 252 N.E.2d 632 (1969); *Haberman v. Grenspan*, 368 N.Y.S.2d 717, 720 (N.Y. Sup. Ct. 1975); *Klott v. Associates Real Estate*, 322 N.E.2d 690, 692 (Ohio Ct. App. 1974).

<sup>201</sup> *Stewart v. Wyoming Cattle Ranch Co.*, 128 U.S. 383, 388 (1888); *Thorwegan v. King*, 111 U.S. 549 (1884); *Connelly Bros. v. Dunlap*, 39 P.2d 155, 156 (Okla. 1934); *Hutsell v. Citizens' Nat'l Bank*, 64 S.W.2d 188, 192 (Tenn. 1933); *Farmers' States Bank of Newport v. Lamon*, 231 P. 952, 953 (Wash. 1925).

<sup>202</sup> *Williams v. Woodruff*, 85 P. 90, 96 (Colo. 1905); *Hays v. Meyers*, 107 S.W. 287, 289 (Ky. 1908); *Patten v. Standard Oil Co.*, 55 S.W.2d 759, 761 (Tenn. 1933).

<sup>203</sup> *E.g.*, *McGrath v. Zenith Radio Corp.*, 651 F.2d 458, 468 (7th Cir. 1981) (applying California law) (it is incumbent upon a party to correct material representations when they prove to be false, even though they were believed to be true when made); *Stevens v. Marco*, 305 P.2d 669, 683 (Cal. Dist. Ct. App. 1957) (citations omitted) ("It is the prevailing law that one who learns that his statements, even if thought to be true when made, have become false through a change in circumstances, has the duty, before his statements are acted upon, to disclose the new conditions to the party relying on his original representations."); *St. Joseph Hosp. v. Corbetta Constr. Co.*, 316 N.E.2d 51, 71 (Ill. App. Ct. 1974) ("It is also well-established that where one has made a statement which at that time is true but subsequently acquires new informa-

It does not matter that the original representation was believed to be or, in fact, was true at the time it was communicated.<sup>204</sup> If supervening events make the original statement false, or the party later learns that the original statement was false, there is a duty to disclose this information to correct the prior representation.<sup>205</sup>

### 3. Partial or ambiguous statement

Even if there is no duty of disclosure, if a party volunteers to speak or does so in response to questions, the response must be complete and full.<sup>206</sup> This rule was set forth succinctly by the California Supreme Court almost half a century ago:

"Even though one is under no obligation to speak as to a matter,

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tion which makes it untrue or misleading, he must disclose such information to anyone whom he knows to be acting on the basis of the original statement—or be guilty of fraud or deceit."); U.S. Fidelity and Guarantee Co. v. Black, 313 N.W.2d 77, 89 (Mich. 1981) (citations omitted) ("[A] party to a business transaction is under an obligation to exercise reasonable care to disclose to the other party, before the transaction is consummated, any subsequently acquired information which he recognizes as rendering untrue, or misleading, previous representations which, when made, were true or believed to be true.") (quoting *Strand v. Librascope, Inc.*, 197 F. Supp. 743, 754 (E.D. Mich. 1961)). PROSSER & KEETON, *supra* note 8 § 106, at 738; 37 AM. JUR. 2d *Fraud and Deceit* § 184 (1968); 37 C.J.S. *Fraud* § 16 (1943).

<sup>204</sup> *McGrath*, 651 F.2d at 468.

<sup>205</sup> *Id.* If, for example, a party learns during contract negotiations that the assets in the opening balance sheet, which was previously submitted to the other party, are, in fact, substantially less than shown, such party has an obligation to correct its prior statement. See PROSSER, *supra* note 10, at 696-97.

<sup>206</sup> *E.g.*, *V.S.H. Realty, Inc. v. Texaco, Inc.*, 757 F.2d 411, 414 (1st Cir. 1985) (applying Massachusetts law, the Court stated that "[t]here is much caselaw in Massachusetts supporting the proposition that a party who discloses partial information that may be misleading has a duty to reveal all the material facts he knows to avoid deceiving the other party"); *Southeastern Fin. Corp. v. United Merchants & Manufacturers, Inc.*, 701 F.2d 565, 566-67 (5th Cir. 1983) (applying Texas law) (applying Texas law, the Court held that a party has a duty to disclose "information necessary to prevent the statements it did make from misleading" the other party); *National Consumer Coop. Bank v. Madden*, 737 F. Supp. 1108, 1112 (D. Hawaii 1990) ("when a party injects himself into a business transaction, however, he incurs a duty to disclose all material information necessary to prevent representations he makes, either directly or indirectly, from misleading other parties to the transaction"); *Zimpl v. Trawick*, 679 F. Supp. 1502, 1510 (W.D. Ark. 1988) (once a purchaser of gas and oil interests began to speak on the subject of the property's prospects, he had a duty to tell the whole truth); *Balch Pontiac-Buick, Inc. v. Comm'r of Motor Vehicles*, 345 A.2d 520, 523 (Conn. 1973); *Nicholson v. Kellin*, 481 So. 2d 931, 936 (Fla. Dist. Ct. App. 1986) ("even assuming that the party to a transaction owes no duty to disclose facts within his knowledge or to answer inquiries respecting such facts, if he undertakes to do so he must disclose the whole truth"); *Nevada Nat'l Bank v. Gold Star Meat Co.*, 514 P.2d 651, 654 (Nev. 1973); *Wirth v. Commercial Resources, Inc.*, 630 P.2d 292, 297 (N.M. Ct. App. 1981) ("to reveal some information on a subject triggers the duty to reveal all known material facts"); *Meeker v. Lanham*, 604 P.2d 556, 558 (Wyo. 1979) (quotation omitted).

if he undertakes to do so, either voluntarily or in response to inquiries, he is bound not only to state truly what he tells but also not to suppress or conceal any facts within his knowledge which will materially qualify those stated. If he speaks at all he must make a full and fair disclosure . . . ." Where there is a duty to disclose, the disclosure must be full and complete, and any material concealment or misrepresentation will amount to fraud sufficient to entitle the party injured thereby to an action.<sup>207</sup>

#### 4. Obligations arising out of relationship

When a confidential or fiduciary relationship exists between the parties,<sup>208</sup> the party who owes the confidential or fiduciary duty has an obligation to divulge or disclose during negotiations all material facts concerning the transaction within his knowledge.<sup>209</sup> Courts have recognized numerous special, confidential or fiduciary relationships for such circumstances. These include the relationship between an employer and employee,<sup>210</sup> brothers and sisters,<sup>211</sup> husband and wife,<sup>212</sup> persons engaged to be married,<sup>213</sup> children and parents,<sup>214</sup> attorney and client,<sup>215</sup> officers of the corporation

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<sup>207</sup> *Pashley v. Pacific Elec. Co.*, 153 P.2d 325, 330 (Cal. 1944) (quoting 12 R.C.L. § 71,310). For example, a party asked by the other party about the magnitude of agreed upon changes in accounting methods cannot limit its answer to "I don't know," or similar evasive statements, if such party has a reasonably good appreciation of the overall impact of the changes, and can easily perceive that the other party has no such knowledge. The fact that the other party had ample due diligence opportunity and could possibly have found out by itself should be no excuse.

<sup>208</sup> A fiduciary or trust relationship is one that involves special trust or confidence. It may be formal or informal, and may even grow out of a close family relationship. See *Central States Stamping Co. v. Terminal Equip. Co.*, 727 F.2d 1405, 1409 (6th Cir. 1984) ("The duty to speak does not depend on the existence of a fiduciary relationship between the parties. It may arise in any situation where one party imposes confidence in the other because of that person's position, and the other party knows of this confidence."); *Umbaugh Pole Bldg. Co., Inc. v. Scott*, 390 N.E.2d 320, 323 (Ohio 1979) ("A fiduciary relationship may be created out of an informal relationship, but this is done only when both parties understand that a special trust or confidence has been reposed.").

<sup>209</sup> *Strong v. Repide*, 213 U.S. 419, 432-33 (1909); *Richardson v. Green*, 133 U.S. 30, 47 (1890); *Stewart v. Phoenix Nat'l Bank*, 64 P.2d 101, 106 (Ariz. 1937).

<sup>210</sup> *United States v. Margiotta*, 688 F.2d 108, 124 (2d Cir. 1982), *cert. denied*, 461 U.S. 913 (1983); *United States v. von Barta*, 635 F.2d 999, 1007 (2d Cir. 1980), *cert. denied*, 450 U.S. 998 (1981); *Arrowood v. Lyon*, 279 S.W.2d 801, 803 (Ky. Ct. App. 1955).

<sup>211</sup> *U.S. v. Ressler*, 433 F. Supp. 459, 464 (S.D. Fla. 1977); *Long v. Mulford*, 17 Ohio St. 484, 505 (Ohio 1867).

<sup>212</sup> *Vai v. Bank of America*, 364 P.2d 247, 252-53 (Cal. 1961).

<sup>213</sup> *Speckman v. Speckman*, 15 Ohio App. 283 (Ohio Ct. App. 1921).

<sup>214</sup> *Peterson v. Mitchener*, 71 N.E.2d 510, 514 (Ohio Ct. App. 1947).

<sup>215</sup> *Cinema 5 Ltd. v. Cinerama, Inc.*, 528 F.2d 1384, 1386 (2d Cir. 1976); *Gidney v. Chappel*, 110 P. 1099, 1100 (Okla. 1910).

and stockholders,<sup>216</sup> joint purchasers,<sup>217</sup> joint owners selling jointly owned property,<sup>218</sup> partners,<sup>219</sup> joint venturers,<sup>220</sup> physician and patient,<sup>221</sup> priest and parishioner,<sup>222</sup> rabbi and congregation,<sup>223</sup> principal and agent,<sup>224</sup> and trustee and cestui que trust.<sup>225</sup> A few cases have also included an accounting firm and investors,<sup>226</sup> a mortgage broker and lender<sup>227</sup> and a stockbroker and his client.<sup>228</sup> At least two courts have even found that close friends stand in such a relationship of trust and confidence as to require full disclosure of material facts.<sup>229</sup>

This wide range of relationships indicates that courts have used the relationship exception to the traditional right to remain silent as a means of imposing disclosure requirements in accord with notions of good faith and fair dealing.<sup>230</sup> The courts, in effect,

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<sup>216</sup> *Davis Bluff Land & Timber Co. v. Cooper*, 134 So. 639, 641 (Ala. 1931).

<sup>217</sup> *Walker v. Pike County Land Co.*, 139 F. 609, 611 (8th Cir. 1905).

<sup>218</sup> *Upton v. Weisling*, 71 P. 917, 920 (Ariz. 1903).

<sup>219</sup> *Palmer v. Fuqua*, 641 F.2d 1146, 1155 (5th Cir. 1981); *Goldsmith v. Koopman*, 152 F. 173, 176 (2d Cir. 1907); *Clear Creek, Inc. v. Royal American Corp.* (*In re Int'l Resorts, Inc.*), 46 B.R. 405, 417 (Bankr. N.D. Ala. 1984).

<sup>220</sup> *Stevens v. Marco*, 305 P.2d 669, 679 (Cal. Dist. Ct. App. 1956).

<sup>221</sup> *Nardone v. Reynolds*, 538 F.2d 1131, 1135 (5th Cir. 1976); *Colvin v. Warren*, 163 S.E. 268, 269 (Ga. Ct. App. 1932).

<sup>222</sup> *Finegan v. Theisen*, 52 N.W. 619, 622 (Mich. 1892).

<sup>223</sup> *Jewish Ctr. of Sussex County v. Whale*, 165 N.J. Super. 84, 92, 397 A.2d 712, 716 (Ch. Div. 1978) (allowing Jewish Center to rescind contract with rabbi where rabbi failed to reveal his mail fraud conviction during negotiations leading up to the execution of agreement with the Jewish Center).

<sup>224</sup> *A.B.C. Packard, Inc. v. General Motors Corp.*, 275 F.2d 63, 69 (9th Cir. 1960); *Jack Eckerd Corp. v. Dart Group*, 621 F. Supp. 725, 732 (D. Del. 1985); *Prudential Ins. Co. v. Crouch*, 606 F. Supp. 464, 471 (S.D. Ind. 1985); *Saporta v. Barbagelata*, 33 Cal. Rptr. 661, 667 (Cal. Dist. Ct. App. 1963); *Stainback v. West* (*In re Arbuckle's Estate*), 220 P.2d 950, 955 (Cal. Dist. Ct. App. 1950); *Village of Burnsville v. Westwood Co.*, 189 N.W.2d 392, 397 (Minn. 1971).

<sup>225</sup> See *FDIC v. Meyer*, 781 F.2d 1260 (7th Cir. 1986); *A.B.C. Packard, Inc.*, 275 F.2d at 69 & n.6.

<sup>226</sup> *IIT, An Int'l Inv. Trust v. Cornfeld*, 619 F.2d 909, 927 (2d Cir. 1980); *Dubowski v. Ash*, (*In re AM Int'l, Inc. Sec. Litig.*), 606 F. Supp. 600, 607 (S.D.N.Y. 1985); *Fischer v. Keltz*, 266 F. Supp. 180, 186 (S.D.N.Y. 1967).

<sup>227</sup> *Sigman v. Stevens-Norton, Inc.*, 425 P.2d 891, 894 (Wash. 1967).

<sup>228</sup> *LeBoce v. Merrill Lynch, Pierce, Fenner & Smith*, 709 F.2d 605, 607 (9th Cir. 1983) (ruling that where a broker controls an account, California law imposes fiduciary obligations); *Pachter v. Merrill Lynch, Pierce, Fenner & Smith*, 444 F. Supp. 417, 422 (E.D.N.Y. 1978), *aff'd*, 594 F.2d 852 (2d Cir. 1978); *Pace v. McEwen*, 574 S.W.2d 792, 796 (Tex. Civ. App. 1978); see also *United States v. Dial*, 757 F.2d 163, 168 (7th Cir. 1985) (finding that a broker in silver futures is a fiduciary to his clients).

<sup>229</sup> *United States v. Ressler*, 433 F. Supp. 459, 464 (S.D. Fla. 1977); *Hammond v. Marrano*, 451 N.Y.S.2d 484, 486 (N.Y. App. Div. 1982).

<sup>230</sup> As one court stated: "The circumstances in which courts are willing to find this relationship of trust and confidence are expanding in accordance with the notion 'that full disclosure of all material facts must be made whenever elementary fair con-

have been able to impose a duty of full disclosure of material facts during negotiations on an *ad hoc* basis by labeling a relationship as confidential or fiduciary in nature.<sup>231</sup> Because such relationships are so broadly defined, courts are free to find such relationships in an almost limitless set of situations. Generally, however, courts have held that sophisticated businessmen negotiating arm's length business transactions are not fiduciaries and thus do not have a special relationship requiring full disclosure of all material facts related to the transaction.<sup>232</sup>

In determining whether a special or confidential relationship exists, courts frequently ask whether the relationship is one in which an individual is bound to act in "good faith" and with "due regard to the one reposing the confidence."<sup>233</sup> Thus, the key ele-

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duct demands it.'" *Sedco Intern'l, S.A. v. Cory*, 522 F. Supp. 254, 323 n.84 (S.D. Iowa 1981) (quoting WILLIAM L. PROSSER, *HANDBOOK OF THE LAW OF TORTS*, § 106, at 698 (4th ed. 1971)).

<sup>231</sup> *Kessler & Fine*, *supra* note 15, at 444; *Holmes*, *supra* note 15, at 449.

<sup>232</sup> See *Brass v. American Film Tech. Inc.*, 987 F.2d 142, 151 (2d Cir. 1993) (asserting that there is no relationship of trust between a prospective investor and an unknown corporate officer explaining the business plans of a company selling stock warrants); *The Original Great American Chocolate Chip Cookie v. River Valley Cookies, Ltd.*, 970 F.2d 273, 280 (7th Cir. 1992) (stating that "parties to a contract are not each other's fiduciaries"); *Salinsky v. Perma Home Corp.*, 443 N.E.2d 1362, 1365 (Mass. App. Ct. 1985) ("The concept of fiduciary relationship thus far does not seem to have been extended to purely commercial transactions."); *Carrolls Corp. v. Canton Joint Venture*, No. 88-21151, 1990 WL 99047, at \*6 (Ohio Com. Pl. June 27, 1990) (pointing out that there is no confidential or fiduciary relationship between a lessor and sub-lessee). Cf. *O'Neal v. Burger Chef Sys., Inc.*, 860 F.2d 1341, 1349 (6th Cir. 1988) (ruling that franchise agreements do not give rise to fiduciary or confidential relationships between the parties); *Banque Arabe Et Internationale D'Investissement v. Maryland Nat'l Bank*, 819 F. Supp. 1282, 1293 (S.D.N.Y. 1993) (finding no special or fiduciary relationship between sophisticated financial institutions in an arm's length real estate transaction); *McDermott v. Western Union Tel. Co.*, 746 F. Supp. 1016, 1023 (E.D. Cal. 1990) (asserting that a customer wiring money with Western Union is in the nature of an arm's length relationship, not a confidential or fiduciary relationship); *Rosenberg v. The Pillsbury Co.*, 718 F. Supp. 1146, 1155 (S.D.N.Y. 1989) ("The franchisor-franchisee relationship is an arms-length, commercial one, with the parties' relations governed by the terms of the offering circular and franchise agreement."). But see *Arnott v. American Oil Co.*, 609 F.2d 873, 883 (8th Cir. 1979) (applying South Dakota law, the court ruled that "the franchisor and franchisee of a service station operation are involved in a fiduciary franchise relationship whereby the parties should act with good faith toward each other").

<sup>233</sup> BLACK'S LAW DICTIONARY 626 (6th ed. 1990). Fiduciary or confidential relation is defined, in part, as follows:

A relation subsisting between two persons in regard to a business, contract, or piece of property, or in regard to the general business or estate of one of them, of such a character that each must repose trust and confidence in the other and must exercise a corresponding degree of fairness and good faith. Out of such a relation, the law raises the rule that neither party may exert influence or pressure upon the other, take



ment in finding a duty to disclose all material facts is the notion that the relationship between the parties implies a duty of good faith and fair dealing. It is this duty of good faith that in turn raises the expectation of, and a requirement for, full disclosures.

5. Effect of inequality of knowledge or superior knowledge, and the "special facts" doctrine

Courts have also recognized that there is a general duty to disclose information during negotiations when one of the parties is aware that he has access to superior material information concerning the transaction and that the other party is acting under a mistaken belief with regard to such information.<sup>234</sup> Moreover, where one party has superior knowledge and the unknowing party takes action the party might not otherwise have taken, one's duty to disclose is particularly compelling.<sup>235</sup> Thus, courts treat the possession of superior knowledge as sufficient to trigger a duty to disclose information.<sup>236</sup>

Two examples of this heightened duty for those with superior knowledge are situations that involve misrepresentations of law and misrepresentations regarding future events. As a general rule, one cannot bring an action for fraud based on a misrepresentation of

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selfish advantage of his trust . . . [and the use of] business shrewdness, hard bargaining, and astuteness to take advantage of the forgetfulness or negligence of another [is] totally prohibited as between persons standing in such a relation to each other.

*Id.*

<sup>234</sup> *E.g.*, *United States ex rel. Bussen Quarries, Inc. v. Thomas*, 938 F.2d 831, 834 (8th Cir. 1991) (applying Missouri law, the court stated that "[t]he duty to disclose may arise from . . . a demonstration of superior knowledge on the part of one party that is not within the fair and reasonable reach of the other party"); *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. First Nat'l Bank*, 774 F.2d 909, 913 (8th Cir. 1985) (applying Arkansas law, the court stated that "[w]hen a fact is peculiarly within the knowledge of one party and of such a nature that the other party is justified in assuming the existence of that fact, then there is a duty to disclose the fact") (citations omitted); *U.S. Concord, Inc. v. Harris Graphics Corp.*, 757 F. Supp. 1053, 1057 (N.D. Cal. 1991) ("Under New York law, a duty to disclose arises when one party possesses superior knowledge not readily available to the other and that party knows the other is acting on the basis of mistaken knowledge.") (citations omitted); *Haberman v. Washington Pub. Power Supply Sys.*, 744 P.2d 1032, 1069 (Wash. 1987) (en banc) (asserting that "allegations of fraud may be asserted where one party possesses superior knowledge yet that party fails to state . . . [a] material fact"); see also *Williams v. Benson*, 141 N.W.2d 650, 656 (Mich. Ct. App. 1966); *Jenkins v. McCormick*, 339 P.2d 8, 11 (Kan. 1959); *Villalon v. Bowen*, 273 P.2d 409, 414 (Nev. 1954); PROSSER, *supra* note 10, § 106, at 697.

<sup>235</sup> *Mann v. Adams Realty Co., Inc.*, 556 F.2d 288, 297 (5th Cir. 1977).

<sup>236</sup> *White v. Pepin*, 561 A.2d 94, 96 (Vt. 1989) (citing *Cheever v. Albro*, 421 A.2d 1287, 1290 (Vt. 1980)). For a more extensive discussion of the *White* decision, see *infra* notes 534-37 and accompanying text.

the law.<sup>237</sup> This rule is based on the idea that each person has a common understanding of the law.<sup>238</sup> When one party has, or claims to possess, a superior knowledge of the law and misleads the other party, however, the rule does not apply.<sup>239</sup> In addition, usually one may not bring an action for misrepresentation based on future events, as opposed to past or existing facts.<sup>240</sup> Yet, one may bring such an action in circumstances where a person purporting to have superior knowledge makes a representation pertaining to future events.<sup>241</sup>

Another disclosure doctrine very similar to the superior knowledge doctrine is the "special facts" doctrine. As early as 1909, the United States Supreme Court recognized that "special facts" may give rise to a duty to disclose in the security transaction context.<sup>242</sup> Since that time, other courts confronting securities cases have similarly recognized this special facts doctrine,<sup>243</sup> and although the special facts doctrine developed in the securities law area, there has been some movement towards applying the doctrine in other contexts.

In *Chiarella v. United States*,<sup>244</sup> for example, Vincent Chiarella was employed at a financial printing operation where he deciphered the names of several companies involved in possible takeovers and then traded in the stock market based on this information.<sup>245</sup> Subsequently, the United States brought an action under section 10(b) of the Securities and Exchange Act of 1934 for

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<sup>237</sup> *E.g.*, *Lucas v. Enkvetchakul*, 812 S.W.2d 256, 260 (Mo. Ct. App. 1991).

<sup>238</sup> *Id.*

<sup>239</sup> *Id.*; *see also Seal v. Hart*, 755 P.2d 462, 464 (Colo. Ct. App. 1988); *Executive Condominiums, Inc. v. State*, 764 S.W.2d 899, 902 (Tex. Ct. App. 1989).

<sup>240</sup> *Sperry Corp. v. Shaeffer*, 394 N.W.2d 727, 730 (S.D. 1986).

<sup>241</sup> *Id.*

<sup>242</sup> *Strong v. Repide*, 213 U.S. 419, 431 (1909).

<sup>243</sup> *See, e.g.*, *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 848 (2d Cir. 1968), *cert. denied*, 404 U.S. 1005 (1971) (stating that "anyone in possession of material inside information must either disclose it . . . [or] abstain from trading"). *Accord Boardman v. Phipps* [1967] 2 AC 46. The court in *Jordan v. Duff and Phelps, Inc.*, explained the underpinnings of the "special facts" doctrine. 815 F.2d 429 (7th Cir. 1985). The *Jordan* court noted that:

The "special facts" doctrine developed by several courts at the turn of the century is based on the principle that insiders in closely held firms may not buy stock from outsiders in person-to-person transactions without informing them of new events that substantially affect the value of the stock.

*Id.* at 435.

<sup>244</sup> 445 U.S. 222 (1979).

<sup>245</sup> *Id.* at 224.

fraudulent activity relating to the purchase or sale of securities.<sup>246</sup> The United States Supreme Court, however, found that Chiarella owed no affirmative duty to disclose this takeover information.<sup>247</sup> Importantly, the Court emphasized that, as an employee at the printing company, Chiarella was not a corporate insider, and he did not share a fiduciary relationship with the sellers of the target companies' securities.<sup>248</sup>

In dissent, Justice Blackmun objected to imposing a duty to disclose only in restricted circumstances, noting that the possession of "special facts" has long been important in determining whether a party has a duty to disclose.<sup>249</sup> Further, Justice Blackmun pointed out that courts have applied the special facts doctrine in a number of contexts.<sup>250</sup> Thus, the "special facts" doctrine, as enunciated by Justice Blackmun, places a duty to disclose on one with specialized knowledge not available to the other party.<sup>251</sup>

New York courts have relied on Justice Blackmun's dissent in applying the "special facts" doctrine to business transactions. In *Congress Financial Corp. v. John Morrell & Co.*, for example, the court applied the "special facts" doctrine in finding that John Morrell & Co. could not claim fraudulent concealment.<sup>252</sup> According to the

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<sup>246</sup> *Id.* at 225.

<sup>247</sup> *Id.* at 232.

<sup>248</sup> *Id.* Subsequent to *Chiarella*, Federal courts and the Securities and Exchange Commission (SEC) have broadened insider trading liability beyond the "fiduciary duty" theory (to, in effect, bring insider trading law back to its original "disclose or abstain" conceptualization as set forth in *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968)) through (1) adoption of the "misappropriation theory" whereby one incurs Rule 10b-5 liability for misappropriating "nonpublic information in breach of a fiduciary duty or similar relationship of trust and confidence and uses such information in a securities transaction" (here, however, the inside trader need not breach a duty to the shareholders or issuers of the securities in question, but only a duty owed to the source of the inside information), *e.g.*, *United States v. Chestman*, 947 F.2d 551, 564 (2d Cir. 1991) (*en banc*), *cert. denied*, 112 S. Ct. 1759 (1992); *SEC v. Clark*, 915 F.2d 439, 444-48 (9th Cir. 1990), and (2) promulgation of SEC Rule 14e-3(a).

<sup>249</sup> *Id.* at 247 (Blackmun, J., dissenting).

<sup>250</sup> *Id.* at 248 (Blackmun, J., dissenting). Justice Blackmun relied on a number of cases involving the purchase of property. For example, in *Jenkins v. McCormick*, a purchaser of a home brought a fraudulent concealment action against the builder for damages related to a latent defect in a basement floor. 339 P.2d 8, 9 (Kan. 1959). In holding that the purchaser had stated a cause of action, the court found that when a fact "is peculiarly within the knowledge of one party and of such a nature that the other party is justified in assuming its nonexistence," the party owes a duty to disclose. *Id.* at 11 (quoting 37 C.J.S. *Fraud* § 16(b) (1955)).

<sup>251</sup> *Chiarella*, 445 U.S. at 248 (Blackmun, J., dissenting). See also *Jones v. Arnold*, 221 S.W.2d 187, 193-94 (Mo. 1949); *Simmons v. Evans*, 206 S.W.2d 295, 296-97 (Tenn. 1947).

<sup>252</sup> *Congress Fin. Corp. v. John Morrell & Co.*, 790 F. Supp. 459, 475 (S.D.N.Y. 1992).

court, the doctrine requires three elements: "(1) one party must have superior knowledge, (2) that knowledge must not be readily available to the other party, and (3) the party with the knowledge must know that the other party is acting on the basis of mistaken knowledge."<sup>253</sup> Because Morrell had unrestricted access to all records and documents prior to its purchase, Morrell could not invoke the "special facts" doctrine. Few courts have applied the "special facts" doctrine by that name outside of New York. Recently, in *Minnesota Power v. Armco, Inc.*, the court alluded to the doctrine in noting that when a party has access to special facts unavailable to the other party, it may have a duty to disclose.<sup>254</sup> While the Second Circuit has not explicitly referred to the "special facts" doctrine, the court has discussed the three requirements for finding a duty to disclose based on superior knowledge.<sup>255</sup>

Recent cases demonstrate that the superior knowledge or "special facts" doctrine is being used to chip away at caveat emptor even in arm's length transactions. In *Brass v. American Film Technologies, Inc.*, for instance, the Second Circuit applied the superior knowledge doctrine to an arm's length transaction involving the sale of stock warrants.<sup>256</sup> The *Brass* court reinstated plaintiff's fraud claim by making it relatively easy to satisfy the elements of the superior knowledge or special facts doctrine. With regard to the requirement that the undisclosed information not be "readily available" to plaintiff, or buyer, the court stated that the buyer had to have "an opportunity equal to that of a seller to obtain information," and that the buyer was "not required to conduct investigations to unearth facts and defects that are present, but not manifest."<sup>257</sup> The court also acknowledged the trend to limit the privilege to take advantage of ignorance.<sup>258</sup> With regard to the requirement that defendant know plaintiff was acting under a mistaken belief, the court indicated that it might not be necessary to

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<sup>253</sup> *Id.* at 473 (citation omitted).

<sup>254</sup> 937 F.2d 1363, 1368 (8th Cir. 1991).

<sup>255</sup> *Brass v. American Film Tech., Inc.*, 987 F.2d 142, 151-52 (2d Cir. 1993); *Gruman Allied Indus. v. Rohr Indus., Inc.*, 748 F.2d 729, 736-39 (2d Cir. 1984); *Aaron Ferer & Sons, Ltd. v. Chase Manhattan Bank*, 731 F.2d 112, 123 (2d Cir. 1984) (imposing the three requirements for finding a duty to disclose based on superior knowledge, but not mentioning the "special facts" doctrine).

<sup>256</sup> 987 F.2d 142, 151 (2d Cir. 1993). A stock warrant is an irrevocable option to purchase stock for a period of time. In *Brass*, plaintiff claimed that defendant, a film colorizing company, was liable for fraud for failing to disclose the fact that its stock, which was subject to the warrants, was not fully transferable for two years pursuant to a Security and Exchange Commission rule. *Id.* at 145-46.

<sup>257</sup> *Id.* at 151.

<sup>258</sup> *Id.* at 151-52.

prove that defendant subjectively knew of plaintiff's mistake. Instead, the court suggested, it may be sufficient to prove that defendant should have known of plaintiff's mistake because of the objective facts surrounding the transaction.<sup>259</sup>

The United States District Court for the Southern District of New York also denied a motion for summary judgment on behalf of a defendant charged with fraud for failure to disclose certain facts material to an arm's length transaction involving loans for a real estate deal.<sup>260</sup> In applying the superior knowledge doctrine under New York law, the court stated that: "The unmistakable trend in New York tort law is to apply the rule of superior knowledge in an increasing number of situations where the rule of *caveat emptor* once applied . . . ."<sup>261</sup>

## 6. Insurance contracts

As noted earlier, when referring to Lord Mansfield's opinion in *Carter v. Boehm*,<sup>262</sup> broad disclosures are required in the formation of insurance contracts. Such disclosure requirements are said to arise because of the nature of the contract itself, which calls for "perfect good faith and full disclosure of all material facts between the parties."<sup>263</sup> The basic notions presented in Lord Mansfield's opinion in *Carter v. Boehm* are apparent in American insurance law today.<sup>264</sup> Insurance contracts require good faith from the participants.<sup>265</sup> The duty of disclosure extends from the time the insurance application is completed to the time the policy is issued.<sup>266</sup>

Appleman and Appleman noted that there is no obligation to

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<sup>259</sup> *Id.* at 152. The court ruled that plaintiff's complaint sufficiently alleged defendant's knowledge by claiming that defendant's agent "surely knew" that plaintiff would not have considered the purchase of the stock warrants had he known of the restrictions on the transferability of the stock. The complaint apparently did not say how defendant "surely knew" this. Plaintiff claimed not to have been told anything about the restriction on the stock's transferability matter.

<sup>260</sup> *Banque Arabe Et Internationale D'Investissement v. Maryland Nat'l Bank*, 819 F. Supp. 1282 (S.D.N.Y. 1993).

<sup>261</sup> *Id.* at 9.

<sup>262</sup> 97 Eng. Rep. 1162 (K.B. 1766). See *supra* notes 38-40 and accompanying text for a discussion on *Carter v. Boehm*.

<sup>263</sup> Keeton, *supra* note 15, at 13; see also JOHN D. CALAMARI & JOSEPH M. PERILLO, *CONTRACTS LAW* § 9-20, at 291 (2d ed. 1977).

<sup>264</sup> See, e.g., 12A JOHN A. APPLEMAN & JEAN APPLEMAN, *INSURANCE LAW AND PRACTICE* §§ 7271-7276 (1981) [hereinafter APPLEMAN & APPLEMAN].

<sup>265</sup> See, e.g., *Stipcich v. Metropolitan Life Ins. Co.*, 277 U.S. 311, 316 (1927) (applying Oregon law); *Sun Mutual Ins. Co. v. Ocean Ins. Co.*, 107 U.S. 485, 510 (1883) (applying marine insurance law); *Indiana Ins. Co. v. Knoll*, 236 N.E.2d 63, 70-71 (Ind. Cl. App. 1968); APPLEMAN & APPLEMAN, *supra* note 264, at § 7271.

<sup>266</sup> *Stipcich v. Metropolitan Life Ins. Co.*, 277 U.S. at 317 & n.1 (citations omitted);

disclose to the insurer things that the insurer should know or may be presumed to know.<sup>267</sup> The concern in the formation of insurance contracts is the inequality of knowledge between the parties, which forces the underwriter to rely on the information provided by the insured when assessing the risk. In *The Columbian Insurance Co. of Alexandria v. Lawrence*, Chief Justice Marshall described the duty of disclosure: "[F]air dealing requires that he [the insured] should state everything which might influence, and probably would influence the mind of the underwriter in forming or declining the contract."<sup>268</sup>

If a change in circumstances should occur while the insurer is evaluating an application, the insured has a duty to inform the insurer of the change.<sup>269</sup> Courts have also held that a change in circumstances even after the policy has been issued, requires the insured to inform the insurer of such a change, provided that the change was substantial and would have led the insurer to cancel the policy or increase the premium if the insurer had known of the risk.<sup>270</sup>

Jurisdictions have been divided on the extent to which the insurer has a duty to disclose limitations on the policy. Several courts have placed the burden of reading and understanding the provisions of the policy on the insured.<sup>271</sup> Other courts, however, have held that when denying benefits to an insured who then disputes such a denial, the insurer must inform the insured of measures available for challenging the denial, especially arbitration.<sup>272</sup>

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APPLEMAN & APPLEMAN *supra* note 264, § 7275. Appleman and Appleman defined the duty of disclosure required by fair dealing as follows:

Fair dealing requires the insured to state everything which might, and probably would, influence the insurer in entering into or declining the risk, and in disclosing all information material to the risk about which information is sought. The insurer, by consenting to undertake a risk, does so under an implied condition that it shall be equally informed with the insured as to all material circumstances, so that it may judge the nature and extent of the risk for itself.

APPLEMAN & APPLEMAN, *supra* note 264, at § 7271 (citations omitted).

<sup>267</sup> APPLEMAN & APPLEMAN, *supra* note 264, at § 7272.

<sup>268</sup> 27 U.S. (2 Peters) 25, 29 (1829); *see also* *Reliance Ins. Co. v. McGrath*, 671 F. Supp. 669, 678 (N.D. Cal. 1989) (stating that "[t]he marine insurance contract is conceived in uttermost good faith . . . the assured must disclose every material circumstance which in the ordinary course of business ought to be known to him").

<sup>269</sup> *Stipich*, 277 U.S. 317.

<sup>270</sup> *Weems v. American Sec. Ins. Co.*, 450 So. 2d 431, 436 (Miss. 1984).

<sup>271</sup> *Security Ins. Co. of Hartford v. Wilson*, 800 F.2d 232, 235 (10th Cir. 1986); *Standard Venetian Blind Co. v. Empire Ins. Co.*, 469 A.2d 563, 566 (Pa. 1983).

<sup>272</sup> *Sarchett v. Blue Shield*, 729 P.2d 267, 277 (Cal. 1987) (en banc); *Davis v. Blue Cross of Northern California*, 600 P.2d 1060, 1067-68 (Cal. 1979) (en banc).

Many states have laws codifying the common law and prohibiting the rescission of some kinds of insurance contracts for misrepresentations by the insured, some of which can include omissions, unless the misrepresentations are material to the contract.<sup>273</sup> Though some statutes may not specifically include "omissions," answering a question incompletely by not disclosing information material to the answer of that question is often considered a misrepresentation or false statement.<sup>274</sup>

<sup>273</sup> See, e.g., CAL INS. CODE §§ 330-339 (West 1972 & Cum. Supp. 1993); KY. REV. STAT. ANN. § 304.14-110 (Michie 1988); MICH. COMP. LAWS ANN. § 500.2218 (West 1983 & Cum. Supp. 1993); N.Y. INS. LAW § 3105 (McKinney 1993); OHIO REV. CODE ANN. § 3923.14 (Anderson 1989). See generally Clayton H. Farnham, *Application Misrepresentation and Concealment In Property Insurance—The Elusive Elements Of The Defense*, 20 FORUM 299 (1985) (describing the numerous state statutory provisions regarding misrepresentation and omission in property insurance contracts).

<sup>274</sup> See, e.g., *Phoenix Ins. Co v. Raddin*, 120 U.S. 183, 189 (1887); *Transamerican Ins. Co. v. Austin Farm Ctr.*, 354 N.W.2d 503, 506 (Minn. Ct. App. 1984); *Randono v. CUNA Mut. Ins. Group*, 793 P.2d 1324, 1325-1326 (Nev. 1990); *Merchant's Indem. Corp. v. Eggleston*, 68 N.J. Super. 235, 250-51, 172 A.2d 206, 214 (App. Div. 1961); *Clingan v. Vulcan Life Ins. Co.*, 694 S.W.2d 327, 330 (Tenn. Ct. App. 1985). For example, the California insurance code's rules regarding the effect of concealment in insurance contracts are quite detailed. California's rules require both parties to communicate in good faith all facts that the party believes are material and which the other party cannot ascertain; a party need not disclose non-material facts, facts which the other party knows, or facts the other could know in the exercise of ordinary care. CAL. INS. CODE §§ 332-333 (West 1972). The California Code also defines "materiality" as the "probable and reasonable" impact of facts upon the party to whom communication is due, when making an estimate of the disadvantages of the proposed contract, or in "making his inquiries." *Id.* § 334. Further, a party can waive their right to know by the (1) terms of the insurance, or (2) neglect to make inquiries as to such facts, where they are distinctly implied in other facts of which information is communicated. *Id.* § 336. In addition, Kentucky's law specifically includes omissions and misrepresentations in stating that the contract will not be voided unless such omissions or misrepresentations are fraudulent, material, or that the contract would not have been issued or would have been issued at a different premium. KY. REV. STAT. ANN. § 304.14-110 (Michie 1992). Moreover, Michigan law states that a misrepresentation will not defeat a disability insurance contract unless the misrepresentation is material. MICH. COMP. LAWS ANN. § 500.2218 (West 1993). Similarly, New York law provides that a misrepresentation will not void a contract unless the misrepresentation is material, meaning that it would have led the insurer to refuse to make such a contract. N.Y. INS. LAW § 3105 (McKinney 1993). The Ohio Revised Code establishes that misrepresentations do not void sickness and accident insurance policies unless the misrepresentation is material and wilfully or fraudulently made. OHIO REV. CODE ANN. § 3923.14 (Anderson 1989).

The foregoing statutes represent a sampling of the types of statutes applicable to disclosure duties in insurance contract formation. State law determines the impact of a party's non-disclosure or concealment of material factors, even though the statutes themselves may define in broad terms what is considered material. See, e.g., MICH. COMP. LAWS ANN. § 500.2218 (West 1983); N.Y. INS. LAW § 3105 (West 1985). Common law notions of materiality still control in particular circumstances. *Penn Mut. Life Ins. Co. v. Mechanics' Sav. Bank and Trust Co.*, 72 F. 413, 419 (6th Cir. 1896) (applying Pennsylvania law). See generally Robert J. Brennan & Jane Hanson, *Misrepresent-*

The court in *Penn Mutual Life Insurance Co. v. Mechanics' Savings Bank & Trust Co.*, for instance, justified a Pennsylvania statute, which provided that no misrepresentation in an insurance contract would void the insurance contract unless it was material or not made in good faith, by stating that the statute relieved insureds of the hardship of the common law remedy of rescission for misrepresentations or misstatements of little importance to the forming of a contract.<sup>275</sup> More regulation and judicial involvement in insurance contract law is justified by both public and third party interests in insurance.<sup>276</sup>

Lord Mansfield noted that an insured need not disclose a fact that the underwriter knows or should know.<sup>277</sup> Because insurance contracts often require the applicant to answer questions, many courts have posited that these questions represent the material issues for which there must be full disclosure, and a failure to ask a question or pursue an ambiguous answer may waive the insurer's right to know.<sup>278</sup> The United States Supreme Court expressed the rule regarding the impact of apparently complete answers to questions on an application for insurance:

Where an answer of the applicant to a direct question of the insurers purports to be a complete answer to the question, any substantial misstatement or omission in the answer avoids a policy issued on the faith of the application . . . . But where upon the face of the application a question appears to be not answered at all, or to be imperfectly answered, and the insurers issue a policy without further inquiry, they waive the want or imperfection in the answer, and render the omission to answer more fully immaterial.<sup>279</sup>

In a case decided by the United States Court of Appeals for the Eleventh Circuit, applying Alabama law, the court remanded the case to determine if the underwriter could have discovered information about the health of the applicant that the applicant failed to disclose

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*sentation In The Application As The Basis For Rescission Of A Property Insurance Policy*, 21 TORT & INS. L.J. 451 (1986) (discussing varying common law definitions of materiality for determining if contract rescission is an applicable remedy for an omission or misrepresentation in an application for property insurance).

<sup>275</sup> 72 F. 413, 418 (6th Cir. 1896).

<sup>276</sup> See, e.g., Holmes, *supra* note 15, at 395-400.

<sup>277</sup> Carter v. Boehm, 97 Eng. Rep. 1162, 1165 (K.B. 1766).

<sup>278</sup> See, e.g., Stipcich v. Metropolitan Life Ins. Co., 277 U.S. 311, 316 (1927); *Phoenix Ins. Co.*, 120 U.S. at 190; *Cora Pub Inc. v. Continental Casualty Co.*, 619 F.2d 482, 487 (5th Cir. 1980); *Allstate Ins. Co. v. Shirah*, 466 So. 2d 940, 944 (Ala. 1985); see also APPLEMAN & APPLEMAN, *supra* note 264, § 7276.

<sup>279</sup> *Phoenix Ins. Co.*, 120 U.S. 183, 189-90 (citations omitted).



based on the answers that the applicant had provided.<sup>280</sup> The court determined that if the insurer does not ask about a particular fact, then silence, without a fraudulent or deceitful intent, will not void the contract.<sup>281</sup>

The issue of insurer knowledge is the basis for common law distinctions between marine insurance contracts, which have the broadest disclosure requirement, and other kinds of insurance contracts.<sup>282</sup> Traditionally, because marine insurance was often purchased while the ship was at sea, the underwriter could not make an independent examination of the ship and had to rely on the information provided by the insured. Underwriters are more likely to have independent access to information in other kinds of insurance situations such as property or life insurance.<sup>283</sup> The non-marine insurance rule does not generally require disclosure in the absence of a specific inquiry.<sup>284</sup>

The jurisdictions are split on whether the intent of the insured in not disclosing information is material to the voidability of a non-marine insurance contract.<sup>285</sup> The language and interpretation of some state statutes allow an insurance contract to be voided if the misrepresentations, concealment, or omission are material without requiring proof of an intent.<sup>286</sup> In other states, misrepresentations, concealment, or omission must be made wilfully or with a fraudulent purpose as well as be material to make the contract voidable.<sup>287</sup> Some states will allow an insurance contract to be voidable if the concealment or omission was wilful or was done with a fraudulent design,

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<sup>280</sup> *Stephens v. Guardian Life Ins. Co. of America*, 742 F.2d 1329, 1334-35 (11th Cir. 1984).

<sup>281</sup> *Cora Pub, Inc.*, 619 F.2d at 487; *Stewart-Smith Haidinger, Inc. v. Avi-Truck, Inc.*, 682 P.2d 1108, 1116 (Alaska 1984); *A.E. Graham v. Aetna Ins. Co.*, 132 S.E.2d 273, 275 (S.C. 1963); *U.S. Life Credit Ins. Co. v. McAfee*, 630 P.2d 450, 455 (Wash. Ct. App. 1981); *APPLEMAN & APPLEMAN*, *supra* note 264, § 7274.

<sup>282</sup> *See, e.g.*, *Penn Mut. Life Ins. Co. v. Mechanics' Sav. Bank and Trust Co.*, 72 F. 413, 436-37 (6th Cir. 1896); *Hartford Protection Ins. Co. v. Harmer*, 2 Ohio St. 452, 472-73 (1853).

<sup>283</sup> *Penn Mut. Life Ins. Co.*, 72 F. at 436-37.

<sup>284</sup> *Id.* at 434-41; *Hartford Protection Ins. Co.*, 2 Ohio St. at 472-73.

<sup>285</sup> *See APPLEMAN & APPLEMAN*, *supra* note 264, at §§ 7273-7274; *Brennan & Hanson*, *supra* note 274, at 456.

<sup>286</sup> *See, e.g.*, *Stephens v. Guardian Life Ins. Co. of America*, 742 F.2d 1329, 1332-33 (11th Cir. 1984); *Davis v. John Hancock Mut. Life. Ins. Co.*, 413 S.E.2d 224, 226 (Ga. Ct. App. 1991); *Clingan v. Vulcan Life Ins. Co.*, 694 S.W.2d 327, 331 (Tenn. Ct. App. 1985); *Ky. Rev. Stat. Ann.* § 304.14-110 (Michie 1988).

<sup>287</sup> *See, e.g.*, *Enserch Corp. v. Shand Morahan & Co., Inc.*, 952 F.2d 1485, 1496-97 (5th Cir. 1992) (applying Texas law); *Hall v. State Farm Fire & Casualty Co.*, 937 F.2d 210, 214 (5th Cir. 1991) (applying Mississippi law); *OHIO REV. CODE ANN.* § 3923.14 (Anderson 1989).

even if it was not material.<sup>288</sup> The individual state must be analyzed in order to determine the extent of the duty to disclose material or non-material information at the time of forming the insurance contract.

The insured's duty of disclosure arises from the good faith obligations of both parties to an insurance contract.<sup>289</sup> The reason for the "rule which obliges parties to disclose, is to prevent fraud and encourage good faith."<sup>290</sup> Though the duty has its limitations, the duty is indicative of the importance of full disclosure in contract formation in order for there to be a true understanding of the risk that is being insured against.<sup>291</sup> If there is no meeting of the minds as to the actual risk insured against, then the contract is void.<sup>292</sup>

Insurance contracts are different from many other types of contractual relationships because they are heavily state regulated.<sup>293</sup> This is because of the variety of interests involved in insurance contract formation.<sup>294</sup> Courts and legislatures seek to protect insureds from the harsh impact of insurance contract rescission by placing some limits on the insured's duty to disclose information.<sup>295</sup> Even in the area where concern for the contracting individual is high, however, the insured still has a duty to disclose information material to the risk. An insurer may be obligated to investigate some information himself, or "material information" may be defined by the insurer's questions, but the insured often still has a duty not to conceal or omit information material to the formation of the contract.

## 7. Statutory disclosure requirements

Some statutes require disclosures in certain contexts.<sup>296</sup> The purposes behind these disclosure provisions vary, but they gener-

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<sup>288</sup> See, e.g., *Penn Mut. Life Ins. Co.*, 72 F. at 419; *Merchant's Indem. Corp. of N.Y. v. Eggleston*, 68 N.J. Super. 235, 172 A.2d 206 (App. Div. 1961); *Lighton v. Madison-Onondaga Mut. Fire Ins.*, 483 N.Y.S.2d 515 (N.Y. App. Div. 1984) (mem.); *Hartford Protection Ins. Co.*, 2 Ohio St. at 472-73.

<sup>289</sup> *Carter v. Boehm*, 97 Eng. Rep. 1162, 1164 (K.B. 1766).

<sup>290</sup> *Id.* at 1165.

<sup>291</sup> *Id.* at 1164.

<sup>292</sup> *Id.*

<sup>293</sup> *Holmes*, *supra* note 15, at 395-96.

<sup>294</sup> *Id.* at 396.

<sup>295</sup> *Penn Mut. Life Ins. Co. v. Mechanics' Sav. Bank and Trust Co.*, 72 F. 413, 418 (6th Cir. 1896).

<sup>296</sup> See *supra* notes 147, 149-55, for a brief description of the Uniform Sales Act, the Securities Act of 1933, the Truth in Lending Act, the Equal Credit Opportunity Act, the Real Estate Settlement Procedures Act, the Interstate Land Sales Full Disclosure Act, the Truth in Negotiations Act and the Magnuson-Moss Warranty Federal Trade Commission Improvement Act. See also *supra* note 168, for a brief discussion of Ohio's residential real estate disclosure law.

ally endeavor to provide information necessary to allow fair dealing and fully informed decision-making. While these laws do not generally address negotiations for the sale of a business, they do reflect society's increasing interest in requiring broader disclosures. Of additional relevance here is the duty to disclose which is inherent in the good faith bargaining requirements of the National Labor Relations Act.

Section 158(d) of the National Labor Relations Act states that "to bargain collectively is the performance of the mutual obligation of the employer and the representative of the employees to . . . confer in good faith."<sup>297</sup> The United States Supreme Court in *NLRB v. Truitt Manufacturing Co.* ruled that a component of this good faith duty is the exchange of information because "if an argument is important enough to present in the give and take of bargaining, it is important enough to require some sort of proof of its accuracy."<sup>298</sup> This case has served as the font for a general duty to disclose information in collective bargaining, both by the employer and by the union.<sup>299</sup> The employer holds a majority of the relevant information, and therefore its duty to disclose is most important. In order for a union to properly perform its duties as a bargaining agent, all relevant information must be provided.<sup>300</sup>

The employer's duty to disclose has two important limitations: (1) the union must demand the information in good faith; and (2) the information must be relevant to the union's capacity as the employees' representative in bargaining with the employer.<sup>301</sup> Once the duty arises, it "continues through the life of the agreements so far as it is necessary to enable the parties to administer the contract and resolve grievances or disputes."<sup>302</sup> The most important information that must be disclosed is financial information. Other information may be obtained if the union needs it to bargain intelligently and "to service and police the contract."<sup>303</sup> This may

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<sup>297</sup> 29 U.S.C. § 158(d) (1988 & Supp. IV 1992).

<sup>298</sup> *NLRB v. Truitt Manuf. Co.*, 351 U.S. 149, 152-53 (1956). The Court ruled that an employer has a duty to open its books and records and provide support for its assertion that it is unable to pay higher wages.

<sup>299</sup> *Local 13, Detroit Newspaper Printing and Graphic Communications Union v. NLRB*, 598 F.2d 267, 271 (D.C. Cir. 1979).

<sup>300</sup> See *Aluminum Ore Co. v. NLRB*, 131 F.2d 485, 487 (7th Cir. 1942).

<sup>301</sup> *Transport of New Jersey*, 233 NLRB 694 (1977).

<sup>302</sup> *Sinclair Ref. Co. v. NLRB*, 306 F.2d 569, 571 (5th Cir. 1962).

<sup>303</sup> *Viewlex, Inc.*, 204 NLRB 1080, 1082 (1973). A refusal to provide relevant requested information is a violation of the NLRA. *Puerto Rico Tel. Co. v. NLRB*, 359 F.2d 983 (1st Cir. 1966); *Curtiss-Wright Corp. v. NLRB*, 347 F.2d 61, 68 (3rd Cir. 1965). Employers may gain access to certain types of information as well, but these cases are not nearly as plentiful. Examples of information the union must disclose

include information pertaining to employees' hours, conditions of employment, benefits and equal employment opportunity data.

The Federal Trade Commission (FTC) has also promulgated rules that apply to negotiations, which are essentially disclosure rules, requiring the franchisor to inform the franchisee about numerous aspects of the business.<sup>304</sup> The rules are very similar to the federal securities acts in requiring disclosure, but do not establish standards for the offering. The FTC permits parties to use the Uniform Franchise Offering Circular (UFOC) in lieu of the FTC rules.<sup>305</sup> Most states also permit parties to comply with the UFOC, rather than state law.<sup>306</sup>

#### D. *Justifiable Reliance*

The preceding section sets forth the established occasions when the courts recognize a duty to speak. Even in these cases, however, courts place a significant barrier before a plaintiff, requiring him to show independent efforts before the judiciary will intervene. This is framed by requiring "justifiable" reliance on the other party's omissions, and a correlated duty to investigate.<sup>307</sup> Jus-

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are: hiring hall and manning information, information about union pension and welfare plans, collective bargaining agreements with other employers and employees on union out-of-work lists.

<sup>304</sup> *Id.*

<sup>305</sup> 1 BUS. FRANCHISE GUIDE (CCH) ¶ 5700 (1980). The UFOC is similar to the FTC rules, but it is more stringent in many respects, and it requires disclosure of, among other things, the salespersons, prior history of the franchise, pending litigation against the franchisor, fees, obligations to make purchases from the franchisor, and earning projections. Neither the FTC rules nor the UFOC contains an explicit duty of good faith and fair dealing.

<sup>306</sup> 62B AM. JUR. 2d *Private Franchise Contracts* § 307 (1990). In substance, most state laws provide that

no person may offer or sell a franchise by means of any written or oral communication which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading.

1 BUS. FRANCHISE GUIDE (CCH) ¶ 5794 (1980).

<sup>307</sup> The elements of common law fraud for failure to disclose facts or omissions are: (1) an omission to state or disclose; (2) material facts; (3) when there is a duty to do so; (4) with intent to deceive or mislead; (5) causing justifiable reliance on the part of the plaintiff; and (6) which is the proximate cause of injury. The fifth element, justifiable reliance, also includes an unstated requirement in many jurisdictions, a duty to investigate. *See, e.g.,* *Affiliated Capital Servs. v. W. Atlantic City Assocs.*, 760 F. Supp. 1067, 1073 (W.D.N.Y. 1991); *Hardy v. Blue Cross and Blue Shield*, 585 So. 2d 29, 32 (Ala. 1991); *Eckley v. Colorado Real Estate Comm'n*, 752 P.2d 68, 78 (Colo. 1988) (en banc); *Stephenson v. Capano Dev., Inc.*, 462 A.2d 1069, 1074 (Del. 1983); *Pyne v. Jamaica Nutrition Holdings Ltd.*, 497 A.2d 118, 131 (D.C. App. 1985); *Lidecker v. Kendall College*, 550 N.E.2d 1121, 1124 (Ill. App. Ct. 1990); *Cornell v. Wunschel*, 408

tifiable reliance and the duty to investigate are perhaps the most important defining aspects of the tort of non-disclosure because the duty to disclose, in effect, is linked to a plaintiff's duty to investigate. If courts impose stringent investigatory requirements on the plaintiff before his reliance on an omission is justifiable, this would effectively extinguish the defendant's duty to disclose. Indeed, this is what caveat emptor did—it placed the burden of investigation to discover the facts solely on the purchaser. Although there are still many cases that require the plaintiff to investigate carefully, particularly in arm's length commercial transactions, and that impute to plaintiff all knowledge he would have learned had he performed a reasonable investigation, the modern trend has been to lessen the plaintiff's duty of investigation and to permit a finding of justifiable reliance as long as the representation or omission relied upon is not obvious and the plaintiff's reliance was in good faith.

1. The traditional rule—there is a duty to investigate

Under the traditional rule, a party claiming fraud could not claim that reliance upon a misrepresentation was reasonable if that party could have, through the exercise of ordinary diligence, discovered the material facts before acting in reliance. A party who failed to exercise ordinary diligence by making an independent inquiry into information readily available to both parties could not claim to be a victim of fraud.<sup>308</sup> Furthermore, according to the traditional view, where there had been a failure to investigate, a

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N.W.2d 369, 374 (Iowa 1987); *Harton v. Harton*, 344 S.E.2d 117, 119-20 (N.C. Ct. App. 1986); *Wilson v. Donegal Mut. Ins. Co.*, 598 A.2d 1310, 1315-16 (Pa. Super. Ct. 1991); *Tokarz v. Frontier Fed. Sav. and Loan Ass'n*, 652 P.2d 1089, 1094 (Wash. Ct. App. 1982).

<sup>308</sup> *E.g.*, *Ewers v. Ford Motor Co.*, 843 F.2d 1331, 1334 (11th Cir. 1988) (explaining that Georgia law provides no recovery where alleged fraud consisted of defendant's silence and plaintiff could have discovered the truth by simple inspection, or when plaintiff clearly had notice that that fact was misrepresented but nevertheless relied upon it); *Modern Enters. Inc. v. Allen*, 802 F.2d 312, 314 (8th Cir. 1986) (applying Missouri law); *Kaken v. Eli Lilly and Co.*, 737 F. Supp. 510, 519 (S.D. Ind. 1989) (explaining that under Indiana law, one relying upon a representation is bound to exercise ordinary care and diligence to guard against fraud); *Moran v. Nav Servs.*, 377 S.E.2d 909 (Ga. Ct. App. 1989) (asserting that no fraud exists where matter was equally open to the observation of all parties and where no special relation of trust or confidence exists); *Southern Intermodal Logistics v. Smith & Kelley Co.*, 379 S.E.2d 612, 614 (Ga. Ct. App. 1989); *Robertson v. Boyd*, 363 S.E.2d 672, 676 (N.C. Ct. App. 1988) (pointing out that even where a defendant makes an affirmative misrepresentation, failure by plaintiff to make diligent inquiries when he has notice of a problem precludes recovery for fraud); *Silva v. Stevens*, 589 A.2d 852, 858 (Vt. 1991) (noting that while plaintiff has a general duty of diligent attention, observation and judgment,

party was deemed to have constructive knowledge of everything that an inquiry might have uncovered.<sup>309</sup> Consequently, in order to recover for fraud based upon a misrepresentation or an omission, a party must show that it had no knowledge of the concealed facts, and that the true facts could not have been discovered even through diligent inquiry.<sup>310</sup>

The traditional rule has been applied in omissions cases even when a party typically has been found to have a duty to speak. For example, if a party has superior information or knowledge concerning a transaction, there is generally no enforceable duty if the information or the facts are obvious or may be discovered by exercise of reasonable diligence. In *Noss v. Abrams*, the court noted that superior knowledge may give rise to a duty to speak when that knowledge is not within the fair reach of another.<sup>311</sup> The court, however, rejected plaintiff's claims, finding that plaintiff must first prove "his inability to discover the undisclosed fact in the exercise of reasonable diligence."<sup>312</sup>

Similarly, in *Grumman Allied Industries v. Rohr Industries, Inc.*, the court held that plaintiff could not maintain its action for fraud and misrepresentation based on defendant's alleged failure to disclose when plaintiff had absolute access to all relevant information.<sup>313</sup> The court emphasized that New York courts are "particularly disinclined" to entertain such claims where the transaction involved "sophisticated businessmen engaged in major

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a specific duty of inquiry is triggered only when it is clear from the facts of the representation that reliance should follow only after an independent inquiry).

<sup>309</sup> *Webb v. Rushing*, 391 S.E.2d 709, 711 (Ga. Ct. App. 1990); *Tri-State Asphalt Prods., Inc. v. McDonough Co.*, 391 S.E.2d 907 (W. Va. 1990) (ruling that parties will be presumed to have made a suitable investigation, and their rights will be determined accordingly).

<sup>310</sup> *Cohen v. Wedbush, Noble, Cooke, Inc.*, 841 F.2d 282, 287 (9th Cir. 1988) (pointing out that reliance on a misrepresentation is not reasonable when plaintiff could have, through the exercise of reasonable diligence, ascertained the truth of the matter); *Lesser v. Neosho County Community College*, 741 F. Supp. 854 (D. Kan. 1990) (explaining that to establish fraud under Kansas law, plaintiff must show that he did not and could not have discovered the material facts by the exercise of reasonable diligence); *Hope v. Brannan*, 557 So. 2d 1208 (Ala. 1989) (asserting that plaintiff's failure to inspect house negated finding of fraud where problems could have been discovered with ordinary diligence); *Brookside Village Mobile Homes v. Meyers*, 782 S.W.2d 365 (Ark. 1990) (ruling that purchaser must show no knowledge of the facts, and that ascertainment of the undisclosed fact was not within the purchaser's diligent attention or observation).

<sup>311</sup> *Noss v. Abrams*, 787 S.W.2d 834, 837 (Mo. Ct. App. 1990).

<sup>312</sup> *Id.*; see also *McCullum v. P/S Invs., Ltd.*, 764 S.W.2d 252, 255 (Tex. Ct. App. 1988).

<sup>313</sup> 748 F.2d 729, 730 (2d Cir. 1984).

transactions [who] enjoy access to critical information but fail to take advantage of that access."<sup>314</sup> The court contrasted this situation with others in which plaintiffs could not discover material information regardless of their efforts to do so.<sup>315</sup> Thus, because plaintiff failed to demonstrate a fiduciary relationship with defendant or the requirements for imposing a duty on one with superior knowledge, the court rejected its claim.

2. The modified traditional rule—sometimes there is a duty to investigate

Some courts have recently tempered the traditional view and as a result have lessened plaintiffs' duty of investigation, depending upon the circumstances surrounding the transaction. Many cases hold that a plaintiff has a duty of inquiry only if a person of the same or similar intelligence, education, or experience would have recognized the representation as false.<sup>316</sup> Similarly, other cases have held that a plaintiff has no general duty of inquiry unless the plaintiff knows that the defendant's representations are false or strongly suspects that they are false.<sup>317</sup> While a plaintiff may not

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<sup>314</sup> *Id.* at 737.

<sup>315</sup> See, e.g., *Mallis v. Bankers Trust Co.*, 615 F.2d 68, 80 (2d Cir. 1980), *cert. denied*, 449 U.S. 1123 (1981); *Tahini Invs., Ltd. v. Bobrowsky*, 470 N.Y.S.2d 431, 433 (N.Y. App. Div. 1987) (reversing summary judgment because plaintiff's allegation of defendant's superior knowledge presented triable issue of fact).

<sup>316</sup> E.g., *West v. Western Casualty and Sur. Co.*, 846 F.2d 387 (7th Cir. 1988) (stating that under Illinois law, plaintiff has a duty to investigate further when the circumstances reasonably require, as a matter of prudence, that an investigation be undertaken; plaintiff's duty, however, is absolved if the defendant's misrepresentations or assurances are designed to lull the plaintiff into a false sense of security or block further inquiry); *Dime Box Petroleum Corp. v. Louisiana Land & Exploration Co.*, 717 F. Supp. 717, 723 (D. Colo. 1989) (Colorado law); *Elco Indus. Inc., v. Hogg*, 713 F. Supp. 1215, 1218 (N.D. Ill. 1989) (explaining that under Illinois law, plaintiff has duty to investigate statements made by the defendant if the full factual circumstances suggest that prudence reasonably required such an investigation); *Vance v. Huff*, 568 So. 2d 745, 751 (Ala. 1990); *Wilson v. Brown*, 496 So. 2d 756, 760 (Ala. 1986) (finding that if the circumstances are such that a reasonably prudent person who exercised ordinary care would have discovered the facts, plaintiff is not entitled to recover for fraud); *Lang v. Lee*, 777 S.W.2d 158 (Tex. Ct. App. 1989) (pointing out that in an arm's length transaction, plaintiff has a duty of inquiry if knowledge of the facts would have excited inquiry in the mind of a reasonably prudent person).

<sup>317</sup> E.g., *Dexter Corp. v. Whittaker Corp.*, 926 F.2d 617, 620 (7th Cir. 1991) (stating that under Illinois law, if plaintiff is not merely careless but knows or suspects that the seller's representations are false, and declines to investigate, he cannot cry fraud); *Astor Chauffeured Limousine Co. v. Runnfeldt Inv. Corp.*, 910 F.2d 1540, 1549 (7th Cir. 1990) (ruling that Illinois law does not create a general duty of reasonable care by buyers, but a buyer that ignores a known or obvious risk may not recover for fraud); *Tower Fin. Servs. v. Jarrett*, 404 S.E.2d 622, 624-25 (Ga. Ct. App. 1991) (asserting that while the law does not protect people who have engaged in cheating or swindling, a

close his eyes to a known or obvious misrepresentation, in the absence of a patent untruth, he is not required to make an independent inquiry.<sup>318</sup> A plaintiff who nevertheless relies on a representation that he knows to be false, however, cannot claim that his reliance was reasonable. Moreover, a party that chooses to make an independent investigation will be chargeable with everything the party could have discovered by exercising diligence.<sup>319</sup>

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plaintiff claiming fraud is bound to make inquiry for himself where alleged fraud consists of general commendations or opinions); *Collins v. Burns*, 741 P.2d 819, 821 (Nev. 1987) (ruling that plaintiff has no duty to investigate absent any facts that "would serve as a danger signal and a red light to any normal person of his intelligence and experience"); *Sugarline Assoc. v. Alpen Assocs.*, 586 A.2d 1115, 1121 (Vt. 1990) (pointing out that plaintiff's duty to investigate is "triggered when he is put on notice by seller's declaration of ignorance as to material facts"); *Wells v. Wells*, 401 S.E.2d 891, 893 (Va. Ct. App. 1991) (explaining that a person has no duty to make further inquiry, but the law will not give "indemnity against the consequences of indolence, folly or careless indifference to known information"); *Atherton Condominium Bd. v. Blume Dev. Co.*, 799 P.2d 250, 251 (Wash. 1990) (explaining that where purchaser discovers evidence of a defect or where defect is apparent, there is an obligation to inquire further).

<sup>318</sup> *Ampat/Midwest v. Illinois Tool Works, Inc.*, 896 F.2d 1035, 1042 (7th Cir. 1990) (finding that under Illinois law, a "victim cannot be reckless in his reliance, but he is not obliged to dig beneath apparently adequate assurances merely because the circumstances might engender suspicion in the proverbial reasonable man"); *Chris Berg, Inc. v. Acme Mining Co., Inc.*, 893 F.2d 1235, 1238 (11th Cir. 1990) (applying Florida law and explaining that "most jurisdictions now permit the recipient of a fraudulent misrepresentation to rely on it whether or not a reasonable investigation would have uncovered the falsity of the representation, unless the recipient of the representation knew it was false or its falsity was obvious").

<sup>319</sup> *Blitz v. 970 Realty Assocs.*, 233 N.J. Super. 29, 36-37, 557 A.2d 1386, 1391 (App. Div. 1989) (citation omitted); *DSK Enters., Inc. v. United Jersey Bank*, 189 N.J. Super. 242, 251, 557 A.2d 1201, 1206 (App. Div. 1983) (citation omitted); *Trautwein v. Bozzo*, 35 N.J. Super. 270, 278, 113 A.2d 848, 852 (App. Div. 1955) (citation omitted). This rule was explained in more detail in *John Hancock Mut. Life Ins. Co. v. Cronin*, 137 N.J. Eq. 586, 589, 46 A.2d 71, 73 (Ch. 1946):

The law governing independent investigations seems clearly to have settled the principle that when one undertakes to make an independent investigation and relies upon it, he is presumed to have been guided by it and be bound accordingly. One cannot secure redress for fraud where he acted in reliance upon his own knowledge or judgment based upon an independent investigation. . . .

. . . .

The respondent's brief contends that the appellant, having made an investigation, became "chargeable with knowledge of any and all facts, which were then in existence . . . ." This rule is too broad. It is only where the independent investigation discloses the falsity of the material representations or the source of the information is revealed by the insured where the parties are not in an equal position to know the facts, and in either event the knowledge gained or which could have been gained by the exercise of reasonable diligence is substituted for the insurance application, that the appellant is precluded from relying upon the misrepresentations in the application. The mere fact that an in-



Additionally, some courts have recognized that the existence of a special relationship between the parties, such as a fiduciary relationship, is among the circumstances that may lessen the plaintiff's duty to make an independent inquiry.<sup>320</sup>

### 3. The modern trend—there is no duty to investigate

The modern trend has been to lessen the duty to investigate or to discard it entirely.<sup>321</sup> This trend represents a shift in the ethi-

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surer makes an investigation does not absolve the applicant from speaking the truth nor lessen the right of the insurer to rely upon his statements, unless the investigation discloses facts sufficient to expose the falsity of the representations of the applicant or which are of such a nature as to place upon the insurer the duty of further inquiry.

*Id.* (citation omitted); *see also* McDonald v. Superior Court, 268 P.2d 1076, 1082 (Cal. Ct. App.) ("When one undertakes an investigation and proceeds with it without hindrance, it will be assumed that he continued until he had acquired all the knowledge he desired and was satisfied with what he learned. He will not be heard to say that he relied on the representation of the other party."), *rev'd on other grounds*, 275 P.2d 464 (Cal. 1954); Jahraus v. Bergquist, 494 P.2d 110, 111 (Colo. Ct. App. 1971) (finding that experienced buyer in possession of documents which were inconsistent on their face as to financial affairs of business did not state a cause of action in fraud); Cherrington v. Woods, 290 P.2d 226, 228 (Colo. 1955) (same); Arnott v. Kruse, 730 S.W.2d 597 (Mo. Ct. App. 1987) (citation omitted) ("When a party makes an independent investigation he is presumed to have relied on what he learned from that investigation and may not claim that he relied on a contrary misrepresentation"); Puget Sound Nat'l Bank v. McMahon, 330 P.2d 559, 561 (Wash. 1958) (ruling that plaintiff's investigation and vast business experience, precluded plaintiff from relying on representations as to net profits); Fleishman v. Hockett, 301 P.2d 166, 171-72 (Wash. 1956) (finding no justifiable reliance in view of plaintiff's experience and investigations); RESTATEMENT (SECOND) OF TORTS § 547 (1967).

<sup>320</sup> Wilson v. Brown, 496 So. 2d 756, 759 (Ala. 1986) (citation omitted) ("Silence is not actionable fraud absent a confidential relationship or some special circumstance imposing a duty to disclose."); Hagans, Brown & Gibbs v. First Nat'l Bank of Anchorage, 810 P.2d 1015, 1019 (Alaska 1991) (finding defendant duty bound to disclose when facts are concealed or unlikely to be discovered because of a special relationship between the parties or their course of dealings); Mister Donut of America v. Harris, 723 P.2d 670, 673 (Ariz. 1986) (ruling that where special relationship of franchisor-franchisee exists between two parties, one party may rely on another's misrepresentations without investigating their truth); Powell v. James, Hereford & McClelland, 377 S.E.2d 683, 685 (Ga. Ct. App. 1989) (asserting that one alleging fraud must show that he exercised ordinary care to find out the facts and protect himself, except where the relationship is a fiduciary one). *But see* Farr v. Shearson Lehman Hutton, Inc., 755 F. Supp. 1219, 1227 (S.D.N.Y. 1991) (finding that under New York law, the existence of a fiduciary relationship does not relieve plaintiff of an obligation to make an inquiry where there is reason to suspect the probability of wrongdoing).

<sup>321</sup> Although many cases state that the trend toward discarding the duty to investigate is "modern," the "trend" has been in existence for over 100 years. *E.g.*, Chamberlin v. Fuller, 9 A. 832, 836 (Vt. 1887) ("No rogue should enjoy his ill-gotten plunder for the simple reason that his victim is by chance a fool."); Kendall v. Wilson, 41 Vt. 567, 571 (1869) (pointing out that "the law will afford relief even to the simple and credulous who have been duped by act and falsehood").

cal standards of our society<sup>322</sup> and has eliminated the duty of inquiry by permitting plaintiffs to rely on representations or omissions as long as the plaintiffs' reliance is in good faith and the misrepresentation or omission relied upon is not obvious.<sup>323</sup> According to the modern view, a plaintiff who receives a representation is still required to be alert to statements that are patently false. In all other cases, however, a plaintiff is entitled to rely upon a representation and to take the defendant at his word, without having a duty to investigate the truth of the statement.<sup>324</sup> Thus, the burden of discerning the truthfulness of a statement is no longer on the party to whom the representation was made. Rather, the party making the statement bears the burden of making certain that the representation is true.<sup>325</sup>

The same rule has been applied in omissions cases. One court has stated that "it is no excuse for the defendant, nor does it lie in his mouth to say, that the plaintiff might, but for his own neglect, have discovered the wrong and prevented its accomplishment."<sup>326</sup>

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<sup>322</sup> Fleming James Jr. & Oscar S. Gray, *Misrepresentation - Part II*, 37 MD. L. REV. 488, 511-22 (1978). James and Gray added that: "The shift in ethical standards by the community and the reflection of the shift in the law of fraud are nowhere better illustrated than by the change in the law's requirement of diligence on plaintiff's part." *Id.* at 511.

<sup>323</sup> The RESTATEMENT (SECOND) OF TORTS, section 540, states that "[t]he recipient of a fraudulent misrepresentation of fact is justified in relying upon its truth, although he might have ascertained the falsity of the representation had he made an investigation." RESTATEMENT (SECOND) OF TORTS § 540 (1976). Section 541, however, states that "[t]he recipient of a fraudulent misrepresentation is not justified in relying upon its truth if he knows that it is false or its falsity is obvious to him." *Id.* § 541. *See also* RESTATEMENT (SECOND) OF CONTRACTS § 172 (1979) ("A recipient's fault in not knowing or discovering the facts before making the contract does not make his reliance unjustified unless it amounts to a failure to act in good faith and in accordance with reasonable standards of fair dealing.").

<sup>324</sup> *Chris Berg, Inc. v. Acme Mining Co.*, 893 F.2d 1235, 1238 (11th Cir. 1990) (finding that under Florida law, whether plaintiff could have discovered the falsity of a representation is irrelevant to recovery for fraud); *Formento v. Encanto Business Park*, 744 P.2d 22, 27 (Ariz. Ct. App. 1987) (pointing out that in cases of incomplete disclosure and misrepresentation, the buyer is entitled to rely on a representation, and has no duty to make an independent inquiry); *Estate of Jones v. Kvamme*, 430 N.W.2d 188, 193 (Minn. Ct. App. 1988) (explaining that plaintiff is justified in relying upon a false representation, although he could have ascertained the truth; plaintiff was not negligent in taking the defendant at his word); *West v. Carter*, 712 S.W.2d 569, 575 (Tex. Ct. App. 1986) (same); *Husman, Inc. v. Triton Coal Co.*, 809 P.2d 796, 800 (Wyo. 1991) (asserting that it was not unreasonable for a contractor to rely upon the owner's representations and to limit its investigation).

<sup>325</sup> *Harris v. M & S Toyota, Inc.*, 575 So. 2d 74, 78 (Ala. 1991) (stating that "this approach continues the move away from the doctrine of caveat emptor, to the modern perspective that parties to transactions should be able to rely on representations that are not obviously false").

<sup>326</sup> *Sutfin v. Southworth*, 539 A.2d 986, 988 (Vt. 1987) (quotation omitted). *See also*

If a person has been led into a trap, "he owes no duty to the one who did the trapping."<sup>327</sup> Therefore, at least some courts recognize that nondisclosure is sufficiently offensive in some contexts that concepts of investigation, similar to the due diligence obligations in negotiations for purchase of a business, may not be relevant.

Consequently, according to the modern trend, a defendant in a fraud action can no longer defeat a claim for damages by claiming that the plaintiff might have discovered the truth had he exercised reasonable diligence in making an independent inquiry.<sup>328</sup> While the traditional view enforced the concept of caveat emptor, or let the buyer beware, cases following the modern trend impose a new standard: *caveat mendax*, or let the liar beware.<sup>329</sup>

#### 4. The issue of "negation of reliance" through disclaimers or integration clauses

Some courts have held that parties to a contract may exculpate themselves of a fraudulent inducement claim by negating the element of reliance with the insertion, at the time when the contract is reduced to writing, of an unambiguously worded merger and integration clause.<sup>330</sup> These courts have dismissed fraud claims on the basis that such contract language negates the reliance element necessary for a fraud claim.<sup>331</sup> To negate the reliance element,

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*Brass v. American Film Technologies, Inc.*, 987 F.2d 142, 151 (2d Cir. 1993) ("[I]n an increasing number of situations, a buyer is not required to conduct investigations to unearth facts and defects that are present, but not manifest."); *Teamsters Local 282 Pension Trust Fund*, 762 F.2d 522, 528 (7th Cir. 1985) ("Once a duty to disclose exists, and lying or nondisclosure is condemned as an intentional tort, it no longer matters whether the buyer conducts an investigation well or at all."); *Banque Arabe Et Internationale D'Investissement v. Maryland Nat'l Bank*, 819 F. Supp. 1282, 1290 (S.D.N.Y. 1993) (quoting *Brass*, 987 F.2d at 151).

<sup>327</sup> *Parker v. Title and Trust Co.*, 233 F.2d 505, 510 (9th Cir.), *reh'g denied*, 237 F.2d 423 (1956).

<sup>328</sup> *West v. Carter*, 712 S.W.2d 569 (Tex. Ct. App. 1986).

<sup>329</sup> *Harris*, 575 So. 2d at 78.

<sup>330</sup> The typical merger and integration clause provides that, (1) the contract constitutes the entire agreement between the parties and supersedes all prior and contemporaneous agreements, discussions, or negotiations, and (2) there are no other warranties, representations, or agreements, express or implied, except as set forth in the contract.

<sup>331</sup> A number of cases have found that such clauses negate the reliance element of a fraudulent inducement claim. *E.g.*, *Jockvony v. RIHT Fin. Corp.*, 873 F.2d 411, 416-17 (1st Cir. 1989); *One-O-One Enters., Inc. v. Caruso*, 848 F.2d 1283, 1286-87 (D.C. Cir. 1988); *Amplicon, Inc. v. Marshfield Clinic*, 786 F. Supp. 1469, 1475-76 (W.D. Wis. 1992); *Acrotube, Inc. v. J.K. Fin. Group, Inc.*, 653 F. Supp. 470, 475-76 (N.D. Ga. 1987); *Gibson v. Home Folks Mobile Home Plaza*, 533 F. Supp. 1211, 1216 (S.D. Ga. 1982). Sometimes essentially the same result is achieved by inserting a disclaimer in the contract whereby the purchaser agrees that he has performed his own examina-

however, most courts state that the integration or merger clause, or the disclaimer, must be specific, not general.<sup>332</sup>

Other authority, however, provides that a contract may not negate a fraud claim: "Fraud vitiates and avoids all human transactions . . . . [W]hen once shown to exist, it poisons alike the contract of the citizen, the treaty of the diplomat, and the solemn judgment of the court."<sup>333</sup> Accordingly, it has been stated generally that, "[e]ven specific provisions or stipulations in a contract providing in effect for immunity from or nullification or waiver of preliminary or extraneous misrepresentations in connection with the contract are generally ineffective, and do not prevent a subsequent assertion of the misrepresentation as a basis for fraud."<sup>334</sup> It has been held that a party to a contract can exclude liability for innocent misrepresentations, even if made negligently,<sup>335</sup> but that no exemption or integration clause can protect the party from liability for his own fraud or require the other party to assume what he knows to be false.<sup>336</sup>

Recently, the Colorado Supreme Court has gone further by holding that integration and disclaimer clauses in a contract for

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tion and relies solely on his own judgment in addition to noting that there are no other agreements, understandings or representations made by the seller. *Pommer v. Medtest Corp.*, 961 F.2d 620, 625 (7th Cir. 1992) (stating that "an express disclaimer of reliance on oral representations . . . protects a seller [from a fraud claim]"); *Landale Enters., Inc. v. Berry*, 676 F.2d 506, 508 (11th Cir. 1982); *Agristor Leasing-II v. Pangburn*, 557 N.Y.S.2d 183, 184-85 (N.Y. App. Div. 1990). The reasoning is that the effect of integration or disclaimer clauses is not to exculpate one of fraud, but rather to negate the reliance element of a fraud claim (and the result is said to be that, obviously, without reliance, there is no fraud).

<sup>332</sup> *E.g.*, *Rosenberg v. Pillsbury Co.*, 718 F. Supp. 1146, 1153 (S.D.N.Y. 1989); *Carlock v. Pillsbury Co.*, 719 F. Supp. 791, 829 (D. Minn. 1989) (asserting that a party cannot reasonably rely on allegedly fraudulent promises that are directly contradicted by a disclaimer clause); *Agristor Leasing-II*, 557 N.Y.S.2d at 184-85. Some courts have also stated that "as is" clauses will not insulate one from fraud. *Lee v. Goldstrom*, 522 N.Y.S.2d 917, 918 (N.Y. App. Div. 1987); *Chopp v. Welbourne & Purdy Agency, Inc.*, 522 N.Y.S.2d 367, 368 (N.Y. App. Div. 1987).

<sup>333</sup> *New York Life Ins. Co. v. Nashville Trust Co.*, 292 S.W.2d 749, 754 (Tenn. 1956) (quotation omitted). *See also* 12 SAMUEL WILLISTON, WILLISTON ON CONTRACTS § 1486 (3d ed. 1970).

<sup>334</sup> 37 AM. JUR. 2d *Fraud and Deceit* § 387 (1968) (footnote omitted). *See also* 17A AM. JUR. 2d *Contracts* § 299 (1991).

<sup>335</sup> *E.g.*, *United States Welding, Inc. v. Burroughs Corp.*, 640 F. Supp. 350, 352-53 (D. Colo. 1985); *Rio Grande Jewelers Supply, Inc. v. Data General Corp.*, 689 P.2d 1269, 1270-71 (N.M. 1982).

<sup>336</sup> *E.g.*, *Banque Arabe Et Internationale D'Investissement v. Maryland Nat'l Bank*, 819 F. Supp. 1282, 1292 (S.D.N.Y. 1992); *United States Welding, Inc.*, 640 F. Supp. at 354; *Sires v. Luke*, 544 F. Supp. 1155, 1165 (S.D. Ga. 1982); *L. Luria & Son, Inc. v. Honeywell, Inc.*, 460 So. 2d 521, 523 (Fla. Dist. Ct. App. 1984); *Bryant v. Troutman*, 287 S.W.2d 918, 921 (Ky. Ct. App. 1956); 6A CORBIN, *supra* note 34, at § 1516.

the sale of silos, which clauses provided that there were no agreements or oral statements other than those set forth in the parties' contract and that any advertisements, brochures, or other statements not in the agreement were not guarantees and had not been relied upon, do not waive a claim for negligent misrepresentation.<sup>337</sup> The court explained that there was a "policy of encouraging honesty and candor in contract negotiations" and that this policy was "reflected in the recognition of an *implied covenant of good faith and fair dealing*."<sup>338</sup> Indeed, the court concluded that "[t]he implied covenant of good faith and fair dealing would be virtually eliminated if a contracting party could escape liability for negligent conduct simply by inserting a general integration clause into the agreement."<sup>339</sup> Obviously, if the court's reasoning applied to negligent misrepresentations, it is at least as applicable to fraudulent misrepresentations. The case may be limited in its application, however, because the case involved an adhesion contract<sup>340</sup> and/or because the court stated that its rule applied only to general integration clauses.<sup>341</sup> In any event, the case is significant insofar as the court indicated that the implied covenant of good faith and fair dealing applied to contract negotiations and because the court additionally encouraged honesty and candor in such negotiations.

Although the cases appear to be split on the issue of negating reliance, they may be reconciled, at least to some extent. On the one hand, the courts do not permit fraud or allow a dissembler to exculpate fraudulent conduct by a general or craftily worded integration or disclaimer clause. On the other hand, courts allow sophisticated parties to agree that as to specific matters they may rely on their own investigation of facts and not upon any representa-

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<sup>337</sup> *Keller v. A.O. Smith Harvestore Prods., Inc.*, 819 P.2d 69, 72-73 (Colo. 1991).

<sup>338</sup> *Id.* at 73 (emphasis added).

<sup>339</sup> *Id.*

<sup>340</sup> The result in *Keller* has been supported based on the argument that the case involved an adhesion contract. CORBIN, *supra* note 34, § 580(a)(19). The disclaimers in the agreement for the silos were not negotiated. The contract was pre-printed and presented on a "take-it-or-leave-it" basis. Thus, *Keller* may stand only for the proposition that boilerplate disclaimers will not be upheld.

<sup>341</sup> The *Keller* court stated that a "general integration clause" does not waive a negligent misrepresentation claim and that a contract purporting to prohibit a party from asserting such a claim must be "couched in clear and specific language." *Keller*, 819 P.2d at 73, 74. A dissenting opinion argued that the majority decision was "antithetical to the principles of freedom of contract." *Id.* at 75 (Rovira, C.J., dissenting). In addition, the dissent believed that the contract was not ambiguous and that the contract did not have to disclaim negligent misrepresentation claims specifically. *Id.* at 76 (Rovira, C.J., dissenting).

tion or information from any other party. These two positions are not necessarily contradictory. If the disclaimers are set forth with particularity, and the information that is not divulged is reasonably accessible to the other party, then the disclaimer probably should be upheld. In such a case, the duty of good faith would not be breached. But an omission that cannot be discovered by a reasonable investigation should not be rendered inactionable by a disclaimer or integration clause. The insertion of a disclaimer or integration clause under such circumstances is meant to prevent, and does prevent, the discovery of the facts rather than shifting the burden to discover such information. When a disclaimer clause shifts the burden to discover information to a particular party or stipulates that the party is relying only upon his own investigation of the facts, it is implied that the facts are discoverable. If the facts are not available, however, then the party who knows of the facts, and who knows that the facts in all probability will not be discovered, should not be permitted, as a matter of contract interpretation as well as of public policy, to hide behind disclaimer and integration clauses.

*E. The Duty of Good Faith Requires Disclosures*

A duty to disclose arises only if contemporary notions of good faith and fair dealing require disclosures. While most of the cases applying the good faith duty to disclose do so in the context of the generally recognized exceptions to the right to remain silent, the rationale is in place for courts to expand upon disclosure requirements. The Restatements of Contracts and Torts have also recognized the applicability of notions of good faith to determine when disclosure should be made, and they have also recognized that the right to remain silent will change as business ethics change.

There is substantial authority stating that the reason why disclosures are mandated in the negotiation of a contract is that notions of good faith and fair dealing require such disclosures. Just what our understanding of good faith and fair dealing will require to be disclosed is in flux, but there is now considerable authority that the yardstick by which omissions are deemed to be actionable is "good faith."

1. The Common Law

Seventy-one years after the United States Supreme Court's decision in *Laidlaw v. Organ*, the Supreme Court took the first step towards recognizing that notions of good faith should be used to

measure what must be disclosed during contract negotiations. In *Stewart v. The Wyoming Cattle Ranch Co.*, a British corporation purchased a cattle ranch in the Wyoming territory after its agent had visited the ranch and received false information from the owner about the size of the cattle herd on the ranch.<sup>342</sup> The owner of the ranch also prevented plaintiff's agent from discovering the truth about the cattle herd by discouraging the agent from making inquiries to the foreman and other persons on the ranch.<sup>343</sup> In upholding a jury verdict for plaintiff and the trial court's jury instructions, the Supreme Court acknowledged the rule in *Laidlaw* and noted that silence as to a material fact was not necessarily "equivalent to a false representation."<sup>344</sup> On the other hand, the Court distinguished silence from concealment, and asserted that

a suppression of the truth may amount to a suggestion of falsehood; and if, with intent to deceive, either party to a contract or sale conceals or suppresses a material fact, *which he is in good faith bound to disclose*, this is evidence of and equivalent to a false representation . . . .<sup>345</sup>

Two years after *Stewart*, in *Farrar v. Churchill*, the Supreme Court repeated the rule that one was guilty of fraud if he suppressed or concealed information he was "in good faith bound to disclose."<sup>346</sup> *Farrar* involved the sale of a plantation. Complainant claimed that the seller's agents misrepresented the acreage that could be cultivated and certain other aspects of the plantation, which the complainant relied on to his detriment in purchasing the property. The Court rejected complainant's claims because the evidence was not sufficient to prove fraud and because complainant had the opportunity to, and did independently, investigate the facts. The Court stated that "[i]f the purchaser investigates for himself and nothing is done to prevent his investigation from being as full as he chooses, he cannot say that he relied on the vendor's representations."<sup>347</sup>

Shortly after the *Farrar* decision, the Supreme Court again sug-

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<sup>342</sup> 128 U.S. 383, 383-84 (1888).

<sup>343</sup> *Id.* at 384.

<sup>344</sup> *Id.* at 388.

<sup>345</sup> *Id.* (emphasis added).

<sup>346</sup> 135 U.S. 609, 616-17 (1890) (quoting *Stewart*, 128 U.S. at 388).

<sup>347</sup> *Id.* In addition, the Court noted that

where the facts lie equally open to both vendor and vendee, with equal opportunities of examination, and the vendee undertakes to examine for himself, without relying on the statements of the vendor, it is no evidence of fraud in such case that the vendor knows facts not known to the vendee and conceals them from him.

*Id.*

gested that notions of good faith were relevant in determining when an omission would be actionable. In *Tyler v. Savage*, plaintiff purchased stock in a company to secure employment for her son at the firm based, in part, upon the company president's false and misleading representations about the company's prospects, profitability and payment of dividends.<sup>348</sup> In affirming a decree for plaintiff, the Supreme Court noted that plaintiff had been informed in April 1884, before her stock purchase, that the last dividend of the company had been "a 7 percent semi-annual," and that the fiscal year ended on June 1.<sup>349</sup> The Court believed that this representation was meant to make plaintiff think the last dividend was declared one year earlier, in June 1883, but in fact the last dividend was actually declared in June 1882.<sup>350</sup> The Supreme Court stated that "[t]his suppression of a material fact, which Tyler [the defendant] was *bound in good faith to disclose*, was equivalent to a false representation."<sup>351</sup>

In 1889, the Supreme Court of Alabama also referred to "good faith" to measure whether omissions to state material facts were actionable.<sup>352</sup> In *Griel*, plaintiff, the assignee of an interest to purchase land, sued the assignors for fraud, in part, because plaintiff claimed that the assignors had failed to inform plaintiff that the assignors' contract to purchase the land with the owner was verbal. The court set forth the applicable rule of law: "[t]he principle may be generalized, in other words, by saying that to constitute fraud, in cases of mere silence, there must be the suppression of some material fact which *honesty and good faith* require to be disclosed, under the facts of a particular case."<sup>353</sup> The court stated that in determining whether there was a disclosure duty a number of factors should be considered including, "the fiduciary or other relation of the parties; the nature of the contract; the degree of trust reposed, whether expressly or impliedly; the value or nature of the particular fact; the relative knowledge of the contracting parties; and other circumstances of the case."<sup>354</sup>

In 1893, in *Loewer v. Harris*, the United States Court of Appeals for the Second Circuit also referred to "good faith" as the standard by

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<sup>348</sup> 143 U.S. 82, 83-85 (1892).

<sup>349</sup> *Id.* at 90.

<sup>350</sup> *Id.*

<sup>351</sup> *Id.* (emphasis added) (citing *Stewart v. The Wyoming Cattle Ranch Co.*, 128 U.S. 383, 388 (1888)).

<sup>352</sup> *Griel v. Lomay*, 6 So. 741, 744 (Ala. 1889).

<sup>353</sup> *Id.* (emphasis added).

<sup>354</sup> *Id.*



which to measure disclosure requirements.<sup>355</sup> In *Loewer*, plaintiff, on behalf of a London syndicate, entered into negotiations with defendant to purchase defendant's brewery.<sup>356</sup> In January 1891, defendant gave plaintiff a six-month old prospectus setting forth the brewery's profitability and growth.<sup>357</sup> When plaintiff asked defendant if the brewery was still doing well, plaintiff said the prospectus was accurate and that the company's business was increasing.<sup>358</sup> In April 1891, a purchase and sale contract was signed by the parties.<sup>359</sup> Shortly thereafter, plaintiff learned that the output and profits of the brewery had declined sharply after January 1891 and before the contract was signed.<sup>360</sup> Defendant failed to inform plaintiffs about the downturn in business and argued that there was no duty to inform plaintiff of subsequent facts correcting defendant's initial representations.<sup>361</sup> In affirming a decision for plaintiff, the court acknowledged that there was no duty of disclosure simply because the undisclosed fact was material, or because the party to whom the fact is known knows the other party is ignorant of it.<sup>362</sup> But, the court went on to conclude that:

[W]hen one of the parties, pending negotiations for a contract, has held out to the other the existence of a certain state of facts, material to the subject of the contract, and knows that the other is acting upon the inducement of their existence, and, while they are pending, knows that a change has occurred, of which the other party is ignorant, *good faith and common honesty* require him to correct the misapprehension which he has created. It becomes his duty to make disclosure of the changed state of facts, because he has put the other party off his guard.<sup>363</sup>

The foregoing cases demonstrate that the general guiding principle for determining when disclosures should be made was first articulated within the short span of five years from 1888 to 1893.<sup>364</sup> A duty to speak arises whenever notions of good faith dictate a disclosure. Of

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<sup>355</sup> 57 F. 368, 373 (2d Cir. 1893).

<sup>356</sup> *Id.* at 370.

<sup>357</sup> *Id.*

<sup>358</sup> *Id.*

<sup>359</sup> *Id.*

<sup>360</sup> *Id.*

<sup>361</sup> *Id.* at 371.

<sup>362</sup> *Id.* at 373.

<sup>363</sup> *Id.* (citing SIR FREDERICK POLLOCK, PRINCIPLES OF CONTRACTS: A TREATISE ON THE GENERAL PRINCIPLES CONCERNING THE VALIDITY OF AGREEMENTS IN THE LAW OF ENGLAND 491). See also *Beers v. Hamburg - American Packet Co.*, 62 F. 469, 472 (S.D.N.Y. 1894) (asserting that if one chooses to answer inquiries, he "is bound to answer in good faith, and without deceit, if he answers at all").

<sup>364</sup> Other cases have also applied this same law. *E.g.*, *Gottschalk v. Kircher*, 17 S.W. 905, 909 (Mo. 1891); *Parry v. Parry*, 48 N.W. 654, 657 (Wis. 1891).

course, the early cases reflect the ethics of their day and the strong influence of caveat emptor that was then prevalent. Thus, it is not surprising that the initial cases found that good faith required disclosures only when there was an affirmative misrepresentation and active concealment (*Stewart*), an affirmative misrepresentation and a half-truth or partial disclosure (*Tyler*), and a representation that later turned out to be false (*Loewer*), while at the same time denying relief where the facts were open and susceptible to discovery by the complainant in an investigation he undertook (*Farrar*). Nevertheless, the stage was set so that increased disclosures would be required as our business ethics changed and the mandates of good faith evolved.

For almost twenty years after *Loewer*, little development of the duty of good faith and fair dealing as applied to disclosures in contract negotiations occurred, although another Supreme Court decision, as well as cases in Georgia, Kentucky, Maine and Texas, recognized that "good faith" determined whether there was a duty to speak.<sup>365</sup> In 1913, the Supreme Courts of Iowa and Oklahoma had occasion to address the issue. Although those courts did not expand upon the disclosures required by good faith, it is significant that both courts recognized that the dictates of good faith determined the duty to speak.

In *Boileau v. Records & Breen*, the Supreme Court of Iowa explained that: "Under certain circumstances concealment of a material fact which the party is *bound in good faith* to disclose will amount to a misrepresentation, if it was an inducing cause in the transaction."<sup>366</sup> The court also noted, however, that mere silence as to a material fact was not as a matter of law "equivalent to a false representation," and the court asserted that if a "purchaser has equal and available means of information, he must make use of them, and in failing to do so he cannot recover on the grounds that he was misled."<sup>367</sup> In accord with this reasoning, the court held that defendant was not liable for failing to inform plaintiff that a tax deed defendant had sold to plaintiff was subject to attack. The court added that the original owner of

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<sup>365</sup> *Strong v. Repide*, 213 U.S. 419, 430-31 (1909) (in a case originating in the Philippines, the Court indicated that a duty to disclose arose when required by "good faith"); *In re J. S. Patterson & Co.*, 125 F. 562, 566 (N.D. Tex. 1903) (quoting *Stewart v. The Wyoming Cattle Ranch Co.*, 128 U.S. 383, 388 (1888)); *Oliver v. Oliver*, 45 S.E. 232, 235 (Ga. 1903) (quoting *Stewart*, 128 U.S. at 388); *Hays v. Meyers*, 107 S.W. 287, 289 (Ky. 1908) (quoting *Stewart*, 128 U.S. at 388); *Barrett v. Lewiston, B. & B. St. Ry.*, 85 A. 306, 308 (Me. 1912) ("If, with intent to deceive, one party to a contract conceals or suppresses from the other a material fact, which he is in good faith bound to disclose, it is tantamount to a false representation.").

<sup>366</sup> *Boileau v. Records & Breen*, 144 N.W. 336, 338 (Iowa 1913) (emphasis added).

<sup>367</sup> *Id.* (citation omitted).

the property had a possible defense, based on his mental incompetence, to the forced sale of his property to pay taxes. The court did not believe that defendant, in good faith, had to reveal information about possible defenses because plaintiff had already been put on notice of possible defenses or could on his own have ascertained the true facts by reviewing court records.

The same law was applied by the Oklahoma Supreme Court in *Miller v. Wissert*, but a different result was reached.<sup>368</sup> In *Miller*, defendant sold real estate to plaintiff after representing that it was a 160 acre parcel when, in fact, it was only 148.94 acres. After plaintiff purchased the property, defendant gave plaintiff a patent showing that the property consisted of only 148.94 acres. Defendant had withheld the patent from both plaintiff and plaintiff's real estate agent prior to consummation of the sale, even though plaintiff had asked for it. Based on those facts, the court asserted that defendant had intentionally fostered the impression that he was selling 160 acres and held:

The rule is that if, with intent to deceive, either party to a contract of sale conceals or suppresses a material fact *which he is in good faith bound to disclose*, this is evidence of and equivalent to a false representation, because the concealment or suppression is in effect a representation that what is disclosed is the whole truth.<sup>369</sup>

As in *Boileau*, the court also stated that to be actionable, the facts concealed must not be "equally within the knowledge or reach of the plaintiff."<sup>370</sup> That a survey of the property or a review of the plats in the public record would have revealed the true facts to plaintiff did not prevent plaintiff's recovery in the case.

*Stewart, Farrar, Tyler, Griel* and/or *Loewer* were followed by a number of cases in the 1920s, 1930s and 1940s in federal court<sup>371</sup> and in Alabama,<sup>372</sup> California,<sup>373</sup> Connecticut,<sup>374</sup> the District of Colum-

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<sup>368</sup> 134 P. 62 (Okla. 1913).

<sup>369</sup> *Id.* at 63-64 (emphasis added).

<sup>370</sup> *Id.* at 64.

<sup>371</sup> *General Reinsurance Corp. v. Southern Sur. Co.*, 27 F.2d 265, 272 (8th Cir. 1928) (finding that in a reinsurance contract the insured must disclose all facts relating to the risk; "the pivotal test is good faith").

<sup>372</sup> *Lovell v. Smith*, 169 So. 280, 284-85 (Ala. 1936); *Southern Land Dev. Co. v. Meyer*, 159 So. 245, 246 (Ala. 1935); *American-Traders' Nat'l Bank v. Henderson*, 133 So. 36, 38 (Ala. 1931). In *Lovell*, the court stated that "in cases of mere silence, there must be the suppression of some material fact which honesty and good faith require to be disclosed, under the facts of the particular case." *Lovell*, 169 So. at 285. In *Meyer*, plaintiff sued defendant for rescission of a contract to purchase real estate alleging that the defendant had misrepresented the location of the property. The court stated that the suppression of a material fact may be actionable if, with intent to

bia,<sup>375</sup> Illinois,<sup>376</sup> Kentucky,<sup>377</sup> Michigan,<sup>378</sup> Minnesota,<sup>379</sup> Nebraska<sup>380</sup> and New York.<sup>381</sup> Thereafter, the general recognition that standards

deceive, the "party to the contract conceals or suppresses a material fact which good faith requires to be declared or disclosed." 159 So. at 246 (citations omitted). *Henderson* set forth essentially the same law citing, among other authority, *Farrar v. Churchill*, 135 U.S. 609 (1890). *Henderson*, 133 So. at 38.

<sup>373</sup> *Kershaw v. Julien*, 72 F.2d 528 (10th Cir. 1934) (applying California law). In this case, which involved plaintiff's purchase of a mortgage from a bank, the court quoted the disclosure requirements set forth in *Tyler v. Savage*, 143 U.S. 79 (1892). *Kershaw*, 72 F.2d at 530-31. The court found that there was a confidential relationship between the parties because plaintiff had been a long time customer of defendant bank, had purchased numerous mortgages from defendant bank over many years, and as a longtime customer of the bank had relied upon the bank's representations to her. *Id.* at 530.

<sup>374</sup> *Siro v. American Express Co.*, 121 A. 280, 282 (Conn. 1923) (citation omitted) ("The suppression of a fact is not a false representation in all circumstances. . . . The fact suppressed must be one which is material to the contract of sale and which the person suppressing was bound in good faith to disclose.").

<sup>375</sup> *Metropolitan Life Ins. Co. v. Adams*, 37 A.2d 345, 350 (D.C. 1944) ("A suppression of the truth may amount to a suggestion of falsehood, and if, with intent to deceive, either party to a contract conceals or suppresses a material fact, which he is in good faith bound to disclose, this is evidence of and equivalent to a false representation.").

<sup>376</sup> *Forest Preserve Dist. of Cook County v. Christopher*, 52 N.E.2d 313, 319 (Ill. App. Ct. 1943) (quoting *Stewart v. Wyoming Cattle Rancho Co.*, 128 U.S. 383, 388 (1890)).

<sup>377</sup> *New York Life Ins. Co. v. Gay*, 36 F.2d 634 (6th Cir. 1929) (applying Kentucky law). In *Gay* the court found that an insured had a duty to disclose material facts discovered after he filed his application of insurance, but before the policy was issued, which materially increased the risk of the insurance company. *Id.* at 638. The court stated that: "It is well-settled that suppression of a material fact which a party is bound in good faith to disclose is equivalent to a false representation." *Id.* (citing *Tyler v. Savage*, 143 U.S. 79 (1892)).

<sup>378</sup> *Wolfe v. A.E. Kusterer & Co.*, 257 N.W. 729, 730 (Mich. 1934) (quoting *Stewart v. The Wyoming Cattle Rancho Co.*, 128 U.S. 383, 388 (1888)).

<sup>379</sup> *Shepard v. City Co. of New York*, 24 F. Supp. 682, 686 (D. Minn. 1938) (applying Minnesota law). In *Shepard*, defendant sold shares of stock in a Minnesota corporation to plaintiff without divulging to plaintiff that the stock was not registered as required by Minnesota law. The court found that this was fraudulent. *Id.* The court stated that: "The suppression of a material fact which one is bound in good faith to disclose may be equivalent to a false representation." *Id.* (citing *Tyler v. Savage*, 143 U.S. 79 (1892)).

<sup>380</sup> *Pearlman v. Snitzer*, 198 N.W. 879, 880 (Neb. 1924) (quoting *Stewart*, 128 U.S. at 388); *Linton v. Sheldon*, 154 N.W. 724, 725-26 (Neb. 1915) (quoting *Stewart*, 128 U.S. at 388).

<sup>381</sup> *Schroeder v. Schroeder*, 56 N.Y.S.2d 36 (N.Y. App. Div. 1945) (citing *Loewer v. Harris*, 57 F. 368, 373 (2d Cir. 1893)); *Noved Realty Corp. v. A. A. P. Corp.*, 293 N.Y.S. 336 (N.Y. App. Div. 1937) (quoting *Stewart* 128 U.S. at 388); *Boston & M. R. R. v. Delaware & Hudson Co.*, 264 N.Y.S. 470, 476 (N.Y. App. Div. 1933) (noting that "[i]t is often difficult to distinguish between facts which a party is bound in good faith to disclose and facts which he is under no obligation to present"). In *Schroeder*, the court ruled that

when one of the parties, pending negotiations for contract, has held out to the other the existence of a certain set of facts material to the subject

of good faith, fair dealing, common decency, equity, or good conscience should determine the propriety of precontractual disclosures gained increased acceptance. Interestingly, this trend followed the general development of the implied duty of good faith in contract performance, which began to blossom in the 1950s and gained widespread acceptance in the late 1960s, 1970s and 1980s. The duty of good faith disclosures, or its essential equivalent,<sup>382</sup> was recognized by at least five cases in the 1950s in five jurisdictions (California, Nebraska, Nevada, New York and Wyoming);<sup>383</sup> by at least six cases in the 1960s in five jurisdictions (Colorado, Idaho, Michigan, New York and Washington);<sup>384</sup> by at least fifteen cases in the 1970s and 1980s in thir-

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matter of the contract, and knows that the other party is acting upon the inducement of their existence, and while they are pending knows that a change has occurred of which the other party is ignorant, good faith and common honesty require him to correct the misapprehension which he has created.

56 N.Y.S. 2d at 38 (citing *Loewer*, 57 F. at 373). In *Noved Realty Corp.*, the court ruled that

if, with intent to deceive either party to a contract of sale conceals or suppresses a material fact, which he is in good faith bound to disclose, this is evidence of and equivalent to a false representation, because the concealment or suppression is in effect a representation that what is disclosed is the whole truth.

293 N.Y.S. at 341 (quoting *Stewart*, 128 U.S. at 388).

<sup>382</sup> Some courts have used such language as "good conscience," "equity," or "common decency."

<sup>383</sup> *Cohen v. Citizens Nat'l Trust & Sav. Bank*, 300 P.2d 14, 16 (Cal. App. 1956) (citation omitted) ("Full disclosure of all material facts must be made whenever fair conduct demands it."); *Darque v. Chaput*, 88 N.W.2d 148, 155 (Neb. 1958) (quoting *Stewart*, 128 U.S. at 388); *Villalon v. Bowen*, 273 P.2d 409, 414 (Nev. 1954) (citing 37 C.J.S. *Fraud* § 16a (1943)) ("The suppression of a material fact which a party is bound in good faith to disclose is equivalent to a false representation, since it constitutes an indirect representation that such fact does not exist."); *Schlenoff v. Kroll*, 141 N.Y.S.2d 370, 373-74 (Mun. Ct. N.Y. 1955) (quotations omitted) (suggesting that a defendant would be guilty of fraud if he concealed or suppressed material facts that had to be disclosed in good faith); *Steadman v. Topham*, 338 P.2d 820, 826-27 (Wyo. 1959) (the court suggested that there is a disclosure requirement when "common decency and ordinary honesty" require it).

<sup>384</sup> *Nicholas v. McGlothlin*, 330 F.2d 455, 457 (10th Cir. 1964) (applying Colorado law, the court ruled that in business transactions involving the purchase and sale of stock the seller of the stock must not conceal "material facts which equity and good conscience required him to disclose fully and honestly"); *Fischer v. Kletz*, 266 F. Supp. 180, 184-86 (S.D.N.Y. 1967) (recognizing that the law of deceit for a non-disclosure was in a state of flux because of inroads being made into the doctrine of caveat emptor, the court also acknowledged that a duty to correct prior statements was required in "good faith and common honesty" and that "the elements of 'good faith and common honesty' which governs the businessman presumably should apply" to independent accountants with regard to their disclosure duties); *Janinda v. Lamming*, 390 P.2d 826, 830 (Idaho 1964) (citing and quoting *W. Page Keeton, Fraud-Concealment and Non-Disclosure*, 15 TEX. L. REV. 1, 31 (1937)) (stating that there is a duty to speak whenever justice, equity and fair dealing demand it); *Bethlamy v. Bechtel*, 415

teen jurisdictions (Alabama, Colorado, Florida, Illinois, Kansas, New Hampshire, New Jersey, New York, North Dakota, Ohio, Pennsylvania, Washington and Wisconsin);<sup>385</sup> and by at least five cases so far in the

P.2d 698, 706 (Idaho 1966) (same); *Nowicki v. Podgorski*, 101 N.W.2d 371, 378 (Mich. 1960) (citation omitted) ("It is also true that one who remains silent when fair dealing requires him to speak may be guilty of fraudulent concealment."); *Obde v. Schlemeyer*, 353 P.2d 672, 675 (Wash. 1960) (citing and quoting *W. Page Keeton, Fraud-Concealment and Non-Disclosure*, 15 TEX. L. REV. 1, 31 (1937)) (ruling that there was a duty of disclosure whenever justice, equity, and fair dealing demanded it).

<sup>385</sup> *Huntsville Dodge, Inc. v. Furnas*, 361 So. 2d 585, 588 (Ala. Civ. App. 1978) ("Where, with intent to deceive, a party to a contract conceals material facts which good faith requires him to declare or disclose, it is the equivalent of a false misrepresentation and fraudulent concealment."); *Schnell v. Gustafson*, 638 P.2d 850, 852 (Colo. Ct. App. 1981) (citation omitted) ("A false representation may be the failure to disclose a material fact which in good conscience should have been disclosed."); *Johnson v. Davis*, 480 So. 2d 625, 628 (Fla. 1985) ("The law appears to be working toward the ultimate conclusion that full disclosure of all material facts must be made whenever elementary fair conduct demands it."); *Gatto v. Walgreen Drug Co.*, 337 N.E.2d 23, 28-29 (Ill. 1975) (quoting *Stewart v. The Wyoming Cattle Rancho Co.*, 128 U.S. 383, 388 (1888)); *Tetuan v. A.H. Robins Co.*, 738 P.2d 1210, 1229 (Kan. 1987) (citation omitted) ("Fraud may arise by the concealment of facts which legally or equitably should be revealed . . ."); *Moore v. State Bank of Burden*, 729 P.2d 1205, 1212 (Kan. 1986) (citations omitted) ("A suppression or concealment of the truth is not at all times such fraud or deceit as will be relieved against . . . . There must be a concealment of facts which a party is under a legal or equitable duty to communicate and in respect of which he could not be innocently silent."); *Burse v. Clement*, 387 A.2d 346, 348 (N.H. 1978) (citations omitted) (ruling that every agreement contains an implied covenant that each of the parties will act in good faith and fair dealing with the other and that this covenant required that a party engaged in negotiations of a contract correct any prior statement he has made when it appears later to be erroneous or false); *Weintraub v. Krobatsch*, 64 N.J. 445, 449, 455-56, 317 A.2d 68, 71, 74-75 (1974) (quotation omitted) (finding that silence is fraudulent where a contracting party suppresses facts that he "under the circumstances, is found in conscience and duty to disclose to the other party" and the court indicated that "modern concepts of justice and fair dealing" are the applicable judicial standards); *Grossman Furniture Co. v. Pierre*, 119 N.J. Super. 411, 420, 291 A.2d 858, 863 (Essex County Ct. 1972) (asserting that a party to a contract must disclose facts that "fair dealing would dictate" be disclosed); *Minpeco, S.A. v. Conticommodity Services, Inc.*, 552 F. Supp. 332, 338 (S.D.N.Y. 1982) (quoting *WILLIAM L. PROSSER, HANDBOOK OF THE LAW OF TORTS* § 106, at 698 (4th ed. 1971)) (stating that the "law appears to be working toward the ultimate conclusion that full disclosure of all material facts must be made whenever elementary fair conduct demands it"); *Diemert v. Johnson*, 299 N.W.2d 546, 549 (N.D. 1980) ("The suppression of a material fact, which a party is bound in good faith to disclose, is equivalent to a false representation."); *Mitchell v. Slocum*, 455 N.E.2d 20, 22 (Ohio Mun. Ct. 1981) (citation omitted) ("The suppression of a material fact which a party is bound in good faith to disclose is equivalent to a false representation."); *Quashnock v. Frost*, 445 A.2d 121, 125 & n.3 (Pa. Super. Ct. 1982) (quoting *WILLIAM L. PROSSER, HANDBOOK ON THE LAW OF TORTS*, § 106, at 697-98 (4th ed. 1971)) (recognizing that disclosures had to be made "when elementary fair conduct demands it" and indicated that this required that the seller of a home disclose serious dangerous and latent defects known to exist by the seller). Judge Spaeth, writing a concurrence in *Quashnock*, stated that even if a party was not guilty of fraudulent concealment they may have engaged in bad faith. *Quashnock*, 445 A.2d at 131

1990s in four jurisdictions (Colorado, Louisiana, New York and Wisconsin).<sup>386</sup> Thus, the duty of good faith disclosure in contract formation has been recognized in federal courts, the District of Columbia and in at least twenty-eight states.<sup>387</sup>

The preceding cases have involved a wide range of transactions, including transactions pertaining to the sale of commercial real estate,<sup>388</sup> residences,<sup>389</sup> businesses,<sup>390</sup> stock or bonds,<sup>391</sup> mortgages,<sup>392</sup>

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(Spaeth, J., concurring). The judge also indicated that disclosures should be made when good faith and fair dealing required such disclosures and that disclosure of known termite infestation was not too much to demand of a seller. *Id.* Bazan v. Dept. of Social and Health Servs., 616 P.2d 413, 416 (Wash. Ct. App. 1980) (citation omitted) ("Fraud may also be the willful concealment of a material fact that one is bound to disclose in good faith."); Ollerman v. O'Rourke Co., 288 N.W.2d 95, 102-03 (Wis. 1980) (quoting W. Page Keeton, *Fraud-Concealment and Nondisclosure*, 15 TEX. L. REV. 1, 31 (1936)) (recognizing that attitudes towards good faith and fair dealing in business transactions have changed).

<sup>386</sup> *Heineman v. S&S Mach. Corp.*, 750 F. Supp. 1179, 1186 (E.D.N.Y. 1990) (asserting that "[t]he law appears to be working toward the ultimate conclusion that full disclosure of all material facts must be made whenever elementary fair conduct demands it.") (quoting WILLIAM L. PROSSER, *HANDBOOK OF THE LAW OF TORTS* § 106, at 698 (4th ed. 1971)). See *Feit v. Donahue*, 826 P.2d 407, 412 (Colo. Ct. App. 1992). In *Feit*, the court declared:

To establish a *prima facie* case of fraudulent concealment, plaintiff must prove that the defendant knowingly concealed a material fact that in equity or good conscience should have been disclosed with the intent the Plaintiff act on that concealed fact and that the Plaintiff did act on the concealment resulting in damage.

*Id.*; see also *Berger v. Sec. Pac. Info. Sys. Inc.*, 795 P.2d 1380, 1383 (Colo. Ct. App. 1990) ("Stated generally, a person has a duty to disclose to another with whom he deals facts that 'in equity and good conscience' should be disclosed.") (quotation omitted); *Bunge Corp. v. GATX Corp.*, 557 So. 2d 1376, 1383 (La. 1990) ("Modern law . . . imposes on parties to a transaction a duty to speak whenever justice, equity, and fair dealing demand it."); *Green Spring Farms v. Spring Green Farm Ass'n Ltd Partnership*, 492 N.W.2d 392, 396-97 (Wis. Ct. App. 1992) (applying a more enlightened rule that rejects strict application of the doctrine of caveat emptor because "business ethics have changed and moved toward more stringent requirements of fair dealing").

<sup>387</sup> These states are: Alabama, California, Connecticut, Colorado, Florida, Georgia, Idaho, Illinois, Iowa, Kansas, Kentucky, Louisiana, Maine, Michigan, Minnesota, Nebraska, Nevada, New Hampshire, New Jersey, New York, North Dakota, Ohio, Oklahoma, Pennsylvania, Texas, Washington, Wisconsin and Wyoming.

<sup>388</sup> *Farrar v. Churchill*, 135 U.S. 609 (1890); *Stewart v. The Wyoming Cattle Ranch Co.*, 128 U.S. 383 (1888); *Southern Land Dev. Co. v. Meyer*, 159 So. 245 (Ala. 1935); *Cohen v. Citizens Nat'l. Trust & Sav. Bank*, 300 P.2d 14 (Cal. Dist. Ct. App. 1956); *Janinda v. Lanning*, 390 P.2d 826 (Idaho 1964); *Burse v. Clement*, 387 A.2d 346 (N.H. 1978); *Diemert v. Johnson*, 299 N.W.2d 546 (N.D. 1980); *Mitchell v. Slocum*, 455 N.E.2d 20 (Ohio Mun. Ct. 1981); *Miller v. Wissert*, 134 P. 62 (Okla. 1913); *Obde v. Schlemeyer*, 353 P.2d 672 (Wash. 1960).

<sup>389</sup> *Feit*, 826 P.2d 407; *Schnell v. Gustafson*, 638 P.2d 850 (Colo. Ct. App. 1981); *Johnson v. Davis*, 480 So. 2d 625 (Fla. 1985); *Bethlahmy v. Bechtel*, 415 P.2d 698 (Idaho 1966); *Boileau v. Records & Breen*, 144 N.W. 336 (Iowa 1913); *Darque v.*

personal property<sup>393</sup> and insurance.<sup>394</sup> In addition, the cases have applied the good faith duty of disclosure to set aside the distribution of an estate,<sup>395</sup> to rescind a contract sending children to a summer camp,<sup>396</sup> to loan transactions,<sup>397</sup> to accountants with regard to their audits and studies performed for a publicly traded company,<sup>398</sup> to the interpretation of the Aid to Families With Dependent Children program,<sup>399</sup> to an employment-at-will contract,<sup>400</sup> to the sale of a dairy farm<sup>401</sup> and to a wholesale distribution contract.<sup>402</sup> Thus, it is clear that the standard of good faith and fair dealing to measure the duty to speak is a general duty applicable to all forms of transactions.

There are also a number of cases that have held that the duty of good faith and fair dealing required disclosures after a contract had been entered into.<sup>403</sup> Although one of those cases declared, *in dicta*,

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Chaput, 88 N.W.2d 148 (Neb. 1958); Weintraub v. Krobatsch, 64 N.J. 445, 317 A.2d 68 (1974); Quashnock v. Frost, 445 A.2d 121 (Pa. Sup. Ct. 1982).

<sup>390</sup> Loewer v. Harris, 57 F. 368 (2d Cir. 1893); Heineman v. S&S Mach. Corp., 750 F. Supp. 1179 (S.D.N.Y. 1990); Nowicki v. Podgorski, 101 N.W.2d 371 (Mich. 1960).

<sup>391</sup> Nichoalds v. McGlothlin, 330 F.2d 454 (10th Cir. 1964); Shepard v. City Co. of New York, 24 F. Supp. 682 (D. Minn. 1938); Lovell v. Smith, 169 So. 280 (Ala. 1936); Wolfe v. A.E. Kusterer & Co., 257 N.W. 729 (Mich. 1934).

<sup>392</sup> Kershaw v. Julien, 72 F.2d 528 (10th Cir. 1934); Noved Realty Corp. v. A. A. P. Co., 293 N.Y.S. 336 (N.Y. App. Div. 1937).

<sup>393</sup> Huntsville Dodge, Inc. v. Furnas, 361 So. 2d 585 (Ala. Civ. App. 1978) (sale of a car); Tetuan v. A.H. Robins Co., 738 P.2d 1210 (Kan. 1987) (sale of an intrauterine device known as the "Dalkon Shield"); Grossman Furniture Co. v. Pierre, 119 N.J. Super. 411, 291 A.2d 858 (Essex County Dist. Ct. 1972) (sale of furniture).

<sup>394</sup> New York Life Ins. Co. v. Gay, 36 F.2d 634 (6th Cir. 1929) (suit for proceeds of life insurance policy); General Reinsurance Corp. v. Southern Sur. Co., 27 F.2d 265 (8th Cir. 1928) (reinsurance); Metropolitan Life Ins. Co. v. Adams, 37 A.2d 345 (D.C. 1944) (suit for proceeds of life insurance policy); Schroeder v. Schroeder, 56 N.Y.S.2d 36 (N.Y. App. Div. 1945) (suit involved assignment of certain insurance policies apparently as part of a divorce settlement).

<sup>395</sup> Villalon v. Bowen, 273 P.2d 409 (Nev. 1954).

<sup>396</sup> Schlenoff v. Kroll, 141 N.Y.S.2d 370 (N.Y. Mun. Ct. 1955).

<sup>397</sup> Moore v. State Bank of Burden, 729 P.2d 1205 (Kan. 1986); Steadman v. Topham, 338 P.2d 820 (Wyo. 1959).

<sup>398</sup> Fischer v. Kletz, 266 F. Supp. 180 (S.D.N.Y. 1967).

<sup>399</sup> Bazon v. Dept. of Social and Health Servs., 612 P.2d 413 (Wash. Ct. App. 1980).

<sup>400</sup> Berger v. Sec. Pac. Info. Sys., Inc., 795 P.2d 1380 (Colo. Ct. App. 1990).

<sup>401</sup> Green Spring Farms v. Spring Green Farm Ass'n Ltd. Partnership, 492 N.W.2d 392 (Wis. Ct. App. 1992).

<sup>402</sup> H&H Distribs., Inc. v. BBC Int'l, Inc., 812 P.2d 659 (Colo. Ct. App. 1990).

<sup>403</sup> Market St. Assocs. Ltd. Partnership v. Frey, 941 F.2d 588, 593-98 (7th Cir. 1991) (asserting that the duty of good faith and fair dealing implied in every contract, under certain circumstances, may require disclosure of information during performance of the contract, particularly when the party with superior knowledge can correct at no cost the mistake of the other party); AMPAT/Midwest, Inc. v. Illinois Toolworks, Inc., 896 F.2d 1035, 1040-41 (7th Cir. 1990) (finding that the duty of good faith and fair dealing read into every contract requires the seller of a defective product to reveal the defect and help the buyer avoid the adverse consequences of the defective condition);



that the duty of good faith was not a duty of candor and was minimized in contract negotiations, that case did not address the considerable authority set forth above.<sup>404</sup>

Most cases that utilize the duty of good faith and fair dealing to measure required disclosures have done so in the context of one or more of the generally recognized exceptions to the rule that one may remain silent without incurring liability. Thus, many of the cases involved affirmative misrepresentations or active concealment,<sup>405</sup> a duty to correct prior statements,<sup>406</sup> partial or ambiguous statements,<sup>407</sup> confidential relationships,<sup>408</sup> superior knowledge or the "special facts" doctrine,<sup>409</sup> or insurance.<sup>410</sup> In addition, at least two of the cases concerned real estate transactions involving a latent dangerous defect (termite infestation), which some jurisdictions have long held to be another exception to the general rule of non-disclosure.<sup>411</sup> Some of the cases that have applied good faith as the standard to measure dis-

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Walker v. KFC Corp., 515 F. Supp. 612, 621-22 (S.D. Cal. 1981) (ruling, in a franchise contract case involving a fast food restaurant, that the duty of good faith and fair dealing implied in all contracts required the franchisor to disclose certain material facts during the performance of the contract), *rev'd*, 728 F.2d 1215, 1222 (9th Cir. 1984) (the appellate court reversed the concealment instructions of the district court because they imposed on every party to a contract a duty to disclose all material facts even if known or reasonably accessible to the other party, which the court explained was not consistent with the California law applicable to the case).

<sup>404</sup> *Market St. Assoc. Ltd. Partnership*, 941 F.2d at 594-95.

<sup>405</sup> *New York Life Ins. Co. v. Gay*, 36 F.2d 634, 634-35 (6th Cir. 1929); *Diemert v. Johnson*, 299 N.W.2d 546, 547 (N.D. 1980); *Obde v. Schlemeyer*, 353 P.2d 672, 675 (Wash. 1960).

<sup>406</sup> *Bursey v. Clement*, 387 A.2d 346, 348 (N.H. 1978); *Fischer v. Kletz*, 266 F. Supp. 180, 188 (S.D.N.Y. 1967); *Schroeder v. Schroeder*, 56 N.Y.S.2d 36, 38 (N.Y. App. Div. 1945); *Bazan v. Dept. of Social and Health Servs.*, 612 P.2d 413, 419 (Wash. Ct. App. 1980).

<sup>407</sup> *Feit v. Donahue*, 826 P.2d 407, 412 (Colo. Ct. App. 1992); *Berger v. Sec. Pac. Info. Sys., Inc.*, 795 P.2d 1380 (Colo. App. Ct. 1990); *Janinda v. Lanning*, 390 P.2d 826, 830 (Idaho 1964); *Noved Realty Corp. v. A. A. P. Co.*, 293 N.Y.S. 336, 341 (N.Y. App. Div. 1937).

<sup>408</sup> *Kershaw v. Julien*, 72 F.2d 528, 530 (10th Cir. 1934); *Schlenoff v. Kroll*, 141 N.Y.S.2d 370, 374 (N.Y. Mun. Ct. 1955).

<sup>409</sup> *Minpeco, S.A. v. Conticommodity Services, Inc.*, 552 F. Supp. 332, 336 (S.D.N.Y. 1982); *Cohen v. Citizens Nat'l Trust & Sav. Bank*, 300 P.2d 14, 16 (Cal. App. 1956); *Villalon v. Bowen*, 273 P.2d 409, 414-15 (Nev. 1954); *Green Springs Farm v. Spring Green Farm Ass'n Ltd. Partnership*, 492 N.W.2d 392 (Wis. Ct. App. 1992).

<sup>410</sup> *New York Life Ins. Co. v. Gay*, 36 F.2d 634, 638 (6th Cir. 1929).

<sup>411</sup> *Quaashnock v. Frost*, 445 A.2d 121, 125 (Pa. Sup. Ct. 1982) (ruling that seller of real estate must disclose to purchaser serious and dangerous context defects such as termite infestation); *Obde v. Schlemeyer*, 353 P.2d 672, 675 (Wash. 1960). Another case that may fall within this category is *Tetuan v. A.H. Robins Co.*, 738 P.2d 1210, 1228-29 (Kan. 1987). Although *Tetuan* does not involve a real estate transaction, the case involved an intrauterine device, the "Dalkon Shield," which was found to be a dangerous device. See generally Keeton, *supra* note 14, at 14-17; see also *Cutter v. Hamlen*, 18 N.E. 397 (Mass. 1888).

closure requirements, however, do not fall neatly within the exceptions to the traditional rule permitting silence, which demonstrates that the disclosures required by good faith are in flux and expanding.<sup>412</sup>

It might be argued that, even though the courts have used the language of good faith and fair conduct to determine when a duty to speak should be imposed, the cases do not warrant any extension of disclosure requirements because almost all of the cases fall within recognized exceptions to the general rule of non-disclosure.<sup>413</sup> This argument, however, misses the point. The cases recognize that contemporary notions of good faith, fair dealing, and common de-

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<sup>412</sup> In *Nowicki v. Podgorski*, 101 N.W.2d 371 (Mich. 1960), the court found defendants, husband and wife, to be guilty of fraud in the sale of defendants' grocery store to plaintiff, even though the wife made no affirmative misrepresentations and none of the exceptions to the general rule permitting silence applied to her conduct, because the wife sat by silently as her husband misrepresented certain facts about the grocery store to plaintiff. *Id.* at 373, 378. In *Schnell v. Gustafson*, 638 P.2d 850 (Colo. App. Ct. 1981), the court held that previous owners of a home could be found guilty of fraud in the sale of the residence to plaintiff for failing to inform plaintiff that the home was built on radioactive uranium mine tailings, even though defendants were not the sellers of the residence (plaintiff bought the home from a company that had purchased the home from defendants). *Id.* at 851-52. The court reasoned that even if defendants were not the sellers of the property, they had a duty to disclose the defect to the buyer because "equity and good conscience" demanded disclosure. *Id.* at 852. Additionally, in *Mitchell v. Slocum*, 455 N.E.2d 20, 23-24 (Ohio Mun. Ct. 1981), defendant was found guilty of fraud in the sale of commercial real estate because he failed to inform plaintiff that the City of Akron, Ohio was going to charge the property in question with the cost of closing a vault under the sidewalk in front of the property. Defendant was found guilty of fraud even though there were no inquiries from plaintiff with regard to this matter, and even though defendant made no disclosures, partial or otherwise, on the topic. *Id.* at 24. Moreover, in *Shepard v. City Co. of New York*, 24 F. Supp. 682 (D. Minn. 1938), the mere sale of unregistered stock alone was found to be fraudulent. *Id.* at 684. Finally, in *Ollerman v. O'Rourke*, 288 N.W.2d 95, 107 (Wis. 1980), the court declared that the seller of a residential lot had the duty to disclose material facts to a non-commercial purchaser when the facts were not readily discernable to the purchaser.

<sup>413</sup> One commentator has asserted this type of argument. Jon Warren, *Is The Duty to Disclose a Question of Fair Conduct?*, 2 IDAHO L. REV. 112 (1965). Warren reviewed the following cases: *Janinda v. Lanning*, 390 P.2d 826 (Idaho 1964); *Obde v. Schlemeyer*, 353 P.2d 672 (Wash. 1960); *Steadman v. Topham*, 338 P.2d 820 (Wyo. 1959); *Cohen v. Citizens Nat'l Trust & Sav. Bank*, 300 P.2d 14 (Cal. Ct. App. 1956); *Villalon v. Bowen*, 273 P.2d 409 (Nev. 1954). Another commentator reviewing the *Obde* decision suggested that the "case might be viewed . . . as a concrete manifestation of the court's ability to place liability where considerations of fair dealing indicate it should lie by mechanism of labeling specific factual patterns arising in the vendor-purchaser interchange as constituting conditions dangerous to life, health or property." Virginia Lyness, Note, *Silence as Fraudulent Concealment - Vendor and Purchaser - Duty to Disclose*, 36 WASH. L. REV. 202, 204 (1961). These commentators appear to have been unaware of the other considerable authority applying notions of good faith and fair dealing to measure disclosure requirements.

gency are ultimately the concepts by which disclosure requirements are to be measured. That most of the cases fall within traditional exceptions to the rule of non-disclosure does not mean that good faith requires disclosures only in those cases. The exceptions were created over time as our society changed and decided that good faith and fair dealing demanded them.<sup>414</sup> This demonstrates that good faith is the proper standard and that, when society's notions of what is required by good faith and business ethics change, disclosure requirements also change.

## 2. Restatement (Second) of Contracts and Torts

Both the Restatements (Second) of Contracts and Torts recognize that notions of good faith and fair dealing, at least under certain circumstances, are relevant for determining when one has a duty to speak. Although the Restatements' rules still give weight to caveat emptor, both acknowledge that changing societal ethics and norms affect disclosure requirements and that those requirements may expand as ethics and norms change.

The Restatement (Second) of Contracts section 161, which deals with the effect of silence during precontractual negotiations, was submitted to the members of the American Law Institute (ALI) on April 15, 1976 and was substantially incorporated into the Restatement (Second) on May 17, 1979.<sup>415</sup> Section 161 is based on the Restatement of Contracts sections 471(c) and 472, adopted in

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<sup>414</sup> Numerous commentators have recognized, after reviewing the cases, that the courts, whether they say so or not, have been applying contemporary standards of good faith and fair dealing to determine whether disclosures should be made. See also note 15 for a discussion of some other commentators' views. In *Ollerman v. O'Rourke Co.*, the court observed:

Over the years society's attitudes toward good faith and fair dealing in business transactions have undergone significant change, and this change has been reflected in the law. Courts have departed from or relaxed the "no duty to disclose" rule by carving out exceptions to the rule and by refusing to adhere to the rule when it works an injustice.

*Ollerman v. O'Rourke Co.*, 288 N.W.2d 95, 102 (Wis. 1980). See also Goldfarb, *supra* note 8, at 43 ("[I]n the typical transaction, nondisclosure of material facts on the part of a vendor or purchaser is not fraudulent. This is the older law, and, notwithstanding a movement in the other direction, manifested by the gradual multiplication of qualifying exceptions, it is the modern law as well."). Another commentator has noted:

[A]ccount should be taken of the ethical quality of the defendant's conduct; and there are clear indications that our courts are moving in this direction. This is one aspect of a general movement toward holding parties to business transactions to standards of fair dealing, a tendency illustrated by the gradual whittling away of the maxim *caveat emptor*.

GEORGE E. PALMER, MISTAKE AND UNJUST ENRICHMENT 83 (1962).

<sup>415</sup> The Restatement (Second) of Contracts § 161 states:

1932, and the Restatement (Second) of Torts section 551.<sup>416</sup> As finally adopted, section 161 is, perhaps, an awkward formulation of rules normally asserted to lie in the tort arena. Most of the disclosure requirements set forth in section 161 are based on well established fraud and misrepresentation law.<sup>417</sup>

Section 161(b) provides that disclosure is required to correct a mistake of the other party as to a basic assumption on which that party is making a contract, if non-disclosure of the fact would amount to "a failure to act in good faith and in accordance with

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A person's non-disclosure of a fact known to him is equivalent to an assertion that the fact does not exist in the following cases only:

(a) where he knows that disclosure of the fact is necessary to prevent some previous assertion from being a misrepresentation or from being fraudulent or material.

(b) where he knows that disclosure of the fact would correct a mistake of the other party as to a basic assumption on which that party is making the contract and if non-disclosure of the fact amounts to a failure to act in good faith and in accordance with reasonable standards of fair dealing.

(c) where he knows that disclosure of the fact would correct a mistake of the other party to the contents or effect of a writing, evidencing or embodying an agreement in whole or in part.

(d) where the other person is entitled to know the fact because of a relation of trust and confidence between them.

RESTATEMENT (SECOND) OF CONTRACTS § 161 (1979).

<sup>416</sup> See *id.* at Reporter's Note. The Restatement of Contracts § 471(c) defined fraud, in pertinent part, as "non-disclosure where it is not privileged, by any person intending or expecting thereby to cause a mistake by another to exist or continue, in order to induce the latter to enter into or refrain from entering into a transaction." RESTATEMENT (SECOND) OF CONTRACTS § 471(c) (1932). Comment g to § 471 provided that it is not always fraudulent "for a person to fail to inform the other party to a bargain that he is acting under a mistake." *Id.* § 471 cmt. g. Section 472 set forth the circumstances when non-disclosure is not privileged:

(1) There is no privilege of non-disclosure, by a party who

(a) has previously made the misrepresentation, either innocently or without any intention or expectation that it would induce conduct and subsequently before a transaction has been induced thereby is aware of the facts and intends or expects that conduct will be induced by the mistake, or

(b) knows that the other party is acting under a mistake as to undisclosed material facts, and the mistake if mutual would render voidable a transaction caused by relying thereon, or

(c) occupies such a relation to the other party as to justify the latter in expecting that his interests will be cared for, or

(d) is denied immunity from non-disclosure by any special rules of law.

(2) Where non-disclosure is not privileged it has the effect of a material misrepresentation.

*Id.* § 472.

<sup>417</sup> See *supra* note 415 (pointing out the disclosure requirements of § 161).

reasonable standards of fair dealing."<sup>418</sup> This is a modification of the older Restatement non-disclosure rule pertaining to contract negotiations. The first Restatement of Contracts did not measure disclosure requirements by standards of good faith and fair dealing.<sup>419</sup> Comment d to section 161 explains that a party is "expected only to act in good faith and in accordance with reasonable standards of fair dealing, as reflected in prevailing business ethics."<sup>420</sup> Consistent with traditional notions of caveat emptor, however, the comments also note that a party may "expect the other to take normal steps to inform himself and to draw his own conclusions."<sup>421</sup>

The Restatement (Second) of Torts section 551, upon which Restatement (Second) of Contracts, is partially based, addresses the topic of "Liability for Nondisclosure" in business transactions.<sup>422</sup> The rule is expressly worded in terms of the duty owed

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<sup>418</sup> See *supra* note 415 (setting forth the text of RESTATEMENT (SECOND) OF CONTRACTS section 161(b)).

<sup>419</sup> See *supra* Section III. D. 2 for a discussion of the first RESTATEMENT OF CONTRACTS.

<sup>420</sup> RESTATEMENT (SECOND) OF CONTRACTS § 161 cmt. d (1979).

<sup>421</sup> *Id.* Moreover, "[i]f the other is indolent, inexperienced or ignorant, or if his judgment is bad or he lacks access to adequate information, his adversary is not generally expected to compensate for these deficiencies." *Id.*

<sup>422</sup> Section 551 provides:

(1) One who fails to disclose to another a fact that he knows may justifiably induce the other to act or refrain from acting in a business transaction is subject to the same liability to the other as though he had represented the nonexistence of the matter that he has failed to disclose, if, but only if, he is under a duty to the other to exercise reasonable care to disclose the matter in question. (2) One party to a business transaction is under a duty to exercise reasonable care to disclose to the other before the transaction is consummated,

(a) matters known to him that the other is entitled to know because of a fiduciary or other similar relation of trust and confidence between them; and

(b) matters known to him that he knows to be necessary to prevent his partial or ambiguous statement of the facts from being misleading; and

(c) subsequently acquired information that he knows will make untrue or misleading a previous representation that when made was true or believed to be so; and

(d) the falsity of a representation not made with the expectation that it would be acted upon, if he subsequently learns that the other is about to act in reliance upon it in a transaction with him; and

(e) facts basic to the transaction, if he knows that the other is about to enter into it under a mistake as to them, and that the other, because of the relationship between them, the customs of the trade or other objective circumstances, would reasonably expect a disclosure of those facts.

during negotiations "before the transaction is consummated." Despite the confusion that revised section 551 would later engender, the original provision had a rather inauspicious origin. The original section 551 appears to have been adopted almost verbatim from Tentative Draft No. 13 at the May, 1936 ALI meeting.<sup>423</sup> The Reporter's explanatory notes to section 551 cited only three cases, which caused at least one court to comment that this was "a slender reed indeed upon which to predicate that section."<sup>424</sup>

The revision of section 551 was first discussed at the 1965 ALI meeting, when suggested improvements were circulated as part of Tentative Draft No. 11. The proposed revision was essentially a reorganization of the original section 551 with one major addition dealing with precontractual negotiations.<sup>425</sup> That new addition, section 551(2)(e), provided that (i) one party to a business transaction is under a duty to disclose to the other before the transaction is consummated, (ii) facts basic to the transaction, if he knows that the other is about to enter into the transaction under a mistake as to such facts, and that the other, because of the relationship between them, the customs in the trade, or other objective circumstances, would reasonably expect a disclosure of such facts.<sup>426</sup>

The Reporter, in his explanatory notes, discussed the legal trends preceding the creation of section 551(2)(e)<sup>427</sup> and cited over twenty-five cases in support of the proposed clause, most of which refer to real estate or animal sales.<sup>428</sup> The discussion of proposed section 551 at the 1965 ALI meeting was wide ranging and inconclusive.<sup>429</sup> At least one judge, however, was later able to review the record of the proceedings and conclude that the section's "history indicates that its purpose was to liberalize the traditional doctrine of *caveat emptor*, not to create a general tort of commercial

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RESTATEMENT (SECOND) OF TORTS § 551 (1976).

<sup>423</sup> *United States Nat'l Bank of Oregon v. Fought*, 630 P.2d 337, 346 (Or. 1981).

<sup>424</sup> *Id.* at 347.

<sup>425</sup> *Proceedings 1965*, 42 A.L.I. PROC. 371 (1965).

<sup>426</sup> RESTATEMENT (SECOND) OF TORTS § 551 (Tentative Draft No. 11, 1965).

<sup>427</sup> *Id.* The Reporter noted:

Clause (e) is new. There were cases to support it when the old Section was drawn in 1936. Since then they have been piling up rapidly, and there are now so many of them that they cannot be ignored . . . . Even if they were not, the Subsection appears quite obviously right, if we consider such results as that in *Swinton v. Whitinsville Savings Bank*, (1942) 311 Mass. 677, 42 N.E.2d 808, where the defendant unloaded a termite-riddled house upon the plaintiff, and escaped all tort liability.

*Id.*

<sup>428</sup> *Id.*

<sup>429</sup> *Proceedings 1965*, 42 A.L.I. PROC. 370-83 (1965).

nondisclosure."<sup>430</sup> Confused over the meaning of section 551(2)(e), the drafters agreed to hold over section for further consideration.<sup>431</sup>

Section 551 returned virtually unchanged to the 1966 ALI meeting. Again, virtually all of the cases designated by the Reporter as support for clause (e) related to undisclosed defects in the title of land or basic chattel such as houses or animals.<sup>432</sup> With little additional fanfare or discussion, the ALI adopted section 551.<sup>433</sup>

The section 551(2)(e) duty to disclose facts basic<sup>434</sup> to the transaction during negotiations is triggered *only* when "the relationship between [the bargaining adversaries], the customs of the trade or other objective circumstances" require as much.<sup>435</sup> Comment k,<sup>436</sup> and its deference to the "legitimate advantages" of supe-

<sup>430</sup> *United States Nat'l Bank of Oregon v. Fought*, 630 P.2d 337, 353 (Or. 1981) (Tanzer, J., dissenting). Judge Tanzer also stated that section 551's "words are consistent with its underlying intent to regulate sales and, to some degree, the broader class of 'business transactions' (e.g., loans, leases) as opposed to on-going business arrangements and relationships such as that in this case." *Id.*

<sup>431</sup> *Proceedings 1965*, 42 A.L.I. PROC. 370-83 (1965).

<sup>432</sup> RESTATEMENT (SECOND) OF TORTS § 551 (Tentative Draft No. 12, 1966).

<sup>433</sup> *1966 Proceedings*, 43 A.L.I. PROC. 411-13 (1966). Unlike the first Restatement, the official comments accompanying the second Restatement were designed to play an important role in the section's interpretation:

The basic system of Blackletter, Comments, and Illustrations has been retained in the second *Restatement*. The Comments are much more discursive, treating the rationale and application of the rule in considerable detail. *Often the Blackletter is written in more general, more flexible language, and it now serves primarily as an introduction to the Comments, which provide the essence of the treatment.*

John W. Wade, *The Restatement (Second): A Tribute to its Increasingly Advantageous Quality, and an Encouragement to Continue the Trend*, 13 PEPP. L. REV. 59, 61 (1985) (emphasis added). Given the breadth of language used in section 551(2)(e), the comments attached to that clause were created to flexibly trace the boundaries for its application.

<sup>434</sup> A basic fact is one

that is assumed by the parties as a basis for the transaction itself. It is a fact that goes to the basis, or essence, of the transaction, and is an important part of the substance of what is bargained for or dealt with. Other facts may serve as important and persuasive inducements to enter into the transaction, but not go to its essence. These facts may be material, but they are not basic.

RESTATEMENT (SECOND) OF TORTS § 551 cmt. j (1976).

<sup>435</sup> *Id.* § 551(2)(e).

<sup>436</sup> *Id.* cmt. k. Comment k provides:

The rule stated in Subsection (1) reflects the traditional ethics of bargaining between adversaries, in the absence of any special reason for the application of a different rule. When the facts are patent, or when the plaintiff has equal opportunity for obtaining information that he may be expected to utilize if he cares to do so, or when the defendant

rior information and "better business acumen," explains why Section 551(2)(e) has not been actively applied in the area of major commercial negotiations. In essence, the customs of these business communities differentiate between facts that are "basic" and those that are merely "material."<sup>437</sup> Even the drafters of Section 551(2)(e) found it difficult to articulate the circumstances under which the duty to disclose facts basic to the transaction would arise.<sup>438</sup>

Despite a deference to the then current customs and ethics of the business community, the comments also indicate that the drafters allowed for, and anticipated, a more expansive use of section 551(2)(e) in the future.<sup>439</sup> Rather than create a static tort rule that

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has no reason to think that the plaintiff is acting under a misapprehension, there is no obligation to give aid to a bargaining antagonist by disclosing what the defendant has himself discovered. *To a considerable extent, sanctioned by the customs and mores of the community, superior information and better business acumen are legitimate advantages, which lead to no liability. The defendant may reasonably expect the plaintiff to make his own investigation, draw his own conclusions and protect himself; and if the plaintiff is indolent, inexperienced or ignorant, or his judgment is bad, or he does not have access to adequate information, the defendant is under no obligation to make good his deficiencies.* This is true, in general, when it is the buyer of land or chattels who has the better information and fails to disclose it. Somewhat less frequently, it may be true of the seller.

*Id.*

<sup>437</sup> The Reporter emphasized that the "[a]dvisers [were] unanimous in wishing to limit Clause (e) to facts 'basic to the transaction.'" *Id.* The Reporter opined that the "law may be moving in the direction of requiring disclosure of 'material' facts, but it is not yet sufficiently clear to justify more than 'basic.'" RESTATEMENT (SECOND) OF TORTS § 551 (Tentative Draft No. 11, 1965).

<sup>438</sup> Comment *l* to § 551 provides, in part:

It is extremely difficult to be specific as to the factors that give rise to this known, and reasonable, expectation of disclosure. In general, the cases in which the rule stated in Clause (e) has been applied have been those in which the advantage taken of the plaintiff's ignorance is so shocking to the ethical sense of the community, and is so extreme and unfair, as to amount to a form of swindling, in which the plaintiff is led by appearances into a bargain that is a trap, of whose essence and substance he is unaware.

RESTATEMENT (SECOND) OF TORTS § 551 cmt. 1 (1976).

<sup>439</sup> Comment *l* to § 551 provides, in part:

The continuing development of modern business ethics has, however, limited to some extent this privilege to take advantage of ignorance. There are situations in which the defendant not only knows that his bargaining adversary is acting under a mistake basic to the transaction, but also knows that the adversary, by reason of the relation between them, the customs of the trade or other objective circumstances, is reasonably relying upon a disclosure of the unrevealed fact if it exists. In this type of case good faith and fair dealing may require a disclosure.

*Id.*



would freeze the rule based on the customs and mores of the day, the ALI noted that section 551 could grow in tandem with the progression, if any, of business ethics. Indeed, sometime after the 1966 annual ALI meeting, a paragraph was deliberately attached to comment I, which provides that:

There are indications, also, that with changing ethical attitudes in many fields of modern business, the concept of facts basic to the transaction may be expanding and the duty to use reasonable care to disclose the facts may be increasing somewhat. This subsection is not intended to impede that development.<sup>440</sup>

The most frequent application of section 551(2)(e) to date has been in the area of negotiations for residential real estate.<sup>441</sup> The section has also been applied to a lesser degree in other consumer negotiations such as securities purchases,<sup>442</sup> lending,<sup>443</sup> car sales<sup>444</sup> and insurance.<sup>445</sup> Some courts have also found an application for section 551(2)(e) in family law.<sup>446</sup>

The Supreme Court of Wisconsin reviewed the developing duty to disclose in *Ollerman v. O'Rourke Co., Inc.*<sup>447</sup> None of the cases analyzed or listed in the review involved major commercial transactions.<sup>448</sup> In fact, the only unifying characteristic to all of the cases that cite section 551(2)(e) is a defendant who takes advantage of an unsophisticated or incompetent plaintiff. *Jersild v. Aker*<sup>449</sup> is a textbook ex-

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<sup>440</sup> *Id.*

<sup>441</sup> See, e.g., *Tusch Enters. v. Coffin*, 740 P.2d 1022, 1028 (Idaho 1987) (reversing summary judgment to determine if fact that real estate was built on fill must be disclosed); *Griffith v. Byers Constr. Co. of Kansas, Inc.*, 510 P.2d 198, 203 (Kan. 1973) (ruling that purchaser may recover from residential real estate developer).

<sup>442</sup> *Minpeco, S.A. v. Conticommodity Servs., Inc.*, 552 F. Supp. 332, 337 (S.D.N.Y. 1982) (pertaining to silver monopoly created artificial prices that lured traders into the futures market).

<sup>443</sup> *Bair v. Public Serv. Employment Credit Union*, 709 P.2d 961, 962 (Colo. Ct. App. 1985) (ruling that lender must disclose terms of credit disability insurance policy to borrower when insurance included as part of loan agreement).

<sup>444</sup> *Gaines Servs. Leasing Corp. v. Carmel Plastic Corp.*, 432 N.Y.S.2d 760, 761-62 (N.Y. Civ. Ct. 1980) (asserting that failure to pay for car is a basic fact requiring disclosure to seller).

<sup>445</sup> *Eddy v. Sharp*, 245 Cal. Rptr. 211, 213-14 (Cal. Ct. App. 1988) (pertaining to insurer's duty to reasonably inform the insured of the insured's rights and obligations under the policy).

<sup>446</sup> *Bryant v. Bryant*, 495 N.Y.S.2d 121, 122 (N.Y. App. Div. 1985) (finding that section 551(2)(e) applied to child support agreement); *Abbate v. Abbate*, 441 N.Y.S.2d 506, 514 (N.Y. Sup. Ct. 1981) (ruling that section 551(2)(e) applied to alimony negotiations).

<sup>447</sup> 288 N.W.2d 95 (Wis. 1980).

<sup>448</sup> *Id.* at 103 n.15.

<sup>449</sup> 766 F. Supp. 713 (E.D. Wis. 1991).

ample of a factual setting that closely approximates that of a major commercial transaction. Plaintiff Jersild was a vice-president of a closely-held corporation. Despite his position, he was neither a stockholder nor privy to information about the finances of the company. Defendant Aker, married to Jersild's cousin, was a shareholder in the company and was fully aware that the company was in dire financial straits.

Rather than answer a cash call for a personal investment in the failing company, defendant Aker donated 150 of his personal shares to the corporate treasury and then invited Jersild to become a shareholder. Jersild, flattered by the invitation, purchased the shares from the corporate treasury. The court, in denying defendant's motion for summary judgment against a subsequent tort claim based on nondisclosure, found sufficient evidence to go forward under section 551(2)(e).<sup>450</sup> While the family aspects of this case make it inapplicable to most major commercial transactions, it is evidence that the courts may be willing to apply section 551(2)(e) in commercial negotiations if the circumstances call for it.

Section 551(2)(e) of the Restatement (Second) of Torts was drafted and passed amid great consternation and debate. Unfortunately, its application over the past twenty-seven years has been so limited as to call into question whether these contentious ALI proceedings were "much sound and fury signifying nothing." Nevertheless, the comments accompanying section 551(2)(e) make clear that as the "customs and mores" of business evolve, so shall the effective reach of the section's duty to disclose.

#### *F. What Needs to be Disclosed—Six Views*

The preceding subsections have demonstrated that the law increasingly has imposed standards of good faith and fair dealing in both contract performance and formation. To the extent that the law requires precontractual disclosures, many courts have recognized that contemporary standards of good faith and fair dealing mandate these disclosures. The courts, for the most part, however, have not set forth any clear standards or rationales for determining what disclosures good faith and fair dealing require. Although the lack of any clear standard or rationale, other than the rubric "good faith and fair dealing," has some value because it allows disclosure requirements to evolve with contemporary standards of morals and business ethics, it is also useful to determine whether any guiding

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<sup>450</sup> *Id.* at 721.

principles or factors have been developed that can be applied generally to help determine what good faith and fair dealing requires. In this subsection, six important views on the duty to disclose shall be set forth and discussed. In addition, the interests or factors utilized to explain disclosure law will be examined.

1. All material facts must be disclosed

Robert-Joseph Pothier, a French lawyer and judge who lived in the 18th Century, espoused the most demanding position on the duty of disclosure in business transactions.<sup>451</sup> Pothier argued that in a sales contract, "good faith" required the divulgence of all material facts that the contracting parties would have an "interest in knowing, touching the thing which is the object of the contract."<sup>452</sup> Pothier thought that equity and justice required contracting parties to be equal. He believed that if one party had knowledge superior to the other, the party with more information had an unfair advantage because the parties were no longer equal.<sup>453</sup>

Pothier also believed that the parties to a sales contract had an obligation to reveal both intrinsic facts—those dealing with the quality of the item itself—and extrinsic facts—those relating to the environment or market in which the item is sold and which may affect its value.<sup>454</sup> Pothier rejected St. Thomas Aquinas's position that a vendor could remain silent without incurring liability unless the defect in the item sold could cause the vendee injury or unless the vendor sold the item for more than it was worth. With regard to this position, Pothier stated:

This decision appears to me to be unjust, since, as the vendor is perfectly at liberty to sell or not to sell, he ought to leave the vendee perfectly at liberty to buy or not to buy, even for a fair price, if that price does not suit the buyer; it is, therefore, unjust to lay a snare for this liberty which the vendee ought to enjoy by concealing from him the vice of the thing, in order to induce him to buy that which he may not have been willing to buy for the price for which it is sold to him, had he known of its defects.<sup>455</sup>

It does not appear that any American courts or other respected au-

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<sup>451</sup> See *supra* note 193 for an example of Pothier's views.

<sup>452</sup> *Pothier, supra* note 193, at 240, *quoted also in* *Laidlaw v. Organ*, 15 U.S. (2 Wheat.) 178, 185 n.2 (1817).

<sup>453</sup> *Id.*

<sup>454</sup> *Id.*, *quoted also in* *Laidlaw*, 15 U.S. (2 Wheat.) at 185 n.2.

<sup>455</sup> *Id.*

thorities have adopted Pothier's views.<sup>456</sup>

2. All material facts must be disclosed that affect the common estimate which fixes the market price for the item

Pothier's views have been considered "extravagant" and have been rejected even by an American author who disagreed vehemently with caveat emptor, Gulian C. Verplank. In 1825, Verplank wrote a book in which he not only criticized the *Laidlaw* decision, but also criticized Pothier, the only authority relied on by the petitioner in *Laidlaw*.<sup>457</sup>

According to Verplank, the vendee's knowledge of the treaty of Ghent in *Laidlaw* and his concealment of that fact from the vendor amounted to "the seizing [of] an advantage, where the contract itself was formed upon the understanding that no such advantage would be taken."<sup>458</sup> Verplank, however, did not believe there was anything dishonest or unfair "*in using superior sagacity as to probabilities, or in applying greater skill and better knowledge, as to those facts which do not necessarily enter into the common calculations of those who fix the current price, and concerning which no confidence, express or implied, is reposed.*"<sup>459</sup> Explaining that full disclosure would "destroy that fair superiority which the industrious or the bold trader has earned by his labour or enterprise, over the careless and idly ignorant,"<sup>460</sup> Verplank therefore rejected Pothier's view. At the same time, however, Verplank also rejected the common law doctrine of caveat emptor because it required "all men . . . to regard their neighbors as sharpers, and to deal with them at arms' length."<sup>461</sup>

Verplank argued instead that the same disclosure rules uti-

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<sup>456</sup> The views of Pothier, however, have been more influential in continental Europe.

<sup>457</sup> GULIAN C. VERPLANK, AN ESSAY ON THE DOCTRINE OF CONTRACTS: BEING AN INQUIRY HOW CONTRACTS ARE AFFECTED IN LAW AND MORALS BY CONCEALMENT, ERROR, OR INADEQUATE PRICE 123-24, 128 (New York, G. & G. Carvill 1825). Verplank set forth the following rule of disclosures in business transactions:

*Whenever any advantage is taken in a purchase, or sale, from the suppression of any fact, (not of an opinion or inference,) necessarily and materially affecting the common estimate which fixes the present market value of the thing sold; in regard whereto, the sale alone conclusively proves, that it was presumed by the losing party, that no advantage would be taken; such advantage is gained by Fraud.*

*Id.* at 125-26.

<sup>458</sup> *Id.* at 124.

<sup>459</sup> *Id.* at 127.

<sup>460</sup> *Id.* at 128.

<sup>461</sup> *Id.*

lized in marine insurance cases, which Lord Mansfield set forth in *Carter v. Boehm*, should be applied universally to determine the duty to speak in business transactions.<sup>462</sup> In support of this proposition, Verplank expressed his belief that insurance law and its disclosure requirements ought be applied in all contract cases because insurance law was wise, easy to understand, similar in all Western countries, and consistent with honesty and fair dealing.<sup>463</sup> Moreover, Verplank asserted that an actionable concealment was "the suppression or reservation of some such fact, within the knowledge of either party, and which the other has not the means of knowing, or has presumed not to know."<sup>464</sup>

Verplank explained that it is unfair to conceal or fail to disclose knowledge of material facts "concerning the terms or the subject of the contract, which necessarily and of course enter into all calculations of price among those whose demand and supply, and estimation of value, fix the market price of similar things . . . ."<sup>465</sup> Verplank stated that material facts are those entering into the calculation of the market price and can relate to extrinsic circumstances which affect the terms of the contract or intrinsic circumstances which relate to the quality and subject of the contract.<sup>466</sup> In addition, Verplank noted that the parties should have the freedom "by the known usage of trade, or by express words," to determine that the contract "is made at all risks," so that "neither party is answerable except for positive and direct Fraud."<sup>467</sup> Moreover, Verplank noted that the buyer must be presumed to have known any defects apparent on inspection, although the buyer may refute the presumption with positive contrary evidence.<sup>468</sup>

3. All material facts must be disclosed which the man of ordinary moral sensibilities would have revealed under the same or similar circumstances

Perhaps the most influential article on fraudulent concealment and non-disclosures is W. Page Keeton's 1936 work in the *Texas Law Review*.<sup>469</sup> In that article, after reviewing the law of fraudulent concealment and non-disclosures, Professor Keeton

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<sup>462</sup> *Id.* at 175-98.

<sup>463</sup> *Id.* at 177-79.

<sup>464</sup> *Id.* at 180 (footnote omitted).

<sup>465</sup> *Id.* at 227.

<sup>466</sup> *Id.*

<sup>467</sup> *Id.* at 229.

<sup>468</sup> *Id.* at 230.

<sup>469</sup> Keeton, *supra* note 15.

suggested that a standard similar to that used in negligence cases should be used to measure disclosure requirements.

In this connection it would seem that the conception of negligence as the care of the ordinary prudent man would be a benefit. It has been said that the standard man in his conduct on the question of negligence evaluates interests in accordance with the sentiment of the community. Why not employ the standard man in this connection? This would be, not the ordinary man's views as to the ethical quality of the silence, but what the man of ordinary moral sensibilities would have done; would he have disclosed the information or would he have remained silent?<sup>470</sup>

Professor Keeton set forth at least nine factors that would be helpful to a judge and a jury in determining whether the ordinary ethical person should have disclosed a material fact under the circumstances of the transaction in question:

(1) "The difference in the degree of intelligence of the parties to the transaction."<sup>471</sup> A greater duty of disclosure is imposed on the intelligent party if the opposing party is unusually ignorant.

(2) "The relation that the parties bear to each other."<sup>472</sup> If the parties are in a confidential relationship or one party has reposed confidence and trust in the other, this supports a higher duty of disclosure.

(3) "The manner in which the information is acquired."<sup>473</sup> If the information subject to being disclosed has been discovered by chance or by an illegal act, this favors disclosure of the information. However, if the information has been gained by extensive effort, "no one would contend that the duty of disclosure should always exist."<sup>474</sup>

(4) "The nature of the fact not disclosed."<sup>475</sup> There is a heightened duty of disclosure with regard to intrinsic facts and not as high a duty of disclosure with regard to extrinsic facts.

(5) "The general class to which the person who is concealing the information belongs."<sup>476</sup> The buyer is not generally under the same duty of disclosure as the seller.

(6) "The nature of the contract itself."<sup>477</sup> Certain agreements,

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<sup>470</sup> *Id.* at 32.

<sup>471</sup> *Id.* at 34.

<sup>472</sup> *Id.*

<sup>473</sup> *Id.* at 35.

<sup>474</sup> *Id.*

<sup>475</sup> *Id.*

<sup>476</sup> *Id.*

<sup>477</sup> *Id.* at 36.

such as releases, contracts of insurance, and contracts of suretyship, call for heightened disclosure of facts.

(7) "The materiality of the fact not disclosed."<sup>478</sup> The more important the fact is the more likely it should be disclosed.

(8) "The type of damage which the ignorant person will, or is likely to, suffer from a non-disclosure."<sup>479</sup> The duty to speak is enhanced if non-disclosure may result in personal injury. There is not as significant an interest in disclosure when silence only results in economic loss.

(9) "[T]he conduct of the person with knowledge of the fact not disclosed."<sup>480</sup> There is a heightened duty of disclosure if the person with knowledge of the material fact takes any affirmative steps to conceal those facts.

Prosser and Keeton have, with the exception of number 8, repeated these same factors in their hornbook on the law of torts.<sup>481</sup> Professor Keeton argued that the courts should address the above factors on a case-by-case basis to determine whether a duty to disclose facts in good faith exists.<sup>482</sup>

4. All material facts must be disclosed which are required by a justifiable expectation of disclosure based on contemporary societal standards of good faith

Professor Eric N. Holmes published a law review article<sup>483</sup> in 1978 that appeared to combine or borrow concepts from Verplank and Keeton. Holmes, to the extent that he relied heavily upon the concepts set forth by Lord Mansfield in *Carter v. Boehm*, borrowed Verplank's analysis by suggesting that the disclosures traditionally required in the formation of insurance contracts should also be applied in all other contracts.<sup>484</sup> Holmes also appeared to borrow from the concepts of Keeton insofar as he relied upon negligence principles and the application of a series of factors to determine whether disclosures were required. Specifically, Holmes wrote that:

Just as negligence is a question of fair conduct, disclosure in contract formation is a question of good faith and fair conduct according to reasonable societal standards. It is the actual mores and expectations of society rather than its abstract ethical

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<sup>478</sup> *Id.*

<sup>479</sup> *Id.*

<sup>480</sup> *Id.*

<sup>481</sup> PROSSER AND KEETON, *supra* note 8, at 739.

<sup>482</sup> Keeton, *supra* note 15, at 39-40.

<sup>483</sup> Holmes, *supra* note 15.

<sup>484</sup> *Id.* at 426-35.

views that control. Each contracting party is thus held to that degree of responsibility regarding disclosure fit to the justifiable expectations which each party knows or has reason to know.<sup>485</sup>

Holmes's analysis differed from Keeton's, however, in that Holmes focused, not on what the reasonable man would have disclosed under the circumstances, but on what the justifiable expectations of the parties to the transaction are with regard to what should be disclosed. As with Keeton, Holmes set forth a series of factors, which were essentially the same as Keeton's, that should be considered by the trier of fact in determining whether disclosures were required.<sup>486</sup> Using these factors as the criteria, Holmes concluded that each contract should be evaluated in its "commercial context in terms of good faith and fair conduct," and that the duty to disclose should be tailored to fit the "expectations of the particular parties."<sup>487</sup>

5. All material facts should be disclosed that have been casually acquired

Building on the third factor set forth by Professor Keeton ("the manner in which the information is acquired"<sup>488</sup>), Professor

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<sup>485</sup> *Id.* at 442.

<sup>486</sup> See Holmes, *supra* note 15, at 443-47. According to Professor Holmes, the first factor that should be considered when determining whether disclosure is required is: (1) "The nature of the fact undisclosed." *Id.* at 443-44. Holmes argued that the distinction in the Restatements between "basic" and "material" facts is tenuous and that the more important the fact is, the more likely it should be disclosed. Holmes wrote that "the nature of the undisclosed fact should be one which would vitally influence a party's basic assumptions in forming the contract and which does have a material effect on the agreed exchange." *Id.* at 444 (footnote omitted). The second factor that should be considered under Holmes' view is: (2) "Accessibility of knowledge." *Id.* at 445. Holmes argued that "[a]nother factor to consider is the effect of superior knowledge or means of acquiring knowledge by one party which creates an inequality in contract formation." *Id.* Although Holmes indicated that it is impossible for the law to put parties on an equal footing with regard to knowledge or experience, he argued that there should be a duty of disclosure if "the superior knowledge of one is not reasonably accessible to the other (and is not discoverable upon fair inquiry pursued with due diligence), or the means of acquiring knowledge are extremely and unfairly unequal . . . ." *Id.* Holmes argued on the other hand the one who is ignorant or mistaken about the facts must bear the risk of "his ignorance or mistake if he does not use due diligence and reasonable efforts to discover all relevant facts." *Id.* at 446. The third factor that should be considered according to Holmes is: (3) "Objective circumstances creating an expectation of and reliance on full disclosure." *Id.* Under this heading, Holmes set forth four other factors relevant to determining a duty to speak: (a) "the nature of the contract," (b) "trade customs and prior course of dealing," (c) "conduct of the party with knowledge," and (d) "status and relationship of the parties." *Id.* at 446-69. All of those factors are taken from Keeton. *Id.* at 447 n.253. For a comparison, see Keeton, *supra* note 15, at 32, 34, 36-37.

<sup>487</sup> Holmes, *supra* note 15, at 449.

<sup>488</sup> Keeton, *supra* note 15, at 35.



Anthony T. Kronman has argued that parties negotiating a contract must generally disclose only information casually acquired and need not disclose information deliberately acquired.<sup>489</sup> Kronman defined "deliberately acquired information" as "information whose acquisition entails costs which would not have been incurred but for the likelihood, however great, that the information in question would actually be produced."<sup>490</sup> Kronman defined "casually acquired" information as information which, if it involves costs, "the costs incurred in acquiring the information . . . would have been incurred in any case . . . ."<sup>491</sup> Thus, Kronman focused on economic efficiency and incentives to discover valuable information as the key factors in determining disclosure requirements.<sup>492</sup>

Kronman argued that deliberately acquired information should be considered a property right and that one way that the legal system may recognize this property right is to permit the party who has acquired the information to act upon it in entering into a contract without divulging the information.<sup>493</sup> Kronman argued that, if courts do not permit deliberately acquired information to be used without its disclosure, the incentive to produce such information will be reduced or curtailed, which is not in the best interests of our society.<sup>494</sup> On the other hand, Kronman noted that requiring the disclosure of casually acquired information will not reduce the incentive to produce such information because that information would have been acquired independently regardless of the cost involved in its production.<sup>495</sup> With regard to casually acquired information, Kronman suggested that the party with this information ought to divulge it because that party was "likely to be a better (cheaper) mistake-preventer than the mistaken party with whom he deals, regardless of the fact that both parties initially had equal access to the information in question."<sup>496</sup>

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<sup>489</sup> Anthony T. Kronman, *Mistake, Disclosure, Information, The Law Of Contracts*, 7 J. LEGAL STUD. 1, 33-34 (1978).

<sup>490</sup> *Id.* at 13.

<sup>491</sup> *Id.*

<sup>492</sup> Another recent law review article also focuses on economic efficiency and the maximization of societal wealth in developing a general theory on disclosure requirements. Christopher T. Wonnell, *The Structure Of A General Theory Of Nondisclosure*, 41 CASE W. RES. L. REV. 329, 333 (1991). Wonnell argued that Kronman "has moved the discussion of nondisclosure in the right direction," but also expressed a belief that Kronman's analysis is in some respects unsatisfactory. *Id.* at 342.

<sup>493</sup> Kronman, *supra* note 489, at 15.

<sup>494</sup> *Id.* at 13-14.

<sup>495</sup> *Id.* at 14.

<sup>496</sup> *Id.* at 16.

Kronman's thesis has been picked up and followed in a series of decisions from the United States Court of Appeals for the Seventh Circuit. In *United States v. Dial*, Judge Posner stated that liability was narrower for non-disclosure than for active misrepresentation and indicated that "someone who bought land from another thinking that it had oil under it would not be required to disclose the fact to the owner, because society wants to encourage people to find out the true value of things, and it does this by allowing them to profit from their knowledge."<sup>497</sup> Shortly after the *Dial* decision, Judge Easterbrook in *Teamsters Local 282 Pension Trust Fund v. Angelos*, discussed disclosure requirements in the context of a suit by the trustees of a pension trust fund against the directors of a bank and a law firm representing the bank which had borrowed money from the fund.<sup>498</sup> The trustees argued that the bank's directors and attorneys failed to disclose material adverse information about the bank. Citing *Dial*, the court indicated that the law often imposes no obligation to disclose because such information is commercially valuable and people must hide it in order to exploit its value.<sup>499</sup> Otherwise, there would be no incentive to produce the information in the first place.<sup>500</sup>

In *FDIC v. W. R. Grace & Co.*, Judge Posner again expounded upon disclosure requirements in arm's length business transactions.<sup>501</sup> While the court recognized that an omission could be actionable as fraud, the court stressed that not every failure of disclosure is actionable because that would turn "every bargaining relationship into a fiduciary one."<sup>502</sup> The court stated that a blanket duty of disclosure would end arm's length bargaining and impede enterprise and commerce.<sup>503</sup> In addition, the court noted that the seller, who had expended large sums of capital and time to obtain information and expertise, was entitled to "take advantage," to a certain extent, of the buyer in an arm's length transaction.<sup>504</sup> The court, however, explained further that a seller, who obtained inexpensive, material information that would be extremely difficult for a buyer to discover, was obligated to disclose such information.<sup>505</sup>

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<sup>497</sup> 757 F.2d 163, 168 (7th Cir. 1985).

<sup>498</sup> 762 F.2d 522, 524 (7th Cir. 1985).

<sup>499</sup> *Id.* at 528 (citing *Dial*, 757 F.2d at 168).

<sup>500</sup> *Id.*

<sup>501</sup> 877 F.2d 614 (7th Cir. 1989).

<sup>502</sup> *Id.* at 619.

<sup>503</sup> *Id.*

<sup>504</sup> *Id.*

<sup>505</sup> *Id.*

6. There is no duty to disclose material information outside of the generally recognized exceptions of misrepresentation law

Perhaps the best known proponent of the position that there should be no general duty of disclosure in arm's length business transactions, beyond the generally recognized exceptions in the area of the law of misrepresentation, is Professor E. Allen Farnsworth. Professor Farnsworth stated that the same duty of disclosure that, for example, exists between fiduciary and beneficiary, would be inappropriate in ordinary contract negotiations.<sup>506</sup> Professor Farnsworth argued that there is little sense to impose a duty on parties to ordinary contract negotiations to disclose material facts unless the parties expressly assume disclosure obligations.<sup>507</sup> He noted that parties to negotiations may be competitors and, even if they are not, there is frequently some concern that information disclosed during negotiations may fall into the hands of competitors.<sup>508</sup> In any event, Farnsworth questioned the necessity of requiring extensive disclosure requirements when the parties can and typically do deal with the matters themselves in their agreement. Professor Farnsworth explained:

Imposing a duty of disclosure on one party would raise the question of the scope of the concomitant duty of confidentiality of the other party. Among the most common types of stop-gap agreements are those providing for disclosure and confidentiality. Given the ease with which parties themselves can and do deal with the matter of disclosure and related questions of confidentiality, there is scant reason for a court to impose such a requirement of disclosure, beyond that already imposed by the law of misrepresentation.<sup>509</sup>

In *Market St. Assocs. Ltd. Partnership v. Frey*, the United States Court of Appeals for the Seventh Circuit, in dicta, supported the proposition that there is no general duty of candor based on good faith and fair dealing in the precontractual stage involving contract negotiations.<sup>510</sup> In *Frey*, the court addressed the disclosure duties of parties to a contract involving a commercial real estate lease with an option to purchase the property under certain circumstances. In dicta, the court also discussed the good faith duty of precontractual disclosure. The court stated that the law contemplated that people will frequently

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<sup>506</sup> Farnsworth, *supra* note 55, at 278.

<sup>507</sup> *Id.*

<sup>508</sup> *Id.*

<sup>509</sup> *Id.* at 278-79 (footnote omitted).

<sup>510</sup> 941 F.2d 588 (7th Cir. 1991).

take advantage of the ignorance of those with whom they contract without thereby incurring liability, and that the precontractual duty of good faith was "not a duty of candor."<sup>511</sup> While taking advantage of superior knowledge at the formation stage of a contract may not be actionable, the court found that taking "deliberate advantage of an oversight by your contract partner regarding his rights under the contract . . . is sharp dealing," which may violate the duty of good faith and give rise to remedies under contract law.<sup>512</sup> The court explained that the duty of good faith disclosure was heightened after the signing of a contract. In the formation or negotiation stage of a contract, however, "the duty is minimized."<sup>513</sup>

In addition, the court posited that disclosure duties differ depending upon whether a contract had been entered into before signing a contract, wherein parties are typically wary of one another and neither party expects total disclosure from the other. Expectations of disclosure change, however, after signing a contract because the relationship becomes cooperative. Nondisclosure after the contract is signed, therefore, is more deceptive because the harmed party would have been less cautious.<sup>514</sup> Thus, although the court stated that the duty of contractual good faith, "considered in all its variety," encompassed not only the performance and enforcement stages, but the formation stage as well, the duty of good faith disclosure in the formation stage is minimal.<sup>515</sup>

#### V. APPLICATION OF THE DUTY OF GOOD FAITH TO DISCLOSURES REQUIRES IN THE SALE OF A BUSINESS

##### A. *Introduction*

Most transactions involving the purchase and sale of a business involve intelligent, capable businessmen, who are represented frequently by counsel and/or other experts. Such sales, as with most business transactions, are generally said to be at arm's length. A significant body of law follows the rule that there is no affirmative duty to disclose information in an arm's length business transaction.<sup>516</sup> That law has been applied even in states explicitly recog-

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<sup>511</sup> *Id.* at 594.

<sup>512</sup> *Id.*

<sup>513</sup> *Id.* at 595.

<sup>514</sup> *Id.* at 594.

<sup>515</sup> *Id.* at 595.

<sup>516</sup> *E.g.*, *American Nat'l Ins. Co. v. Murray*, 383 F.2d 81, 87 (5th Cir. 1967) ("Where parties deal at arm's length, there is no duty of disclosure where the facts are equally within the knowledge of both parties . . ."); *Simpson Timber Co. v. Palmberg Constr.*

nizing that notions of good faith and fair dealing determine the duty to speak during precontractual negotiations.<sup>517</sup> This suggests that at least some courts believe that our society's mores and business ethics permit the concealment (as long as it is not active), suppression, or nondisclosure of material facts in arm's length business transactions. Although some courts share in this sentiment, this belief is not a true reflection of what the law is or should be in light of the continuing evolution of business ethics that has occurred in the last few decades. In the following subsections this Article will demonstrate that many recent cases involving business transactions show a marked, though admittedly at times carefully worded, movement away from caveat emptor and toward disclosure of all material facts. Next, the Article will demonstrate that the rationale or justifications behind good faith disclosures support disclosure of all material facts by the seller of a business.

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Co., 377 F.2d 380, 385 (9th Cir. 1967) (applying Washington law, the court ruled that "businessmen dealing at arm's length are rarely under a duty to speak"); Bank of Red Bay v. King, 482 So. 2d 274, 285 (Ala. 1985) ("When both parties are intelligent and fully capable of taking care of themselves and dealing at arm's length, with no confidential relations, no duty to disclose exists when information is not requested, and mere silence is then not a fraud. There must be active concealment or misrepresentation.") (citations omitted); Universal Inv. Co. v. Sahara Motor Inn, Inc., 619 P.2d 485, 487 (Ariz. Ct. App. 1980) (ruling that in an arm's length transaction there is no special relationship that gives rise to a duty to disclose); Banks v. Salina, 413 So. 2d 851, 852 (Fla. Dist. Ct. App. 1982) (explaining that "there is no duty to disclose when parties are dealing at arm's length") (citation omitted). Furthermore, in *London v. Courduff*, the court declared:

It is settled law in New York that the seller of real property is under no duty to speak when the parties deal at arm's length. The mere silence of the seller, without some act or conduct which deceived the purchasers, does not amount to a concealment that is actionable as a fraud . . . . The buyer has the duty to satisfy himself as to the quality of his bargain pursuant to the doctrine of *caveat emptor*.

*London v. Courduff*, 529 N.Y.S.2d 874, 875 (N.Y. App. Div. 1988) (citations omitted); see also *Blon v. Bank One, Akron, N.A.*, 519 N.E.2d 363, 367 (Ohio 1988) ("Ordinarily in business transactions where parties deal at arm's length, each party is presumed to have an opportunity to ascertain relevant facts available to others similarly situated and, therefore, neither party has a duty to disclose material information to the other.") (citations omitted); *Tokarz v. Frontier Fed. Sav. and Loan Ass'n.*, 656 P.2d 1089, 1094 (Wash. Ct. App. 1982) (stating that "[o]rdinarily, the duty to disclose a material fact exists only where there is a fiduciary relationship and not where the parties are dealing at arm's length") (citations omitted).

<sup>517</sup> For example, relatively recent decisions from Alabama, Florida, New York, Ohio, and Washington have all followed the traditional rule that there is no duty of disclosure in arm's length business transactions. See *supra* note 516. Courts from all of those states have, however, recognized on various other occasions that the duty of good faith and fair dealing determines when a duty to speak arises. See *supra* section IV. E. 1.

*B. Movement Away from Caveat Emptor Toward Disclosure*

Recent cases dealing with non-disclosures in the context of the sale of a business can be broken down roughly into three categories. The first category of cases appears to support the traditional rule that allows sophisticated businessmen in an arm's length transaction to remain silent. Even in these cases, however, the courts have suggested that the rule applies only when the facts are open or available to both parties. A second category of cases gives lip service to the traditional rule, but appears to apply more scrupulous moral and ethical standards by requiring disclosures in instances where a more traditional application of caveat emptor would not have found an actionable wrong. A final category of cases appear to dispense with caveat emptor entirely.

1. The modified traditional rule—there is no duty to disclose when the facts are available to both parties

Two relatively recent cases from the Supreme Courts of South Dakota and New Mexico follow the traditional rule of caveat emptor. Neither of these jurisdictions had adopted the good faith duty of disclosure standard. In *Taggart v. Ford Motor Credit Co.*, the South Dakota Supreme Court upheld a summary judgment that concluded that neither Ford Motor Company (Ford) nor Ford Motor Credit Company (Ford Credit) owed a duty to reveal negative financial information to a prospective dealer who purchased a Ford farm machinery and implement dealership from the former individual owners of the franchise with financing by Ford Credit.<sup>518</sup> The court held that even if Ford and Ford Credit knew of the unstable financial condition of the dealership during the negotiations and declined to disclose that fact, there was no duty of disclosure because "[t]his court has never imposed a duty to disclose information on parties to an arm's-length business transaction, absent an employment or fiduciary relationship."<sup>519</sup> The *Taggart* court stressed that the buyer of the dealership was "an experienced businessman capable of taking adequate precautions to protect himself in his business transactions."<sup>520</sup> The court further emphasized that the buyer hired able counsel to represent him in his negotiations. Another important, and perhaps dispositive, fact was that Ford and Ford Credit were not parties to the sales transaction; plaintiffs did

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<sup>518</sup> 462 N.W.2d 493 (S.D. 1990).

<sup>519</sup> *Id.* at 499 (citation omitted).

<sup>520</sup> *Id.* at 500.

not even request any information from Ford or Ford Credit.<sup>521</sup> Plaintiffs bought the franchise from the former owners and engaged in only minimal contact with Ford and Ford Credit. Moreover, the court noted that plaintiff, independently of defendants, had received extensive financial information about the dealership, including a financial report prepared by accountants, showing that the dealership had contingent liabilities of over \$1,000,000.<sup>522</sup> Consequently, the court found that Ford and Ford Credit did not owe the buyer a duty to protect his interests.<sup>523</sup>

Similarly, in *Wilburn v. Stewart*, the New Mexico Supreme Court refused to hold that the seller had a duty to disclose the true value of the assets of the corporation being sold merely because of the relative imbalance of knowledge between the parties.<sup>524</sup> The court stressed that sophisticated parties, with access to the records of the corporation and an opportunity to conduct an independent investigation, conducted an arm's length business transaction.<sup>525</sup> The court also noted the absence of allegations of any fraudulent or willful activity, as well as the absence of any "special relationship or trust that would create a duty" of disclosure.<sup>526</sup> Finally, the court stated that the purchasers included an attorney who was given the opportunity to inspect the books of the corporation. In fact, the court pointed out, the purchasers conducted their own investigation and worked in the business for six weeks before the sale was consummated.<sup>527</sup>

2. Authority that ostensibly follows but which suggests discomfort with caveat emptor

A number of cases continue to use the rubric of caveat emptor, but evidence a movement away from that doctrine. Some cases have applied the superior knowledge doctrine to the sale of a

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<sup>521</sup> *Id.*

<sup>522</sup> *Id.* at 497.

<sup>523</sup> *Id.* at 500.

<sup>524</sup> 794 P.2d 1197, 1200 n.2 (N.M. 1990).

<sup>525</sup> *Id.*

<sup>526</sup> *Id.*

<sup>527</sup> *Id.* at 1198, 1200 & n.2. Other cases apply the same law. *See, e.g.,* *Duke v. Jones*, 514 So. 2d 981, 984 (Ala. 1987) (citing *Trio Broadcasters, Inc. v. Ward*, 495 So. 2d 621, 624 (Ala. 1986)) (finding that in negotiations involving the purchase of a business, there is no duty "to disclose [facts] where the parties to a transaction are knowledgeable and capable of handling their own affairs"); *Lowder Realty, Inc. v. Odom*, 495 So. 2d 23, 26 (Ala. 1986) (ruling, in the context of a business merger, that there is no duty of disclosure where the transaction is at arm's length and where each party was astute in business matters and was equally capable of protecting its respective business interests).

business between apparently sophisticated parties. In *Smith v. Peterson*, for example, the sellers of a lounge business and real estate were found guilty of fraud for failing to reveal to the purchaser that a nearby road was going to be widened, which would cause a loss of access to the lounge and presumably a loss of business.<sup>528</sup> The court held that even in an arm's length transaction, the sellers of a business must reveal important matters relative to the business where the seller has "superior knowledge of facts, resulting in an inequality of condition or knowledge between the parties."<sup>529</sup> There was no indication in *Smith* that a reasonable investigation, which could have been limited to public records, could not have discovered the widening of the road.

Likewise, in *Young v. Keith*, the court held that a purchaser stated a cause of action against the sellers of a mobile park for the sellers' failure to reveal to the purchaser that the water and sewer systems for the mobile park were in serious need of repair.<sup>530</sup> The court noted that the purchasers had bought an on-going business and that the sewer and water deficiencies required expensive reconstruction and posed a threat to the business's operating license. In addition, the court also observed that the purchasers had alleged that they could not have discovered the deficiencies in the sewer and water systems through a reasonable inspection. The court held that there is a duty to disclose "when one party to a contract has superior knowledge which is not available to both parties."<sup>531</sup>

Applying the superior knowledge doctrine to cases involving arm's length transactions between sophisticated businessmen, particularly when the facts may be discovered in a reasonable investigation, which appears to have been the case in *Smith*, is tantamount to a complete rejection of caveat emptor. After all, the only material facts that a seller could be liable for failing to disclose are ones that are based on "superior knowledge." Saying that someone has superior knowledge of material facts is simply stating an obvious prerequisite in all nondisclosure cases—that the other party is unaware of the facts. And if that is coupled with the circumstance that the facts are available to be discovered in a reasonable investigation, then a requirement to disclose such facts is a complete rejection of caveat emptor.

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<sup>528</sup> 282 N.W.2d 761, 767 (Iowa Ct. App. 1979).

<sup>529</sup> *Id.* (citations omitted).

<sup>530</sup> 492 N.Y.S.2d 489, 490-91 (N.Y. App. Div. 1985).

<sup>531</sup> *Id.* at 491 (citation omitted).



While the *Young* court noted that the facts were alleged to have been available to both parties, even that case evidences a shift away from caveat emptor. The most extreme formulation of caveat emptor applied the doctrine regardless of whether the facts were latent or discoverable.<sup>532</sup> Even when facts are not readily discoverable in an independent investigation, sophisticated businessmen usually know what they ought to inquire about from the other party and thereby have the wherewithal to learn of the facts. This may be one reason why some courts have stated that there is no duty to disclose facts in arm's length transactions regardless of the discoverability of the facts. *Young* appears to reject this position and certainly has moved away from the most extreme formulations of caveat emptor.<sup>533</sup>

In *White v. Pepin*, the Supreme Court of Vermont ruled in favor of a disappointed purchaser who had acquired a corporation in a transaction consummated after only brief negotiations.<sup>534</sup> The purchaser claimed that the seller had a duty to disclose his knowledge of certain problems that the purchaser did not encounter until after the sale. The court acknowledged that under Vermont law, when facts are equally obtainable by both parties, neither party was required to speak in the absence of inquiry. The court held that where an appropriate relationship exists between the parties, however, a duty to disclose does arise.<sup>535</sup>

After noting that the trial court had correctly characterized the sale in question as an arm's length transaction because the parties were two sophisticated businessmen with no previous relationship, the court nevertheless held that a duty of disclosure during negotiations existed because the seller had asked the buyer to

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<sup>532</sup> E.g., *Swinton v. Whitinsville Sav. Bank*, 42 N.E.2d 808 (Mass. 1942) ("The law has not yet, we believe, reached the point of imposing upon the frailties of human nature [a duty to disclose a nonapparent material defect known to the seller] . . . . The rule of nonliability for bare nondisclosure has been stated and followed by this court . . . .") (citations omitted).

<sup>533</sup> Other cases have also applied the superior knowledge doctrine to cases involving arm's length transactions. Although these cases pay lip service to caveat emptor, they cannot be reconciled with that doctrine. See *supra* Section IV. 5. and accompanying text for a discussion of these cases.

<sup>534</sup> 561 A.2d 94, 98 (Vt. 1989). The negotiations lasted only one weekend in duration. *Id.*

<sup>535</sup> The court noted:

While there is no general duty to disclose facts absent inquiry, this Court has consistently held that liability for non-disclosure will arise when there is "some duty, legal or equitable, arising from the relations of the parties, such as that of trust or confidence or superior knowledge or means of knowledge."

*Id.* at 96 (quotation omitted).

move rapidly. Referring to this accelerated process, the court asserted that "[i]t is precisely this kind of conduct which gives rise to an equitable duty to disclose all material facts and information."<sup>536</sup> The court stressed that the purchaser had been placed in a position where it was impossible, if he wanted to make a deal, to make any investigation other than what he did, which was to examine the books and records of the corporation provided by the seller, to tour the factory on two separate occasions, and to question the seller and other company representatives as to the liability of the business.<sup>537</sup>

The *White* case demonstrated that even in arm's length business transactions, courts are willing to bend the rules to require disclosures when good faith and fair dealing require them. Although the *White* court indicated that the seller of the business placed the purchaser in a position where it was impossible to make a satisfactory investigation, the court might with equal validity have concluded that the purchaser voluntarily accepted the risk created by the inability to investigate. After all, the purchaser did not have to purchase the company or go forward with the sale under any terms. Nothing was forced upon the purchaser; he acquiesced in the timing of the transaction. Thus, it might be concluded that the purchaser was just as responsible for the inability to investigate as was the seller. Why then shouldn't the traditional caveat emptor rules apply? It is submitted that the reason the traditional rules were not applied in *White* was because the court did not believe it was fair or reasonable to do so under the circumstances of the case. *White* appears to be an attempt to draw away from the older rules without admitting that this is what is happening.

Other cases have also appeared to bend or even break the traditional rules in arm's length transactions without admitting that this has occurred. The United States Court of Appeals for the Eighth Circuit, for instance, in *American Family Service Corp. v. Michelfelder*, held that lawyers representing the sellers of a business were guilty of fraud for not disclosing to the prospective purchaser and/or its attorneys that the sellers were also negotiating with another firm in violation of a no-shop clause in a letter of intent that the parties had signed.<sup>538</sup> The sellers' lawyers were faulted, among other reasons, for not revealing a draft agreement the seller had with another party when the prospective purchaser's lawyers had

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<sup>536</sup> *Id.* at 97.

<sup>537</sup> *Id.* at 98.

<sup>538</sup> 968 F.2d 667, 672-74 (8th Cir. 1992).

requested all major acquisition agreements involving the business.<sup>539</sup> This case demonstrates that some courts are willing to uphold a higher standard of good faith and fair dealing on parties to business transactions.<sup>540</sup>

In *In re Jogert, Inc.*, the United State Court of Appeals for the Ninth Circuit also went out of its way to find that a real estate agent involved in the sale of a lumberyard was guilty of fraud under California law.<sup>541</sup> In that case, plaintiff acquired all of the stock of the lumberyard from its three shareholders.<sup>542</sup> A real estate agent with Coldwell Banker acted as the seller's broker.<sup>543</sup> After the sale, plaintiff alleged that the sellers and the real estate agent had misrepresented the lumberyard's financial condition.<sup>544</sup> The court found that the real estate agent had misrepresented the profitability and cash flow of the lumberyard and rejected the agent's argument that any false representations were immaterial because plaintiff had a duty to perform an investigation of the lumberyard's finances on its own, which it performed with the assistance of experts, and was charged with knowing what a reasonable investigation would have revealed.<sup>545</sup> The agreement between the sellers and plaintiff also had an integration clause and incorporated financial statements that contradicted the real estate agent's alleged misrepresentations.<sup>546</sup>

Nevertheless, the court held that the real estate agent could not rely upon the integration clause of the purchase agreement because he was not a party to that agreement.<sup>547</sup> In addition, while the court acknowledged that plaintiff had conducted an extensive eight month investigation with the help of a lawyer, broker and financial advisor, the court still found that the real estate agent

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<sup>539</sup> *Id.* at 673.

<sup>540</sup> The traditional position is that lawyers and accountants do not have to reveal the fraudulent conduct of their clients to opposing parties in arm's length sales transactions. *E.g.*, *Schatz v. Rosenberg*, 943 F.2d 485, 490 (4th Cir. 1991) (finding that the lawyers representing the purchaser of a business had no obligation to reveal to the seller that the purchaser was having financial difficulties which made it unlikely that the purchaser could pay the seller on promissory notes given by the purchaser to the seller for the business); *LHLC Corp. v. Cluett, Peabody & Co.*, 842 F.2d 928, 932-33 (7th Cir. 1988) (finding that accountant had no obligation under the security laws to reveal that its client, the seller of a business, had given to the purchaser allegedly incorrect information about the inventory of the business).

<sup>541</sup> *In re Jogert, Inc.*, 950 F.2d 1498, 1507 (9th Cir. 1991).

<sup>542</sup> *Id.* at 1500.

<sup>543</sup> *Id.*

<sup>544</sup> *Id.*

<sup>545</sup> *Id.* at 1505-07.

<sup>546</sup> *Id.* at 1506.

<sup>547</sup> *Id.*

could be held guilty of fraud because the real estate agent had "mesmerized" the plaintiff.<sup>548</sup> The court noted that even though plaintiff had the books and records of the company, which showed its true financial position, the agent had told plaintiff that the books and records were flawed.<sup>549</sup> The court noted that the agent had held himself out as an expert with superior knowledge of the lumberyard's financial condition.<sup>550</sup> In any event, the court ruled that even if a proper investigation on behalf of the plaintiff would have revealed the truth, no defrauder should benefit because he dealt with an ignorant and gullible person.<sup>551</sup>

3. The duty to disclose all material facts is required by good faith and fair dealing

In *Green Spring Farms v. Spring Green Farm Associates Ltd. Partnership*, a court of appeals in Wisconsin decided that notions of justice, equity and fair dealing should be used to determine when disclosures ought to be made.<sup>552</sup> The case dealt with the arm's length sale of a dairy farm to investors. The purchasers of the farm alleged that the sellers were guilty of fraud for failing to disclose an outbreak of salmonella bacteria in the dairy livestock two years before the sale. Although some of the court's analysis may have been based on the real estate nature of the transaction, the court's reasoning was not limited to that context, because the case also involved the sale of a business. The court noted that strict application of the doctrine of caveat emptor was being abandoned in favor of a more enlightened rule and that business ethics had changed to follow "more stringent requirements of fair dealing."<sup>553</sup> The court abandoned caveat emptor and held that sellers of real estate must disclose all material facts that the "purchaser is in a poor position to discover."<sup>554</sup>

Another recent case also suggests that the buyer of a business owes a duty of good faith and fair dealing to the seller to reveal all material information concerning the transaction that fairness would require. In *Heineman v. S & S Machinery Corp.*, a United

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<sup>548</sup> *Id.* at 1505.

<sup>549</sup> *Id.* at 1506-07.

<sup>550</sup> *Id.* at 1507.

<sup>551</sup> *Id.*

<sup>552</sup> 492 N.W.2d 392, 396-97 (Wis. Ct. App. 1992) (quotation and citations omitted).

<sup>553</sup> *Id.* at 397 (citation omitted). The court stated that "[t]he doctrine of *caveat emptor* no longer excuses real estate sellers from fully disclosing to potential purchasers the existence of conditions which may be material to the decision to purchase and which the purchaser is in a poor position to discover." *Id.*

<sup>554</sup> *Id.*

States District Court dealt with the issue of whether the buyer of a business had a duty of good faith and fair dealing to disclose material facts during negotiations, even when there may have been no traditional, flagrant misrepresentation and no special fiduciary relationship between the parties.<sup>555</sup> In *Heineman*, plaintiff, the former owner of a corporation, sued an acquiring corporation and its individual officers for fraud and breach of contract. During the course of negotiations, among other things, defendant company promised that it would guarantee certain indebtedness of plaintiff's company. Shortly before the execution of a stock purchase agreement, plaintiff learned that defendant company, which was originally to purchase the stock, had decided that one of its subsidiaries, which had insubstantial assets, would do so. Plaintiff permitted the change and later sought recovery.

The *Heineman* plaintiff conceded that he had agreed to the purchase of his company's stock without inquiring into the financial status of the subsidiary and without verifying its assets. Defendants argued that in an arm's length business transaction involving no special relationship between the parties, there is no affirmative duty of disclosure, and plaintiff could not base a fraud claim on plaintiff's own failure to make a simple inquiry with regard to information that would have been made available upon request. In response to these arguments, the *Heineman* court noted the trend toward imposing a duty of disclosure even when there is no fiduciary relationship between the parties. The court supported this assertion by quoting from *Gaines Service Leasing Corp. v. Carmel Plastic Corp.*,<sup>556</sup> wherein the court explained that:

We decline to endorse the "dubious business ethics of bargaining transactions with which deceit was first concerned." . . . It is no longer acceptable, if it ever was, to conclude in knowing silence, a transaction damaging to a party who is mistaken about its basic factual assumptions when . . . he "would reasonably expect a disclosure."<sup>557</sup>

In addition, the *Heineman* court cited Professor Prosser for the proposition that "the law appears to be working toward the ultimate conclusion that full disclosure of all material facts must be made whenever elementary fair conduct demands."<sup>558</sup> Although the court suggested that it would have been difficult, if not impossible, for plain-

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<sup>555</sup> 750 F. Supp. 1179 (E.D.N.Y. 1990).

<sup>556</sup> 432 N.Y.S.2d 760, 762-63 (N.Y. Civ. Ct. 1980), *aff'd*, 453 N.Y.S.2d 391 (1981).

<sup>557</sup> *Id.* (citations omitted).

<sup>558</sup> *Id.* (quoting WILLIAM PROSSER, HANDBOOK OF THE LAW OF TORTS § 106, at 698 (4th ed. 1971)).

tiff to verify independently the financial status of defendant's subsidiary,<sup>559</sup> the court seemed oblivious to the fact that a sophisticated, intelligent businessman in plaintiff's position should have been wary of the last minute decision by the purchaser to have its subsidiary buy the company, and that plaintiff could have discovered the subsidiary's financial condition by asking for its financial statements and capitalization. In light of the court's finding that defendants' conduct was unreasonable and unfair, and that the traditional caveat emptor rules would not apply, the court probably deemed the foregoing facts as unimportant.

Subsequently, in *Minpeco, S.A. v. Conticommodity Services, Inc.*, the court cited *Gaines Service Leasing Corp.* with approval, and in addition cited the same language from Professor Prosser's work that the *Gaines* court had earlier relied upon.<sup>560</sup> Moreover, the *Minpeco* court referred to Justice Blackmun's dissent in *Chiarella v. United States*,<sup>561</sup> in which the Justice wrote:

Even at common law, . . . there has been a trend away from strict adherence to the harsh maxim *caveat emptor* and toward a more flexible, less formalistic understanding of the duty to disclose. Steps have been taken toward application of the "special facts" doctrine in a broader array of contexts where one party's superior knowledge of essential facts renders a transaction without disclosure inherently unfair.<sup>562</sup>

Cases citing *Heineman* and/or *Minpeco, S.A.* have not read either case broadly to support the proposition that those engaged in a business transaction must disclose all material facts concerning the transaction that good faith and fair dealing would require. In *Brass v. American Film Technologies*, for example, the court acknowledged, by citing *Heineman* and *Minpeco, S.A.*, that "New York courts appear to be expanding the duty to disclose, even where no fiduciary relationship can be established."<sup>563</sup> The *Brass* court, however, suggested that this duty of disclosure was especially likely to arise only "when the defendant engaged in conduct that deceived the plaintiff."<sup>564</sup>

Furthermore, in *Congress Financial Corp. v. John Morrell & Co.*, the court suggested that the *Heineman* decision was simply an application

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<sup>559</sup> *Id.* at 1187.

<sup>560</sup> 552 F. Supp. 327, 337-38 (S.D.N.Y. 1982).

<sup>561</sup> 445 U.S. 222 (1980).

<sup>562</sup> *Minpeco, S.A.*, 552 F. Supp. at 338 (quoting *Chiarella*, 445 U.S. at 248) (other citations omitted) (Blackmun, J., dissenting).

<sup>563</sup> No. 91-CIV-5395, 1992 WL 47982, at \*4 (S.D.N.Y. March 2, 1992).

<sup>564</sup> *Id.*

of the "special facts" doctrine.<sup>565</sup> The court explained that the "special facts" doctrine required that one party have superior knowledge not readily available to the other party who is known to be mistaken as to the facts.<sup>566</sup> Applying that law, the court found that there could be no recovery when the respective parties had access to all relevant information and failed to exercise diligence to discover allegedly omitted information.<sup>567</sup> Under such circumstances, the court explained, there is no duty of disclosure.

It is not surprising that the recent cases dealing with arm's length transactions involving the sale of a business seem to be split on the duty to disclose. This split is understandable because notions of what disclosures are required by good faith and fair dealing may differ and because any precedent as ingrained as caveat emptor, particularly in arm's length transactions, will be discarded gradually. There is, however, agreement on two points: (1) there is no duty to disclose obvious facts, and (2) regardless of the expertise of the parties, a duty to disclose arises if the material facts cannot be reasonably discovered under the circumstances of the negotiations in question. Some cases go further and suggest that material facts should be disclosed even though a diligent or reasonable inquiry may have led to the discovery of those facts. In either case, it is noteworthy that recent cases are not applying the strictest forms of caveat emptor, i.e., that silence is never actionable, even with regard to nonapparent conditions, as long as there are no affirmative misrepresentations or active concealment.

*C. Rationale of Good Faith Disclosures Supports Disclosure of all Material Intrinsic Facts*

The trend toward discarding caveat emptor, even in arm's length business transactions involving the sale of a business, is supported by the various reasons set forth for requiring disclosures reviewed in section IV above. To appreciate this point, it is first helpful to understand the information that the typical buyer ought to know before purchasing a business.

Businesses are acquired most frequently through an asset acquisition.<sup>568</sup> If the business is a corporation, the buyer may also have the option of purchasing the company by acquiring all of its stock, and if the buyer is also a corporation, a merger or consolida-

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<sup>565</sup> 790 F. Supp. 459, 473 (S.D.N.Y. 1992).

<sup>566</sup> *Id.* (citing *Aaron Ferer & Sons, Ltd. v. Chase Manhattan Bank, N.A.*, 731 F.2d 112, 123 (2d Cir. 1984)). See *supra* note 253 and accompanying text.

<sup>567</sup> *Id.* at 474.

<sup>568</sup> FRANK L. BRUNETTI & STANLEY J. YELLIN, *BUSINESS ACQUISITIONS: TAX & LEGAL GUIDE* ¶ 202 (1987) [hereinafter BRUNETTI & YELLIN].

tion may be possible. A stock purchase is often not the preferred method of acquisition because it exposes the purchaser to "hidden, contingent, or unknown liabilities."<sup>569</sup> In any event, in either an asset acquisition or stock purchase of a business, it is well recognized that the typical buyer ought to be informed of or know the following information and facts about the business:

- (1) The financial history of the business, including its past stability, growth, and diversity of operations;<sup>570</sup>
- (2) The profit and loss statements, balance sheets, and tax returns;<sup>571</sup>
- (3) Tax and audit history;<sup>572</sup>
- (4) Contracts and other agreements;<sup>573</sup>
- (5) Credit history;<sup>574</sup>
- (6) Good will, including reputation or prestige of business and ownership of trade or brand names.<sup>575</sup>

In addition, the buyer should also be given a detailed description of the assets that are to be purchased.<sup>576</sup> If a major part of the inventory of a business involves the sale of merchandise from inventory, the seller will have to comply with the Bulk Sales Act, which requires the seller to furnish a list of creditors and a schedule of property to be transferred.<sup>577</sup> The buyer must give notice of a bulk sale to all creditors.<sup>578</sup>

In a stock purchase, the buyer should also be aware or informed of additional facts. The buyer should be informed of the corporation's history and should be given access to the corporation's minute books, articles of incorporation, by-laws, certificate of incorporation

<sup>569</sup> *Id.* ¶ 203. See also HOWARD L. WEINREICH, *Contract of Sale, in Drafting Agreements For The Sale Of A Business*, ¶ 5,202A (1971).

<sup>570</sup> BRUNETTI & YELLIN, *supra* note 568, ¶¶ 201.2, 201.4(A).

<sup>571</sup> *Id.* ¶ 201.2(B); Lawrence S. Bangser, *Negotiations and Planning, in 1 BUSINESS ACQUISITIONS: PLANNING AND PRACTICE* § 1.202a (1971) [hereinafter BANGSER]; Willard D. Horwick & Harry C. Sigman, *Collecting Information, in DRAFTING AGREEMENTS FOR THE SALE OF A BUSINESS*, §§ 1.19, 1.20, 1.21, 1.22, 1.23 (1971) (hereinafter Horwick & Sigman); David A. Savner & Julia A. Foster, *Preliminary, Corporate Law, and Contractual Considerations in the Purchase and Sale of a Business, in BUYING AND SELLING BUSINESSES*, ¶¶ 1.7, 1.8, 1.9, 1.10, 1.11, 1.12 (1990) [hereinafter SAVNER & FOSTER].

<sup>572</sup> BRUNETTI & YELLIN, *supra* note 568, ¶ 201.2(C); Savner & Foster, *supra* note 571, § 1.11, 1.12.

<sup>573</sup> BRUNETTI & YELLIN, *supra* note 568, ¶ 201.2(D); Savner & Foster, *supra* note 571, § 1.13; Horwick & Sigman, *supra* note 571, § 1.61.

<sup>574</sup> BRUNETTI & YELLIN, *supra* note 568, ¶ 201.2(E).

<sup>575</sup> *Id.* ¶ 201.4(E).

<sup>576</sup> *Id.* ¶ 202.2(A).

<sup>577</sup> *Id.* ¶ 202.3; Savner & Foster, *supra* note 571, ¶ 1.65. See also UCC §§ 6-102, 6-104 (1991).

<sup>578</sup> UCC § 6-105 (1991).



and registrations to transact business.<sup>579</sup> Additionally, in a stock purchase, the buyer should be informed of other facts because the buyer will be subject to all liabilities of the seller's company, whether known or unknown. Thus, the buyer should be informed of all outstanding or threatened litigation, potential liabilities, debts, contracts, leases, insurance, licenses, pension plans, and agreements.<sup>580</sup>

In most instances, the foregoing information will be sought out and discovered by the buyer or experts hired by the buyer, such as an attorney or accountant, prior to the consummation of the sale of the business. But what if the buyer has not discovered or made sufficient inquiries to discover all of the material information related to the sale of the business set forth above? In such a case, does the seller have the duty to disclose such information even when the parties are dealing at arm's length? Do current business ethics allow the seller to take advantage of the buyer's ignorance, mistakes and/or indolence? Does it matter whether a reasonable investigation could have produced the information?

As set forth in the preceding section, many courts still apply the doctrine of caveat emptor in arm's length transactions involving the sale of a business. There are, however, sound reasons why the doctrine should be discarded in the sale of a business.<sup>581</sup>

First, when a business is purchased, the buyer is typically purchasing an ongoing commercial venture that may include a financial track record, books and records, a product or products (or services), existing customers or business opportunities, debts and obligations and other contracts and agreements. Because a buyer of a business is, in effect, purchasing all relevant information and facts concerning the business, including confidential information, if there is any, it follows

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<sup>579</sup> BRUNETTI & YELLIN, *supra* note 568, ¶¶ 201.2, 201.2(A), 201.2(B); Horwick & Sigman, *supra* note 571, § 1.33, 1.42 to 1.44; Savner & Foster, *supra* note 571, § 1.23.

<sup>580</sup> BRUNETTI & YELLIN, *supra* note 568, ¶ 203.1; Horwick & Sigman, *supra* note 571, § 1.15.

<sup>581</sup> The focus of the discussion in the text is on the seller's obligation to disclose material facts to the buyer, although it is recognized that, in certain circumstances, a buyer may as well be subject to disclosure obligations. There are a number of reasons for applying less stringent standards to the buyer's obligation of disclosure. First, it is usually presumed that the seller of a business knows or should know about his own business; therefore, there is no expectation that the buyer ought to disclose his knowledge of the business. Secondly, to the extent a buyer has ascertained information about the business independent of the seller and of which the seller may be unaware, the buyer will probably have expended time and money in discovering such information. Under Professor Kronman's analysis, the buyer should have a right to remain silent about such facts.

A buyer may have, on the other hand, a duty to disclose information, *e.g.*, about his ability to pay. See the discussion of *Heineman*, *supra* Section V. B. 3.

that the seller should provide all such facts and information to the buyer prior to the sale. After all, such information and facts are the subject matter of the sale.

Secondly, although most transactions involving the sale of a business may be at arm's length, the typical transaction involves a considerable amount of cooperation and the free and open exchange of information before it can be consummated. Thus, it would be incorrect to believe that arm's length business transactions are adversarial in nature, a notion that has led courts to suggest that the seller need not disclose facts to the buyer, and to characterize the seller and the buyer as "hostile" and "adversaries." Because this characterization of the sale of a business is generally false, the courts ought to impose heightened disclosure requirements in the sale of a business (at least when the transaction can be characterized as involving cooperation instead of adversity).

Third, even if only the exceptions to the general rule that one has a right to remain silent are applied, it is the rare case in which a court will not be able to find extensive disclosure requirements in the typical sale of a business. This is because in almost every sale of a business the seller will volunteer some information about the business to encourage the sale and to justify the price the seller is requesting. It does not take too much imagination to suggest that this scenario fits within the exception that requires full disclosure of all material facts when a partial disclosure is made. Thus, any information a seller gives to the buyer about a business could be construed to be a partial disclosure requiring a full disclosure of all material facts.

Likewise, as set forth in the preceding subsection, the superior knowledge or the "special facts" doctrine can be applied easily to the sale of a business. The seller will almost always have superior or special knowledge about the business. This knowledge may not be readily available to the buyer without the seller's disclosure of the information. And even if it might be considered available, some courts seem to ignore this requirement, or are willing to find it satisfied in most cases. The most recent cases hold that disclosure of all material facts must occur when there is superior knowledge on the part of one party to a transaction unless the information in question is equally available to the parties. The seller of a business will almost always have better availability of facts about the business than a prospective purchaser, which means that disclosures will be required. To the extent some courts require the seller to know that the buyer was mistaken about the true facts, this may be found by a court merely on the basis of what the buyer paid for the business. If it is obvious from

the price that the business has been sold for an amount that a reasonable purchaser probably would not have paid had he been aware of all of the facts, a court might find that the seller must have, or should have, known of the mistake. Finally, to the extent that an undisclosed fact concerns the ability of a business to continue to function, it is likely that a court will almost always apply the superior knowledge or special facts doctrine.<sup>582</sup>

Fourth, the principles of disclosure enunciated by Verplank support a duty on the part of the seller to reveal the material facts set forth above that are relevant to the sale of a business. All of the above facts are common ones that are widely recognized to fix the market value of a business. Accordingly, it is not surprising that the authorities in the sale of a business all list or discuss most of the material facts set forth above as the ones which should be examined in determining whether a sale of a business should be consummated, and at what price the business should be sold. This, of course, does not mean that the individual seller or purchaser must reveal his own personal assessment or judgment with regard to how the business might be operated or what it is worth. Rather, requiring disclosure of all material facts simply means that the common factors that all parties have recognized to be relevant to determining whether, and at what amount, a business should be sold, should be revealed or open to examination.

Fifth, Professor Kronman's argument that parties negotiating a contract should, in general, disclose information that has been casually acquired, supports disclosure of all material facts relevant to the seller's sale of a business. Of course, the seller may have acquired the information material to a business deliberately and at a cost. The seller, however, will generally acquire this information in the normal course of the seller's business. In other words, the costs of acquiring the information would have been incurred in any case. It is this type of information that Professor Kronman believes should be divulged. Disclosure of such information will not reduce the incentive to produce the information because the operation of the business itself drives the incentive. Moreover, as Professor Kronman has suggested, the seller ought to divulge all material information about a business because the seller is in a better and cheaper position to reveal such information. It does not make economic sense to require the purchaser to engage in a costly independent investigation of the seller's business when the seller has the information and can divulge it at almost no cost.

Finally, at times a business sale involves a letter of intent, followed

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<sup>582</sup> See RESTATEMENT (SECOND) OF TORTS § 551 cmt. k, illus. 10, 11, and 12 (1976).

by a formal purchase agreement, with a postponed closing. Although the absence of a letter of intent does not mean that there is no good faith duty of disclosure in the sale of a business, certainly if there is a letter of intent or other indication of a firm agreement to negotiate a sale, which either requires or is construed to require the parties to negotiate in good faith, then there should be no question that there is also a heightened duty of good faith disclosure.<sup>583</sup> One caveat is important to stress at this point. The duty of good faith negotiation that may arise in the context of the sale of a business based on a letter of intent, or similar agreement, is different from the duty of good faith disclosure. The duty of good faith negotiation relates to actually concluding a sale. Some courts have, therefore, been reluctant to find such a duty, or have circumscribed the duty of good faith in such contexts.<sup>584</sup> This does not mean that the duty of good faith disclosure is

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<sup>583</sup> A number of cases have recognized that a duty of good faith and fair dealing to consummate a deal applies to negotiations for the sale of a business. *E.g.*, *Arnold Palmer Golf Co. v. Fuqua Indus., Inc.*, 541 F.2d 584, 588 (6th Cir. 1976) (determining that there was a factual issue as to whether the parties had contractually bound themselves to prepare a definitive agreement consistent with a "Memorandum of Intent"); *Thompson v. Liquichimica of Am.*, 481 F. Supp. 365, 366 (E.D.N.Y. 1979) (finding that while an "agreement to use best efforts" set forth in a letter does not require the agreement sought to be achieved, it does require the parties in "good faith" to work to achieve it); *Pepsico, Inc. v. W.R. Grace & Co.*, 307 F. Supp. 713, 720 (S.D.N.Y. 1969) (noting, in dicta, that if the parties "agreement in principle" for the purchase by the plaintiff of defendant's 53% stock ownership in the Miller Brewing Company was enforceable, then the "agreement in principle" carried with it the "obligation to negotiate the terms of a definitive agreement in good faith and to execute the contract on the terms that had been agreed upon"); *Itek Corp. v. Chicago Aerial Indus.*, 248 A.2d 625, 629 (Del. 1968) (ruling that a letter of intent "obligated each side to attempt in good faith to reach final and formal agreement").

<sup>584</sup> *E.g.*, *A/S Apothekernes Laboratorium v. I.M.C. Chem. Group*, 873 F.2d 155, 158 (7th Cir. 1989) (ruling that while a letter of intent to purchase a business or the assets of a business is generally not considered a binding contract requiring the parties to consummate a transaction, the terms of a letter of intent may impose upon the parties an obligation to negotiate in good faith); *Runnemed Owners, Inc. v. Crest Mortgage Corp.*, 861 F.2d 1053, 1056 (7th Cir. 1988) (stating that a letter of intent merely provides "the initial framework from which the parties might later negotiate a final . . . agreement, if the deal works out"); *Reprosystem, B.V. v. SCM Corp.*, 727 F.2d 257, 264 (2d Cir. 1984) (recognizing that under some circumstances a party to a contract may be bound by an implied agreement to negotiate in good faith to reach an agreement, the court nevertheless found that the agreement in principle was "too indefinite to be enforceable under New York law"); *Dacourt Group, Inc. v. Babcock Indus., Inc.*, 747 F. Supp. 157, 160 (D. Conn. 1990) (ruling that no duty of good faith can be implied absent an agreement between the parties); *Ridgeway Coal Co. v. FMC Corp.*, 616 F. Supp. 404, 407 (S.D. W. Va. 1985) (finding that although an employee of defendants had sent a letter to plaintiffs specifying conditions that plaintiffs would have to satisfy before a lease would be entered, and although plaintiffs allegedly met those conditions, the court ruled that the letter was simply an agreement to negotiate and that it was not enforceable. Stressing that the alleged agreement was so vague and indefinite that no remedy could be fashioned); *Metromedia Broadcasting Corp. v. MGM/UA*

limited. The duty of good faith disclosure, of course, relates to the revelation of information material to the sale. The reason why the duty of good faith negotiation supports a heightened duty of good faith disclosure is that the duty of good faith negotiation, when it is applicable, puts the parties into a more cooperative and binding framework in which one would more likely expect disclosure of all material facts.<sup>585</sup>

The above analysis does not mean that the seller of a business must specifically remind the buyer of obvious facts, or facts that the seller has every right to believe that the buyer ought to know because of what has been disclosed or what is available through observation.

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Entertainment Co., 611 F. Supp. 415, 420 (C.D. Cal. 1985) (finding a clause in the parties' licensing agreement requiring the defendant to negotiate in good faith exclusively with plaintiff was unenforceable because the agreement to negotiate in good faith was too vague); *Carrols Corp. v. Canton Joint Venture*, No. 88-2115-1, 1990 WL 99047, at \*6-7 (Ohio Com. Pl. June 27, 1990) (ruling that there is no implied duty of good faith and fair dealing in the negotiation of a lease). Numerous other cases have also recognized that the terms of a letter of intent may impose upon the parties an obligation to negotiate in good faith, e.g., *Channel Home Ctrs. v. Grossman*, 795 F.2d 291, 299 (3d Cir. 1986); *Chase v. Consol. Foods Corp.*, 744 F.2d 566, 571 (7th Cir. 1984); *Reprosystem*, 727 F.2d at 264; *Teachers Ins.*, 670 F. Supp. at 499; *Itek*, 248 A.2d at 629. In *I.M.C. Chem.*, however, the Seventh Circuit explained, that what is required by "good faith" depends solely upon the terms of the letter of intent. See *I.M.C. Chem.*, 873 F.2d at 158-59 & n.2 ("The full extent of a party's duty to negotiate in good faith can only be determined, however, from the terms of the letter of intent itself."). The Seventh Circuit further explained that the duty of good faith that a letter of intent may impose upon parties negotiating the terms of a purchase agreement is not the same as the implied duty of good faith and fair dealing that is read into almost all contracts. *I.M.C. Chem.*, 873 F.2d at 159-60 n.2; see also *Channel Home Ctrs.*, 795 F.2d at 299 n.8; *Teachers Ins.*, 670 F.2d at 498. The contract duty of good faith and fair dealing in the performance of contracts requires the use of "reasonable efforts" in carrying out its terms, but the good faith duty imposed by a letter of intent only requires the exercise of good faith as specifically set forth by the letter of intent. Most recently, in *First Nat'l Bank v. Atlantic Tele-Network*, the Seventh Circuit stated that in general there is "no duty to bargain in good faith over the terms of a contract." *First Nat'l Bank v. Atl. Tele-Network*, 946 F.2d 516, 520 (7th Cir. 1991). The court also noted that "the duty of good faith is weak in the formation stage, if indeed it can be said to exist at all there." *Id.*

<sup>585</sup> In an interesting recent English Case, *Walford v. Miles* [1992] All E.R. 453, the House of Lords disapproved *Channel Home Centers v. Grossman*, 795 F.2d 291 (3d Cir. 1986), which recognized that a letter of intent may impose upon the parties a duty to negotiate in good faith. Their Lordships stated that "[t]he concept of a duty to carry on negotiations in good faith is inherently repugnant to the adversarial position of the parties when involved in negotiations." This case does not deal with good faith disclosures and does not recognize the cooperation between those negotiating the sale of a business in terms of the exchange of information that is typically a necessary part of such transactions. The parties may be adversarial in the sense that they both want to obtain the best deal, and in most instances can terminate negotiations at any time, but they are not adversarial in that both expect the other to act in good faith in divulging material that is necessary to conclude the transaction.

The seller may take into account the sophistication and intelligence of the buyer in determining what is an "obvious fact," and what the buyer ought to know. While the modern trend, which does not require a duty of investigation before reliance on a misrepresentation or omission is justified, should be applied in the sale of a business, the seller does not have to reveal facts that are obvious to a sophisticated buyer.

Professor Farnsworth has articulated one of the strongest objections to the notion that all material facts should be disclosed in the sale of a business. According to Professor Farnsworth, parties involved in negotiations are often competitors. Therefore, it might be inappropriate to reveal confidential information during negotiations.<sup>586</sup> Professor Farnsworth also concluded that there was little necessity for requiring extensive disclosure requirements when sophisticated parties can, and typically do, deal with these matters themselves. Of course, Professor Farnsworth was correct in recognizing that sophisticated parties involved in the sale of a business do generally deal with the issue of disclosures on their own. The issue is, however, how the law should handle the situation when the parties do not expressly deal with the issue.

For the reasons set forth above, when the parties to a transaction do not privately determine disclosure standards, all material facts should be revealed. Likewise, the issue of confidential information is not a sufficient reason to permit parties to be silent with regard to material information. First, depending on the circumstances, it may be appropriate for the seller to withhold confidential information until it has become clear that the buyer is serious and that a deal will probably be struck. Secondly, the parties will know whether they are dealing with confidential information that should be protected. In that case, the parties can enter into an enforceable confidentiality agreement. Thus, the fact that there may be confidential information should not be a basis to absolve a seller of a business from revealing all material facts to the buyer.

## VI. CONCLUSION

For over 100 years, disclosures have been recognized in the United States as being required in contract negotiations to the extent that one is bound by good faith and fair dealing to disclose information material to the transaction. What disclosures are required by good faith, and the extent of required disclosures has

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<sup>586</sup> Farnsworth, *supra* note 55, at 278.

been in flux, but the notion has expanded as society's understanding of the requirements of good faith has changed.

Late in the last century and earlier in this century, the courts generally found that the dictates of good faith permitted parties to remain silent, particularly in arm's length transactions (except in a few circumstances). The exceptions to the rule permitting silence, however, have expanded consistent with the recognition that all parties to a contract owe each other a duty of good faith and fair dealing, the increasing usage of moral and ethical standards to determine legal obligations and the decline of *caveat emptor*.

Although *caveat emptor* has been abandoned in many areas of the law, its last stronghold has been in commercial transactions between sophisticated businessmen. Presumably, such businessmen are savvy enough to look after their own interests. This Article, however, has demonstrated that even in arm's length transactions, the doctrine of *caveat emptor* has lost much of its efficacy. In particular, in the sale of a business, the courts have evinced an increasing discomfort with a harsh or doctrinaire application of *caveat emptor*. There are sound reasons for this discomfort.

Generally, all material facts about a business should be disclosed during the negotiations for the sale of a business because: (1) such facts are typically part of the business being sold; (2) modern business sales usually involve extensive cooperation between the parties raising justified expectations of full disclosures; (3) almost all business sales involve the disclosure of some information about the business indicating that all material information should be, or has been, divulged; (4) the seller almost always has superior knowledge about the business, which is often not as accessible to the buyer; (5) the material facts related to a business sale are widely recognized so that there is generally no confusion as to what factors are relevant to the market value of the business; (6) the seller is almost always in a cheaper and less costly position to reveal material facts about the business and the disclosure of such information will not discourage its production; and (7) if a letter of intent is used or the parties enter a similar agreement to negotiate a sale, a heightened duty of good faith and fair dealing arises that supports disclosure of all material facts about the business.

There are no good reasons to support nondisclosure of material facts in the sale of a business. If confidential information is involved, the information can be protected by agreement of the parties. Implying a duty to disclose all material facts does not impede one's freedom of contract. Freedom is restricted, as was

stated by Professor Corbin, to what "organized society both forbears and enforces, forbears to penalize him for making his bargain and enforces it for him after it is made."<sup>587</sup> The parties can still by agreement disclaim specific individual disclosure requirements provided such disclaimers do not offend the overriding policy of honesty, trust and cooperation, necessary for ethical commercial relationships. Ultimately, the issue boils down to what kind of community we want to live in, and what kind of business ethics should be imposed by law. This Article has endeavored to demonstrate that the ethics of the business community have been evolving to the point where the law should recognize a duty on the parties to reveal all material facts, unless the facts are obvious.

As social understandings of what is commercially reasonable trade develops so that the parties to the sale of a business expect disclosures of all material facts during negotiations, the buyer will buy, and the seller will sell, at a price commensurate with their expectations. To allow nondisclosure of material information in violation of such an understanding will create economic inefficiency. The law ought not require expensive defensive measures to protect against bad faith, and it does not.

The cases reviewed herein, in a variety of factual contexts, suggest that our society as a whole has expanded its notions of good faith and fair dealing. This is consistent with the civil law, and clearly reflects a recognition of the societal benefits to be obtained by the imposition of a duty of good faith and fair dealing.

## VII. APPENDIX: NOTES ON THE PRECONTRACTUAL DUTY OF GOOD FAITH IN ITALIAN AND GERMAN LAW

### A. *Italian Law*

Article 1337 of the *codice civile* (c.c.) provides that the parties in the process of negotiations and formation of the contract must behave according to good faith.<sup>588</sup> Good faith is a limitation on pri-

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<sup>587</sup> CORBIN, *supra* note 27, at 1165.

<sup>588</sup> Many articles, and several books, have been written in the last 40 years in Italy on the precontractual duty of good faith, and of good faith disclosures, and there is a wealth of court cases dealing with this issue. This brief appendix note addresses the general precontractual good faith requirements and is not limited to the area of disclosures. The references are selective, and by no means exhaustive. See generally Giuseppe Grisi, L'OBBLIGO PRECONTRATTUALE DI INFORMAZIONE, Napoli, 1990 (on good faith requirements in the precontractual stage); Luca Nanni, LA BUONA FEDE CONTRATTUALE, Padova, 1988, 1 - 143; Benatti, *Culpa in contrahendo*, in CONTRATTO E IMPRESA, 1987, 287 *seq.*; Francesco Benatti, LA RESPONSABILITA' PRECONTRATTUALE, Milano, 1963. See also Vincenzo Cuffaro, voce "Responsabilità precontrattuale" in EN-



vate autonomy that restricts, during negotiation as well as in execution of a contract, the freedom of the parties; private control of legal transactions is not indiscriminate freedom to act, but freedom to act in good faith. The contracting parties owe each other a duty to disclose all material information of which they have actual or constructive knowledge.<sup>589</sup> Commercial practice shows that

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CICLOPEDIA DEL DIRITTO, XXXIX, Milano, 1988, 1265 *seq.*; Guido Ferrarini, *Investment banking, prospetti falsi e culpa in contrahendo*, Giur. comm., 1988, II 585; Andrea Fusaro, *Fondamento e limiti della responsabilità precontrattuale*, Giur. it., 1984, I.1, 1199; M.-G. Loi & F. Tessitore, *BUONA FEDE E RESPONSABILITA' PRECONTRATTUALE*, Milano, 1975; Salvatore A. Rasi, *La responsabilità precontrattuale*, Riv. dir. civ., 1974, 496; Giovanna Visintini, *LA RETICENZA NELLA FORMAZIONE DEI CONTRATTI*, Padova, 1972, 251 *seq.*; Mario Besone, *Rapporto precontrattuale e doveri di correttezza*, Riv. trim. dir. proc. civ., 1972, 962; Luigi Mengoni, *Sulla natura della responsabilità precontrattuale*, Riv. dir. comm., 1955, I, 360; Franco Carresi, *Introduzione ad uno studio sistematico degli oneri e degli obblighi delle parti nel processo di formazione del negozio giuridico*, Riv. trim. dir. proc. civ., 1949, 822. See discussion of the topic in textbooks on the law of contracts: Pietro Trimarchi, *ISTITUZIONI DI DIRITTO PRIVATO*, 7th ed., Milano, 1986, 312-315, 325; Andrea Torrente & Piero Schlesinger, *MANUALE DI DIRITTO PRIVATO*, 12th ed., Milano, 1986, 519-21; Rodolfo Sacco, *IL CONTRATTO*, in *Trattato di Diritto Civile Italiano* (Vassalli), IV.6, Torino, 1975, 674-77; Francesco Messineo, *IL CONTRATTO IN GENERE*, in *Trattato di Diritto Civile e Commerciale*, XXI.1, Milano 1973, 360-367; Adriano De Cupis, *IL DANNO*, Milano, 1946, 48 *seq.* and *id.* 2d ed., Milano, 1966, I, 95 *seq.* See comment on art. 1337 *c.c.* in Angelo De Martini & Giovanni Ruoppolo, *RASSEGNA DI GIURISPRUDENZA SUL CODICE CIVILE*, IV.2, Milano, 1972, 169 *seq.* Among the recent publications, see further G. Patti, *LA RESPONSABILITA' PRECONTRATTUALE*, in *Cod. civ. comm.*, a cura di P. Schlesinger, Milano 1993 (cited by Benatti, unpublished note to *Walford v. Miles*, *infra* note 595); C. Turco, *INTERESSE NEGATIVO E RESPONSABILITA' CONTRATTUALE*, Milano, 1990 (cited, *e.g.*, by Carbone, *infra* note 605). Cass. 5.6.1948, n. 851, *Foro it. rep.*, 1948, *voce* "Obblig. e contr.," n. 114: "The duty in negotiating a contract is not different from the duty to perform it, which is always the duty of the reasonable man (*buon padre di famiglia*)," App. Bologna 13.4.1950, *Foro it.*, 1950, I, 582 (Annotation by Angelo De Martini, *In tema di silenzio nella conclusione dei contratti*): "Articles 1175 and 1337 *c.c.* have transformed into legal duties what were before only social duties." Santoro-Passarelli summarises:

In order to assure satisfaction of the interest to the contract on the side of those who have conducted themselves in accordance with the other party's behavior, our law establishes an equivalent for the missing or incomplete intent, and this equivalent is in fact the risk for the other party's unfaulty reliance.

Francesco Santoro-Passarelli, *DOTTRINE GENERALI DEL DIRITTO CIVILE*, 6th ed., Napoli 1959, at 147. Specific code provisions on good faith in negotiations are contained in art. 1338 *c.c.* (liability for damages of the party who knows of a cause of invalidity of the contract but does not disclose this to the other who relies without negligence on the validity of the contract), art. 1398 *c.c.* (similar provision in favor of the party that has, without negligence, relied on an agent without powers or who has acted *ultra vires*), and art. 1328 *c.c.* (damages in favor of the offeree who has in good faith initiated performance before receiving notice of the revocation of the offer).

<sup>589</sup> Article 1337 *c.c.* protects, in first place, reliance of a party "in correct and serious negotiations," Cass. 28.1.1972, n. 199, *Foro it.*, 1972, I, 2088 (also reprinted in Nanni, *supra* note 588, at 15 *seq.*). On the duty of precontractual good faith disclosures see Benatti, *Culpa in contrahendo*, *supra* note 588, at 295-96

there is information that both parties can easily obtain using reasonable care. But there is other information that can be acquired only (or, at least, much more easily) by one of the contracting parties. The duty to disclose this information to the other party is one of the principles of good faith embodied in article 1337 (and 1338) c.c.<sup>590</sup>

The *Relazione al codice civile* explains that good faith is the basis for the behavior of the parties during negotiations and formation of the contract, meaning that the parties must deal in the precontractual phase with "a sense of probity . . . having always in mind the purpose which the contract is intended to satisfy, the harmony of the interests of the parties, and the superior interests of the nation requiring productive cooperation."<sup>591</sup> "In the precontractual phase, the breach of this duty leads to a liability *in contrahendo* when one party knows of, but does not reveal to the other, the existence of a cause of invalidity of the contract."<sup>592</sup> Failure to

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[R]esta da affrontare il problema se vanno comunicate, oltre le circostanze che un soggetto conosce, anche quelle che potrebbe conoscere con la normale diligenza, *sempreché, beninteso, l'altra parte non avrebbe potuto conoscerle. La soluzione positiva si deduce da un argomento di ordine sistematico. [I]l legislatore del 1942 ha costantemente equiparato, ai fini del sorgere del dovere di comunicazione, la conoscenza delle circostanze da rendere note alla loro conoscibilità* (citations omitted), at 296. [The problem needs to be addressed whether there is a need to disclose, in addition to the known circumstances, those which could be known applying ordinary diligence, provided, of course, that the other party could not have known them. The positive answer derives from a systematic reasoning. The law of 1942 [the new Civil Code] has constantly equated, with respect to the rise of the duty of disclosure, knowledge of the circumstances to be disclosed to those that could have been known.]

See also Grisi, *supra* note 588, at 11; Benatti, LA RESPONSABILITA' PRECONTRATTUALE, *supra* note 588, at 35 *seq.* See Cass. 30.12.1969, n. 4059, in Nanni, *supra* note 588, at 117 (for an example of a less stringent standard in the case of disclosures on relevant private and professional information by a prospective employee to the prospective employer).

<sup>590</sup> Art. 1337 c.c. may apply if a claim for nondisclosure cannot be based on fraudulent or negligent concealment when one party has concealed a fact which would have prevented the other to go forward with the transaction, had such other party known about it, Cass. 27.10.1961, n. 2425, *Foro it. rep.*, 1961, *voce* "Obblig. e contr.," n. 138. The duty of precontractual good faith also applies to government contracts, Nanni, *supra* note 588, at 23 *seq.*; Sacco, *supra* note 588, at 675; Cass. 8.2.1972, n. 330, *Riv. dir. comm.*, 1975, II, 22, with annotation of Giuseppe Stolfi, *Sulla colpa "in contrahendo" dell'amministrazione pubblica*, Cass. 28.9.1968, n. 3008, *Giur. it. rep.*, 1968, *voce* "Amm. Pubbl.," n. 57, 58, 59; Cass. 30.1.1968, n. 297, *Giust. civ.*, 1968, I, 839.

<sup>591</sup> *Relazione al codice civile*, n. 638, cited in De Martini & Ruoppolo, *supra* note 588, at 170. But see Benatti, LA RESPONSABILITA' PRECONTRATTUALE, *supra* note 588, at 11 (stating cautionary remarks with respect to the political background of the *Relazione*).

<sup>592</sup> *Relazione al codice civile*, n. 638, cited in De Martini & Ruoppolo, *supra* note 588, at 170.

abide by this obligation results in "damages for expenses, lost opportunities to enter into a valid contract, and time wasted in the negotiations which could have been spent in other useful activities."<sup>593</sup>

The *Corte di Cassazione* has thus attempted to describe the ethical ingredients of the duty of good faith:

The need for good faith, taken in its ethical sense, constitutes one of the hinges of the legal discipline of obligations and establishes a *legal duty* in the true sense of the word . . . which is violated not only if one of the parties has acted maliciously to the other party's detriment, but also *when the conduct of said party was not guided by openness, diligent fairness, and a sense of social solidarity*, which are integral parts of good faith; thus, even if the result of mere negligence, or even silence . . . such constitute a transgression of the duty of good faith if suitable to induce reasonable reliance in the other party . . .<sup>594</sup>

The traditional view is that any advance exemption from, or limitation of, liability from breach of the duty of good faith imposed under art. 1337 *c.c.* would be against public policy and, therefore, not permitted under art. 1229(2) *c.c.* It was noted by Professor Benatti that the foregoing statement is too general and needs to be qualified because only those exemptions which are unqualified or wholesale by

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<sup>593</sup> *Id.* n. 638. The Master of the Seal (the Minister of the Italian Department of Justice, in his function as "Chancellor" or keeper of the official seal) said, in his Report regarding the preliminary draft of the new code:

Also new is art. 189 (corresponding to the new code articles 1337 and 1338) which imposes upon the parties, during negotiation and formation of the contract, the duty to deal in good faith. This duty could hardly be derived from the existing law notwithstanding the fact that the duty of good faith dominated the performance of contracts. To have it specifically affirmed here is consistent with the concept of a healthy legal system . . . which draws from the above mentioned principles the need for a minimum of loyalty and honesty even in the free play of private interests. As a result, a party with knowledge of a cause of invalidity of the contract has a duty to disclose this fact to the other: to benefit from the invalid manifestation of the other party notwithstanding the fact that the cause of the invalidity is known is a *contra bonos mores* act comparable to an intentional omission (*dolo di omissione*) since the other party relies, because of lack of knowledge, on an expectation which is bound to be wrong.

*Id.* *Relazione del Guardasigilli all'art. 189 del Progetto preliminare*, n. 163, cited in De Martini & Ruoppolo, *supra* note 588, at 170. The reference to "existing law" is to art. 1124 Civil Code of 1865 ("*I contratti debbono essere eseguiti di buona fede, ed obbligano non solo a quanto è nei medesimi espresso, ma anche a tutte le conseguenze che secondo l'equità, l'uso o la legge ne derivano.*").

<sup>594</sup> Cass. 27.10.1961, n. 2425, *Foro it. rep.*, 1961, *voce* "Obblig. e contr.," n. 138 (emphasis added). See also Cass. 29.2.1960, n. 387, *Foro it. rep.*, 1960, *voce* "Obblig. e contr.," n. 114.

classification would be void, as against public policy, under art. 1229(2) *c.c.* General or wholesale exemptions favor dishonesty and are a serious impediment to the course of dealings in the marketplace while specific exemptions and carefully drawn limitations from individual duties of disclosure should be permissible unless made intentionally or recklessly (*con dolo o colpa grave*), as prescribed by art. 1229(1) *c.c.*<sup>595</sup>

Recently, the duty of good faith disclosures in the precontractual phase has been applied in the context of the sale of securities.<sup>596</sup> The Court of Appeals of Milan held that an intermediary bank (even if not itself the issuer of the prospectus), which had caused by its professional advice prospective clients to transfer their savings from one security to another, had incurred liability of a different type than the one under the general precept in art. 2043 *c.c.* of *neminem laedere* (one shall not injure another), because of reliance and trust. This liability, the court said, is derived from art. 1337 *c.c.* because "*culpa in contrahendo* . . . is intended to assure, in the general interest, the functionality of the market, . . . and the overall flow of trade, besides . . . protecting the individual reliance of the other party."<sup>597</sup>

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<sup>595</sup> For the traditional approach, see, e.g., Massimo Bianca, *La nozione di buona fede quale regola di comportamento contrattuale*, Riv. dir. civ., 1983, I, 206; Stefano Rodotà, *LE FONTI DI INTEGRAZIONE DEL CONTRATTO*, Milano, 1969, 175 *seq.* (cited by Benatti, *Culpa in contrahendo*, *supra* note 588, at 312). For the qualified approach, see Francesco Benatti, *Sulla natura ed efficacia di alcuni accordi precontrattuali*, note to Walford v. Miles [1992] All E.R. 453, unpublished at time of writing, page 6 of manuscript; Benatti, *Culpa in contrahendo*, *supra* note 588, at 308-09. Art. 1229 *c.c.* states:

(1) *E' nullo qualsiasi patto che esclude o limita preventivamente la responsabilità del debitore per dolo o per colpa grave.* (2) *E' nullo altresì qualsiasi patto preventivo di esonero o di limitazione di responsabilità per i casi in cui il fatto del debitore o dei suoi ausiliari costituisca violazione di obblighi derivanti da norme di ordine pubblico.* (footnotes omitted). ((1) Any agreement that excludes or limits in advance the liability of the debtor from intentional misrepresentation or gross negligence is void. (2) Any advance agreement that exonerates or limits liability of the debtor or his agents from breach of duties imposed under public policy is also void.).

It is generally accepted, in Italian law, that the requirement of good faith in all dealings (art. 1175 *c.c.*) and the requirement of good faith in the precontractual stage (art. 1337 *c.c.*) are provisions imposed by public policy.

<sup>596</sup> App. Milano 2.2.1990, Giur. comm., 1990, II, 755, with anonymous note and further references, *affirming*, Trib. Milano 11.1.1988, Giur. comm., 1988, II, 585 (Annotation by Guido Ferrarini). See Giuseppe B. Portale, *Informazione societaria e responsabilità degli intermediari*, Banca borsa, 1982, I, 3; Pietro Abbadesse, *Diffusione dell'informazione e doveri di informazione dell'intermediario*, Banca borsa, 1982, I, 305.

<sup>597</sup> App. Milano 2.2.1990, *supra* note 596, at 762. The court adopted the theory—as had been suggested by several authors—that a person who is not a party to the future contract, e.g., an intermediary, can be subject to the good faith precontractual requirements. See, e.g., Benatti, *Culpa in contrahendo*, *supra* note 588, at 300-01. According to App. Milano, the liability is of contractual nature, and the recoverable lost

Breach of the precontractual duty of good faith disclosures subjects one to liability for damages. In order to assess this liability, the nature of the duty—contractual or extra-contractual—must first be determined. The conditions to be met for obtaining damages are different depending on how the breach of the duty of good faith is characterized because different standards and rules of law apply to those different regimes: requirements of good faith,<sup>598</sup> types of damages,<sup>599</sup> burden of proof,<sup>600</sup> statute of limitation,<sup>601</sup> liability of minors,<sup>602</sup> and others, will vary accordingly.

Most commentators view the nature of this duty as contractual (art. 1218 c.c.).<sup>603</sup> It is argued that art. 1337 c.c. is an extension of the

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profits are those that could have been obtained with reasonable alternate forms of investment. *Id.* at 761, 765. See also *supra* note 37 and accompanying text.

<sup>598</sup> An objective standard of good faith applies in contract; a subjective standard applies to torts. See Mengoni, *supra* note 588, at 362; Benatti, LA RESPONSABILITA' PRECONTRATTUALE, *supra* note 588, at 128.

<sup>599</sup> In contract, the civil sanction is prescribed in art. 1218 c.c. (the debtor who does not exactly perform is liable for damages unless he proves that the non-performance or delay were due to impossibility caused by circumstances not attributable to him), and unforeseeable damages would only be recoverable in case of intentional misrepresentation (*dolo*), art. 1225 c.c. (if the non-performance or delay is not caused by intentional misrepresentation of the debtor, damages are limited to those that were foreseeable at the time when the obligation was undertaken).

<sup>600</sup> In contract, the burden of proving violation of article 1337 c.c. lies with the plaintiff, art. 2697 c.c. (one who intends to pursue a right in court must prove the underlying facts). See Benatti, LA RESPONSABILITA' PRECONTRATTUALE, *supra* note 588, at 155. See Trib. Milano 11.1.1988, Giur. comm., 1988, II, at 600.

<sup>601</sup> In contract, the right to sue is subject to the general limitation period sanctioned in art. 2946 c.c. (as opposed to the shorter periods in tort, see Cass. 19.4.1983, n. 2705, Foro it. rep., 1983, voce "Contratto in genere," n. 143).

<sup>602</sup> In contract, liability does not apply to a minor who has not disclosed such condition to the other party, Sacco, *supra* note 588, at 675. See also Benatti, *Culpa in contrahendo*, *supra* note 588, at 293; G. Stolfi, *Sulla responsabilità precontrattuale del minore*, in STUDI IN MEMORIA DI ANDREA TORRENTE, Milano, 1968, 1181 and G. Stolfi, *La responsabilità precontrattuale del minore*, in SCRITTI GIURIDICI, Milano, 1980, 436, both cited in De Martini & Ruoppolo, *supra* note 588, at 190; Trib. Milano 3.4.1967, Mon. trib., 1967, 607.

<sup>603</sup> Ferrarini, *supra* note 588, at 597; Benatti, *Culpa in contrahendo*, *supra* note 588, at 303 seq.; Ferrarini, *La responsabilità da prospetto delle banche*, Banca borsa, 1987, I, 437, at 477; Messineo, *Il contratto in genere*, *supra* note 588, at 365; Visintini, *supra* note 588, *passim*; Renato Scognamiglio, voce "Responsabilità contrattuale ed extracontrattuale" in NOVISSIMO DIGESTO ITALIANO, XV, 1968, Torino, at 675; De Cupis, *supra* note 588, at 50 (2d ed., at 98); Benatti, LA RESPONSABILITA' PRECONTRATTUALE, *supra* note 588, at 115 seq., and 129 seq.; Francesco Messineo, voce "Contratto" in ENCICLOPEDIA DEL DIRITTO, IX, 1961, 892; Salvatore Romano, voce "Buona fede" in ENCICLOPEDIA DEL DIRITTO, V, 1959, 661, at 682 ("the truth is that we are not in a situation of 'no' relationship as would be characteristic for the extra-contract as provided for in art. 2043 seq."); Giuseppe Stolfi, Annotation to Cass. 12.1.1954, n. 22, Foro it., 1955, I, 1108, with further references; Mengoni, *supra* note 588, at 360. App. Milano 2.2.1990, Giur. comm., 1990, II, 755, *affirming*, Trib. Milano 11.1.1988, Giur. comm., 1988, II, 585; Trib. Milano 17.9.1973 (on precontractual responsibility of a bailee who had

contractual good faith to the precontractual phase, and that it is, therefore, appropriate "to have an identical characterization for the liability arising from violation of the duty of good faith independently of whether such duty is linked to the contractual relationship or is based on the precontractual situation."<sup>604</sup> On the other hand, substantial case law characterizes *culpa in contrahendo* as extra-contractual.<sup>605</sup> Some authors have advanced the view that *culpa in contrahendo*

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received goods "on sale or return"), reported by Nanni, *supra* note 588, at 113 *seq.*; App. Venezia 11.4.1953, Foro pad., 1954, I, 1050. It is argued: *culpa in contrahendo* is contractual because it is not an obligation *erga omnes* (i.e., of the type of *neminem laedere*) but rather an obligation to a defined party, as is typical for contracts; the liability which stems from articles 1337 and 1338 c.c. is contractual because art. 1337 c.c. must be viewed as an extension of the principle of good faith in contractual relations (art. 1175 c.c.) and, the same as the general duty of good faith establishes a contractual liability according to art. 1218 c.c., so must the duty arising from art. 1337 c.c.; the duties of trust and disclosure deriving from art. 1337 c.c. can easily be construed as "obligations," because they have a definite content corresponding to a definite behavior of the debtor that satisfies a particular interest of the beneficiary, and this definite content would exclude its construction as a tort; moreover, the duties of good faith prescribed in art. 1337 c.c. are intended to satisfy an expectation and thus have a positive purpose, while the duties under art. 2043 c.c. have just a negative purpose, i.e., the purpose to protect; the tacit compact arising from the negotiations between the parties establishes liability *in contrahendo* that would either become part of the ensuing contract or attain an autonomous life because, even if no contract follows, the compact survives as the basis for contractual liability for damages.

<sup>604</sup> "[A]ppare coerente . . . attribuire identica natura alla responsabilità per violazione del dovere di buona fede sia che esso si ricollegi al rapporto contrattuale sia che si fondi sul rapporto prenegoziale," Benatti, *Culpa in contrahendo*, *supra* note 588, at 304.

<sup>605</sup> Cass. 12.3.1993, n. 2973, Corr. giur., 5/1993, 560 (Annotation by Vincenzo Carbone); Cass. 11.5.1990, n. 4051, Corr. giur., 8/1990, 832 (Annotation by P. L. Carbone, *Un'occasione perduta: la Cassazione riconferma la natura aquiliana della responsabilità precontrattuale*); Cass. 18.6.1987, n. 5371, Giust. civ., 1988, I, 197; Cass. 19.4.1983, n. 2705, Foro it. rep., 1983, voce "Contratto in genere," n. 143; Cass., s.u., 6.3.1976, n. 749, Giust. civ., 1976, I, 1671, 1678; Cass. 7.8.1974, n. 2385, Foro it. rep., 1974, voce "Contratto in genere," n. 106; Cass. 19.10.1972, n. 3129, Giust. civ., 1973, I, 818; Cass. 28.1.1972, n. 189, Foro it., 1972, I, 2088; Cass. 28.9.1967, n. 2224, Foro it. rep., 1967, voce "Obblig. e contr.," n. 115; Cass. 28.9.1956, n. 3299, Foro it., 1957, I, 1027; Cass. 5.5.1955, n. 1259, Riv. dir. comm., 1955, II, 360 (Annotation by Luigi Mengoni); Cass. 12.1.1954, n. 22, Foro it., 1954, I, 1108 (Annotation by Giuseppe Stolfi). The *Cassazione* said that "*culpa in contrahendo* is of extra-contractual nature and stems from the action of the debtor who has reasonably authorized the other party to rely on his performance," Cass. 20.7.1943, n. 1892, Foro it. rep., 1943-45, voce "Obblig. e contr.," n. 148. See discussion, in Nanni, *supra* note 588, at 94 *seq.* with numerous further references; Benatti, *Culpa in contrahendo*, *supra* note 588, at 303 *seq.*; Benatti, LA RESPONSABILITÀ PRECONTRATTUALE, *supra* note 588, at 120 *seq.* See also Torrente & Schlesinger, *supra* note 588, at 520; Sacco, *supra* note 588, at 676; De Martini & Ruopolo, *supra* note 588, at 171-72; Giuseppe Osti, voce "Contratto" in *NOVISSIMO DIGESTO ITALIANO*, IV, 1959, Torino, at 514-15; Vittorio E. Calusi, *In tema di trattative e responsabilità precontrattuale*, Riv. trim. dir. proc. civ., 1956, 470, at 485. The arguments are: but for art. 1337 c.c., liability for breach of the duty of precontractual good faith would be subject to art. 2043 c.c.; since no contract is yet in existence, there can be no contractual effect, and no autonomous compact can come into existence without a

derives from an independent source of liability.<sup>606</sup>

If one party has justifiably relied on precontractual dealings or negotiations, which were seriously commenced and could have led to the formation of a contract,<sup>607</sup> and the other party withdraws from such negotiations without cause (or in bad faith), and damage has occurred, then damages representing the "negative interest", i.e., the *id quod interest contractum initum non fuisse*, would be awarded. Such "reliance" damages would normally be limited to expenses and lost opportunities that the innocent party would not have suffered, had he never entered into those negotiations. The concept of "negative interest" itself is controversial.<sup>608</sup>

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specific separate manifestation of intent; if there is no contract, the source of liability lies in tort; the source of the duty to deal in good faith is not established by mutual consent of the parties; it is not uncommon for the law to establish relationships similar to contract—or also of a different nature than contract—but without the mediation of a contract, between two parties, in which rights and obligations derive from the law and not from a contract. On the application of article 2043 *c.c.* rather than article 1337 *c.c.*, see Cass. 13.7.1968, n. 2521, Foro it., 1968, I, 2454 (also in Nanni, *supra* note 588, at 18, 131 *seq.*).

<sup>606</sup> Pietro Rescigno, *voce* "Obbligazioni (diritto privato)" in ENCICLOPEDIA DEL DIRITTO, XXIX, Milano, 1979, at 142, 160; Rodolfo Sacco, *Culpa in contrahendo e culpa aquilia; culpa in eligendo e apparenza*, Riv. dir. comm., 1951, II, 82, at 86. See Cuffaro, *supra* note 588, at 1270 (art. 1337 *c.c.* establishes a conceptually autonomous basis of responsibility). This so-called "*tertium genus*" theory has not been widely followed. See discussion in Benatti, LA RESPONSABILITA' PRECONTRATTUALE, *supra* note 588, at 115.

<sup>607</sup> The test for reliance is objective, Cass. 5.9.1952, n. 2843, Foro it. rep., 1952, *voce* "Obblig. e contr.," n. 96, 97; App. Genova 17.2.1951, Foro pad., 1951, II, 45. Mere negligence is sufficient. App. Firenze 29.3.1950, Foro it. rep., 1950, *voce* "Obblig. e contr.," n. 114. Article 1337 *c.c.* specifically states that good faith is required during formation and during negotiation of a contract, and reliance would be reasonable and justified if serious negotiations have commenced, Cass. 11.9.1989, n. 3922, Foro it. rep., 1989, *voce* "Contratto in genere," n. 255; Cass. 22.10.1982, n. 5492, Foro it. rep., 1984, *voce* "Contratto in genere," n. 133; especially if the fundamental terms of the prospective contract have been discussed and agreed upon. Cass. 25.2.1992, n. 2335, Foro it., 1992, I, 1766 (Annotation by F. Caringella): "In order for *culpa in contrahendo* to occur, there must have been, even during negotiations, the discussion of the fundamental terms of the prospective contract, because only in this case there can be a reasonable reliance of the parties, or one of them, on the stipulation of the transaction;" Cass. 18.1.1988, n. 340, Foro it. rep., 1988, *voce* "Contratto in genere," n. 267; Cass. 22.10.1982, n. 5492, Giur. it., 1984, I, 1, 1199, Annotation by Fusaro; Cass. 17.1.1981, n. 430, Foro it. rep., 1981, *voce* "Contratto in genere," n. 112; Cass. 13.7.1968, n. 2521, Foro it., 1968, I, 2454; Cass. 8.5.1963, n. 1142, Foro it. rep., 1963, *voce* "Obblig. e contr.," n. 105; Trib. Piacenza 24.3.1949, Foro pad., 1950, I, 200 (Annotation by Fernando Quagliolo).

<sup>608</sup> Cass. 12.3.1993, n. 2973, *supra* note 605; Cass. 25.1.1988, n. 582, Foro it. rep., 1988, *voce* "Contratto in genere," n. 266; Cass. 20.5.1977, n. 2083, cited (and partially quoted) by V. Carbone, *supra* note 605, at 563; Cass. 28.1.1972, n. 199, Foro it., 1972, I, 2088; Cass. 13.7.1968, n. 2521, Foro it., 1968, I, 2454; Cass. 6.4.1968, n. 1053, Giur. it. rep., 1968, *voce* "Obblig. e contr.," n. 116; Cass. 10.10.1962, n. 2919, Foro it. rep., 1962, *voce* "Obblig. e contr.," n. 105, 106; Cass. 9.12.1957, n. 4619, Foro it. rep., 1957, *voce* "Obblig. e contr.," n. 92, 93; Cass. 11.12.1954, n. 4426, Foro it. mass., 1954, 893.

The rule of article 1337 *c.c.* is applied to disclosures required in the context of commitments to negotiate,<sup>609</sup> and to letters of comfort or *patronage*<sup>610</sup> because:

[T]he duty to say the truth during the phase of formation of the contract . . . must be interpreted in an increasingly extensive way, in order to satisfy the profound needs of most rigorous good faith in the merchant dealings (which take place in a situation of growing weakness of the consumer . . .), and of maximum social solidarity.<sup>611</sup>

### B. German Law

The "legal relation stemming from contract negotiations" (*Rechtsverhältnis der Vertragsverhandlungen*)<sup>612</sup> and the ensuing liability for *culpa in contrahendo*<sup>613</sup> are well established doctrines of Ger-

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"Although article 1338 *c.c.* regulates a hypothesis of 'aquilian' negligence [torts], the assessment of damages is not much dissimilar from damages assessed under contractual negligence, and thus, within the limits of the negative interest, lost profits and actual damages are included," Cass. 5.5.1955, n. 1259, Foro it., 1956, I, 375 (also reported in Riv. dir. comm., 1955, I, 360, annotation by Luigi Mengoni). On the measure of damages as negative interest, see Benatti, LA RESPONSABILITA' PRECONTRATTUALE, *supra* note 588, at 139 *seq.*; Trimarchi, *supra* note 588, at 314-15; Torrente & Schlesinger, *supra* note 588, at 520-21; Messineo, *supra* note 588, at 366. Not included are damages for advantages that could have been obtained if the contract had been concluded, Cass. 5.6.1958, n. 1599, Foro it. mass., 1959, 386. The *Relazione*, at n. 638, *supra* note 592, states that the negative interest includes damages caused by expenses, lost opportunities to enter another valid contract, and the activity wasted in negotiations and diverted from other useful applications. For a broader approach, see Cass. 12.3.1993, n. 2973, *supra* note 605, where it was held that the precontractual duty covers, within the limits of the negative interest, all immediate and direct consequences of a breach of precontractual good faith, and includes damages for economic loss incurred as a result of the withdrawal from other negotiations even if of a different content. See also the critical remarks by, e.g., Grisi, *supra* note 588, at 338; Cuffaro, *supra* note 588, at 1274; Benatti, LA RESPONSABILITA' PRECONTRATTUALE, *supra* note 588, at 151. An interesting case is Cass. 19.11.1983, n. 630, in Nanni, *supra* note 588, at 73 *seq.*, where the court awarded damages to workers who had relied on being hired, and were not.

<sup>609</sup> Trimarchi, *supra* note 588, at 325.

<sup>610</sup> Fausto Severini, *Il patronage tra la promessa unilaterale atipica e la promessa del fatto del terzo*, in Giur. comm., 1991, I, 884, at 890.

<sup>611</sup> "L'obbligo di dire la verità nella fase di formazione del contratto, . . . va interpretato in senso sempre più estensivo per soddisfare le profonde esigenze di più rigorosa correttezza dei traffici mercantili [svolgentisi in una situazione di crescente debolezza per il consumatore . . .], e di maggiore solidarietà sociale." Osvaldo Prosperi, *Lettre de patronage e mendacio bancario*, in Banca borsa, 1979, I, 152, at 172-73 (citations omitted). See also App. Roma 17.10.1989, Giust. civ., 1989, I, 2652. See a brief discussion on the possible application of *culpa in contrahendo* in the area of advertizing, in Vincenzo Franceschelli, *Pubblicità ingannevole e culpa in contrahendo*, Riv. dir. civ., 1983, II, 268, at 275 *seq.*

<sup>612</sup> Stoll, *Haftung für das Verhalten während der Vertragsverhandlungen*, LZ 1923, 544.

<sup>613</sup> See note 37 *supra*.



man law.<sup>614</sup> Case law and legal writers have developed the doctrine that, with the commencement of contract negotiations, or by entering into comparable business contacts, a relation of trust similar to contract comes into being (*vertragsähnliches Vertrauensverhältnis*) which commits the parties to the "duty of care of debtors" (*Sorgfalt von Schuldnern*).<sup>615</sup> The early cases explained that the liability stemming from *culpa in contrahendo* was due to the subsequently concluded contract.<sup>616</sup> It became a well established doctrine that, before the conclusion of the contract between the parties, certain duties arise based on the requirements of good faith disclosure and information (*Offenbarungs- und Mitteilungspflichten*).<sup>617</sup> On occasion, the German Supreme Court implied the existence of terms aimed at specifically protecting this duty of good faith.<sup>618</sup> Legal authorities have written of a tacit contract aimed at assuring these effects of protection<sup>619</sup> or of an organic link with the ensuing contract.<sup>620</sup> Today's understanding is that a legal relationship springs from the commencement of contractual negotiations and binds the parties to reasonable diligence in their dealings.<sup>621</sup>

The basis of liability is the same as in torts. Liability may be based on intent or negligence, and includes liability for servants and agents.<sup>622</sup> The breach of duty lies in the breach of a precontractual duty of disclosure, advice, protection, care or assistance (*Aufklärung, Beratung, Schutz, Obhut, Fürsorge*).<sup>623</sup>

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<sup>614</sup> BGH NJW 1979, 1983; Staudinger-Loewisch, BGB, Vor § 275 Bem. 39. The BGB—the German Civil Code—does not contain a general provision that specifically addresses nondisclosures during negotiations. The doctrine of *culpa in contrahendo* is based on § 242 BGB. There is also other statutory authority for *culpa in contrahendo* in a number of sections of the BGB, e.g., §§ 122, 179, 307, 309, 463(2), 600, 663, 694.

<sup>615</sup> RGZ 95, 58; 120, 251; 162, 156; BGHZ 6, 333; 66, 54.

<sup>616</sup> RGZ 95, 60.

<sup>617</sup> RGZ 107, 362.

<sup>618</sup> RGZ 74, 125.

<sup>619</sup> Planck-Siber, Vorb. I 4c vor § 276, and others cited in Soergel-Reimer Schmidt, n. 4, at page 254.

<sup>620</sup> Stoll, *supra* note 612, at 544.

<sup>621</sup> BGHZ 6, 333. The duty of good faith imposes a host of implied supplementary obligations ranging from affirmative requirements of disclosure to sharing of hardship.

<sup>622</sup> § 278 BGB. Modern theories of the law of obligations, as expounded by legal writers and case law, have affirmed the applicability of negligence standards to precontractual dealings. Soergel-Reimer Schmidt, *supra* note 619, at page 253.

<sup>623</sup> Palandt-Heinrichs, BGB, 51st ed., § 276 Bem. 72-91. Special provisions, such as warranty liability in the law of sales, override the general liability from *culpa in contrahendo*. §§ 459 *seq.* However, liability *ex culpa in contrahendo* would still apply concurrently for misleading information regarding the object of sale since this information would not fall within the scope of §§ 459 *seq.* BGB (BGH NJW-RR 1990, 79, 971). *See, e.g.,* BGH NJW 1980, 777 (leases) and BGH DB 1976, 958 (general contractors).

*Culpa in contrahendo* presupposes that trust has been granted during negotiations for a business transaction.<sup>624</sup> By starting contractual negotiations, a "legal" relationship is established which creates duties similar to contract (*vertragsähnliche Sorgfaltspflicht*) regardless of the parties' intent. A high standard of care is exacted, independent of contract, commensurate with the trust advanced by each party to the other long before the contract is fully formed because the parties are bound, within the framework of their relationship, by imposed duties of "correctness and maintenance" (*Rücksichts- und Erhaltungspflichten*).<sup>625</sup> By entering into contractual negotiations the parties expose their assets to a higher than normal risk, and to this risk corresponds a higher standard of care (*Einstandspflicht*) on the side of each party.<sup>626</sup> The "contacts" requiring such special standard of care come into existence, by operation of law, when the parties start negotiations, and the need for protection is present whether or not a contract will be eventually concluded.<sup>627</sup>

*Culpa in contrahendo* is a liability imposed by law. It is characterized by the fact that it does not recognize primary duties of performance, but duties for reciprocal accommodation, care and loyalty (*gegenseitige Rücksichtnahme, Fürsorge und Loyalität*). According to modern view, liability for *culpa in contrahendo* is based on "granting of trust taken advantage of" (*Gewährung in Anspruch genommenen Vertrauens*).<sup>628</sup> Liability is based on the enhanced "social contact."<sup>629</sup> This "contact" does not suffice, by itself, to establish liability, which is, in fact, established independently from any consideration of whether a contract is ever concluded. What counts is conduct aimed at the conclusion of a contract or at commence-

<sup>624</sup> Larenz, *Culpa in contrahendo, Verkehrssicherungspflicht, und "sozialer Kontakt,"* MDR 1954, 515.

<sup>625</sup> § 242 BGB, Bem. 35, 100 *et seq.*, in Soergel-Siebert-Knopp, BGB (10th ed. 1967).

<sup>626</sup> Vor § 275, n. 2, Soergel/Siebert *id.* *Culpa in contrahendo* also applies to the public administration (including lack of form): RGZ 162, 129, 158; BGHZ 6, 330; 21, 59, 65; München MDR 1953, 165; BFH Betr. 1963, 1489. See references in Soergel-Siebert-Knopp, BGB, at § 242 n.91 (10th ed., 1967).

<sup>627</sup> Traditional tort law would not be sufficient to adequately cover all breaches of the precontractual duty of good faith. *Culpa in contrahendo* thus establishes, in addition to the liability stemming from the law of torts, a concurrent basis of liability (liability in tort does not *per se* protect any and all kinds of property loss, and the law of torts contains an exculpatory provision which allows a principal, under certain circumstances, to disclaim liability for his servants while no such provision exists under the law of contracts). § 831 BGB.

<sup>628</sup> Ballerstedt, *Zur Haftung für culpa in contrahendo*, AcP 151, 501, at 507; BGHZ 60, 226; BGH NJW 1981, 1035 (*Haftung für 'enttäushtes' Vertrauen*).

<sup>629</sup> Dölle, *Aussergesetzliche Schuldspflichten*, ZStaatsW 1943, 67.

ment of business contacts.<sup>630</sup>

With respect to the burden of proof, the German Supreme Court has said that the plaintiff must show that he and his agents applied all diligence necessary to avoid a condition in violation of commercial course of dealings.<sup>631</sup> Negligent conduct has been held to be present when the other party was induced to believe that a contract had been reached causing such party to incur expenses or forebear another favorable contract, a result that could have been avoided with the required disclosure of the real factual background.<sup>632</sup> The duty of disclosure during precontractual negotiations may be of different intensity according to the type of contract and the requirements of good faith and fair dealing (*Treu und Glauben im redlichen Verkehr*).<sup>633</sup> In this context, during contractual negotiations there is a fundamental duty to disclose to the other party circumstances that are capable of frustrating the scope of the contract.

The remedy for breaches of the duty of good faith are generally damages in tort, but contractual damages are also awarded if the imposed duty concurs with assumed duties. The damages are calculated as the negative interest (*Vertrauensschaden*), that is the other party is to be put in as good a position as he would have been without the breach of the duty.<sup>634</sup> If, however, the conduct in breach of good faith disclosures has caused the avoidance of the conclusion of the contract, the interest in performance can be claimed because in such case the interest in performance is equivalent to the negative interest.<sup>635</sup> However, the negative interest is not limited by the interest in performance.<sup>636</sup> If, without the culpable conduct of the party in breach, the other party could have entered into another contract, the damages would include lost profits from this other opportunity.<sup>637</sup> If the damages are based on the establishment of a liability (for example, the claimant has entered the contract because of insufficient disclosures), then his claim could be for release from the liability, and the claim from

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<sup>630</sup> See the example of a potential customer rather than a mere visitor in BGHZ 66, 54.

<sup>631</sup> BGHZ 66, 54; 67, 387; BGH NJW 1962, 31; NJW 1987, 640.

<sup>632</sup> RGZ 159, 55.

<sup>633</sup> RGZ 97, 325.

<sup>634</sup> BGH VersR 1962, 562; RGZ 103, 47; 132, 76; 147, 103; BGH NJW 1981, 167.

<sup>635</sup> RGZ 151, 359; BGHZ 49, 82; 57, 193; 69, 56; BGH NJW 1977, 1538 *seq.*; MÜNCHENER KOMMENTAR-Emmerich Vor § 275 Rn. 175.

<sup>636</sup> BGH NJW 1965, 812; BGH VersR 1962, 562. See Soergel-Reimer Schmidt, *supra* note 619, Vor § 275 n. 18.

<sup>637</sup> BGH NJW 1988, 2236.

*culpa in contrahendo* could be brought as a defense to the other party's claim for performance.<sup>638</sup> If, because of *culpa in contrahendo*, the contract has been concluded at unfavorable terms, and if the party not in breach intends to maintain the contract, then recent case law provides a claim for contract adjustment. The claim can be for reduction of performance to an appropriate level, and for restitution of excess payments already made.<sup>639</sup> Additional cost caused by the other party's conduct in breach of the duty of good faith can also be claimed as damages.<sup>640</sup> Specific performance can be sought under certain circumstances.<sup>641</sup> In any event, the claimant shall not be put in a better position than he would have been had there been no breach.<sup>642</sup>

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<sup>638</sup> MÜNCHENER KOMMENTAR - Emmerich Vor § 275 Bem. 176.

<sup>639</sup> BGHZ 69, 56; 111, 82; BGH NJW-RR 1988, 10; 1989, 151, 307; NJW 1990, 1661; 1991, 1819.

<sup>640</sup> BGH NJW-RR 1991, 600.

<sup>641</sup> BGHZ 40, 22; BGH NJW 1965, 814; 1977, 1536.

<sup>642</sup> MÜNCHENER KOMMENTAR - Emmerich Vor § 275 Bem. 178.