G Model
IRL-5792; No. of Pages 11
ARTICLE IN PRESS

International Review of Law and Economics xxx (2017) xxx–xxx

Contents lists available at ScienceDirect

International Review of Law and Economics

Consumer Fraud, Misrepresentation and Reliance

Alon Klement[a], Zvika Neeman[b], Yuval Procaccia[c,*]

[a] Tel Aviv University, Buchman Faculty of Law, Israel
[b] Tel Aviv University, Berglas School of Economics, Israel
[c] Interdisciplinary Center (IDC) Herzliya, Radyzner Law School, Israel

ARTICLE INFO

Article history:
Received 15 December 2016
Received in revised form
22 November 2017
Accepted 26 November 2017
Available online xxx

Keywords:
Fraud
Misrepresentation
Reliance
Damages
Restitution
Price impact
Class actions

ABSTRACT

It is a deeply-entrenched principle in the law of misrepresentation that a false statement can be actionable only upon a showing of reliance. In order to prevail, plaintiffs must establish not only that a misstatement was wrongly conveyed, but also that they were exposed to the information, acted upon it, and suffered harm as a consequence. A mere potential for deception is not enough; plaintiffs must show that they were *actually deceived*.

Yet, despite the reliance requirement's intuitive appeal, this paper argues that it should be abandoned. It shows that conditioning recovery on reliance leads to inadequate deterrence of misrepresentations, which in turn results in a host of inefficient effects: from allocative inefficiency to wasteful investments and rent-seeking activities. Instead of reliance, recovery should depend on a showing of a 'price impact', namely that the statement triggered an increase in market price. Once an effect on price is established, liability should extend to all representees—relying and non-relying alike.
© 2017 Elsevier Inc. All rights reserved.

1. Introduction

Suppose that a firm advertises false information about a product it offers for sale. Some consumers are deceived and are consequently lured into purchasing an undesired product. Others are not deceived—either because they never noticed the advertisement, or because they would have purchased the product regardless. Suppose that such non-deceived consumers nevertheless bring suit against the firm, seeking damages for fraudulent or negligent misrepresentation. Should they prevail?

A strong intuition suggests that the answer ought to be no. Indeed, under extant doctrine, recovery for misrepresentation requires a showing of *reliance*.[1] Plaintiffs must establish not only that the firm wrongly conveyed false information, but also that they were *exposed* to the information and *relied* upon it to their detriment. The plaintiff must prove that the misrepresentation caused her to change her position and sustain an injury—that she was *actually deceived*. Plaintiffs whose decision to buy was not driven by the information conveyed did not rely on the false statement. Hence, their action for damages will be denied.

This paper, however, argues that the reliance requirement ought to be abandoned. Contrary to conventional perception, consumers should be able to recover damages even if they did not rely on the information presented. Restricting recovery to relying consumers results in the under-deterrence of fraudulent and negligent misrepresentations. This in turn induces the formation of inefficient transactions; prevents the formation of efficient ones; prompts wasteful investments in the production of fraud; and engenders inefficient investments by consumers.

The theory's point of departure is the observation that in market settings reliance is not a necessary condition for the causation of harm. Market participants can be harmed by misrepresentations even if they do not rely. The source of their harm is rooted in the misrepresentation's effect on market price: When a firm falsely depicts its product as being of superior quality, some of those who are deceived raise their willingness to pay. Consequently, aggregate demand rises, and so does the equilibrium price. Injury is thereby caused to *all* consumers, relying and non-relying alike: All are charged a higher price, including those who were never exposed to the statement or for whom the statement did not drive the decision to buy. For deterrence to be efficient, the firm must be held

* Corresponding author.
E-mail address: yprocaccia@idc.ac.il (Y. Procaccia).

[1] *See*, e.g., Restatement (Second) of Torts §§ 537(a) (fraudulent representation), 552(1) (negligent representation) (1977); Dobbs (2000: 1349–1354). If the misrepresentation is viewed as a breach of warranty, however, reliance may not be required in some jurisdictions. For a more detailed review see Section 2, *infra*.

https://doi.org/10.1016/j.irle.2017.11.003
0144-8188/© 2017 Elsevier Inc. All rights reserved.

Please cite this article in press as: Klement, A., et al., Consumer Fraud, Misrepresentation and Reliance. International Review of Law and Economics (2017), https://doi.org/10.1016/j.irle.2017.11.003

liable for the entire harm it inflicts, including the harm incurred by non-relying consumers.[2]

To illustrate the deterrence deficit created by the reliance requirement, consider the following example: Suppose that a monopolistic firm can produce one of two goods, A or B, with production costs of 80 and 150 respectively. There are three groups of consumers, consisting of 100 members each. Consumers' valuations of the two goods are given in the following table:

	Valuation of Good A	Valuation of Good B
Group 1	120	75
Group 2	120	110
Group 3	120	120

Notice that the firm cannot sell good A at a profit, since the cost of production (150) exceeds consumers' valuations (120). Hence, under truthful representation the firm sells only good B, charging the profit-maximizing price of 110, and capturing an overall profit of 200 · (110-80) = 6000.[3] Also notice that members of group 3 then extract a consumer surplus of 100 · (120-110) = 1000, so that overall welfare equals 7000.

Now assume alternatively that the firm misrepresents good B as being of type A, while raising the price to 120.[4] Now all three consumer groups buy the product, yielding a (pre-liability) profit for the firm of 300·(120 − 80) = 12,000. Members of groups 1 and 2 lose from this transaction an overall amount of 100·(120 − 75) + 100 · (120 − 110) = 5500, and thus social welfare falls to 6500. The reason for the decline in welfare is that members of group 1 were induced into entering socially inefficient transactions, whereby the cost of production (80) exceeded the value of consumption (75).

Suppose now that consumers bring suit against the firm, but their claim is restricted by the reliance requirement. As only groups 1 and 2 meet the requirement,[5] overall recovery is given by 100·(120 − 75) + 100·(120 − 110) = 5500. Thus, deducting 5500 from the pre-liability profit of 12,000, the firm is now left with a net profit of 6500.[6] Importantly, this is more than what the firm could extract by representing truthfully (6000). Hence, even though the misrepresentation is welfare-reducing, it is not deterred by the threat of liability.

What accounts for the rule's failure to induce efficient deterrence? The answer is that while the firm fully internalized the benefit from the misrepresentation, the reliance requirement kept it from fully internalizing the attendant cost. Although the firm charged all consumers—relying and non-relying—an inflated price, liability was restricted only to relying consumers. To achieve full internalization of cost, liability would have to extend to non-relying consumers as well. Indeed, if members of group 3 were also compensated for the inflated price, the deterrence deficit would be corrected. The firm's profit would fall by an additional 1000–5500, which would leave the firm with 500 less than its profit under truthful representation. This decline in profit would exactly match the social loss emanating from the misrepresentation.

For efficient deterrence to obtain, non-relying consumers should therefore be entitled to damages, whose measure is given, at the very least, by the misrepresentation's *price impact*. The price impact is the extent to which the price has risen as a result of the misrepresentation. By allowing such recovery, the law would induce firms to fully internalize the social cost of a misrepresentation, and would consequently drive them into taking optimal precautions to avoid it.

Our conclusions remain intact also when considering a somewhat more complicated setting, in which consumers may choose to return the good for a refund, instead of claiming damages. Indeed, while damages are a remedy available in tort, rescission and restitution are available in contract.[7] Different consumers may choose differently between keeping the good and claiming damages, and returning the good for a refund. Their choice, in turn, may well affect the welfare consequences of a misrepresentation. However, we show that regardless of the choices that consumers make, the ultimate result stands that harm can be fully internalized only if the reliance requirement is set aside. If a consumer seeks damages as a remedy, then lack of reliance should not bar her claim.

The conclusion that optimal deterrence requires the revocation of reliance does not depend on the structure of the market in which the firm operates. We initially examine the case of a firm acting as a monopoly—in both the actual and misrepresented goods. We show that the suggested rule induces optimal deterrence of the firm. We further show that under the suggested rule, if the firm engages in misrepresentation, the quantity it produces equals the quantity produced under perfect price discrimination, which implies that the firm maximizes social welfare up to a constant.[8] Hence, in the monopolistic context, a misrepresentation may also carry social benefits, by reducing the monopolistic deadweight loss. When these social benefits outweigh the costs of misrepresentation, the firm will optimally choose to misrepresent.

We then proceed to examine the case of monopolistic competition, in a setting akin to Hotelling (1929). In a competitive setting, the misrepresentation harms not only consumers but also competitors, as it causes demand to shift from competitors to the firm. As the firm internalizes the benefit emanating from the diversion of demand, but not the cost, it is optimally deterred only if it bears liability for their losses as well.[9]

It should finally be noted that the argument for removing the reliance requirement concerns *primary markets*, in which the misrepresenting firm sells the product to a buyer. It does not directly extend to *secondary markets*, in which two other parties trade in the firm's product in light of a false statement communicated by the firm. Since in secondary markets the firm is not itself a party to the transaction, it cannot gain from the misrepresentation's effect on price: Its statement may cause one party to gain and the other to lose, but the change in price does not directly affect the firm's own profit. As it does not capture the gains, having it fully internal-

[2] For an analogous point made in the antitrust literature, see Landes (1983).

[3] If the firm were to charge a higher price, 120 at most, its net profits would be lower, equal to 100 · (120 − 80) = 4, 000.

[4] 120 is indeed a profit-maximizing price for the firm given misrepresentation. See note 6 infra.

[5] Group 3 does not meet the requirement, because members of that group would have purchased the good even if they knew it to be of type B.

[6] Observe that given misrepresentation, 120 is a weakly optimal price for the firm regardless of whether a reliance requirement is applied. If reliance is required, the firm will not set the price below 120, because with each dollar reduction in price its initial profits will fall by 300, while liability will fall at most by 200 (since group 3 will not be entitled to recover). If reliance is not required, then for any dollar reduction from 120, profits and liability will initially fall by the same amount (between 120 and 110), and then profits will fall by more than liability (below 110). Also notice that in both cases, if the firm charges more than 120, sales drop to zero and thus the misrepresentation becomes redundant.

[7] *See* Restatement (Second) of Contracts, § 164, 376 (1981); U.C.C. § 2–721 (2002); Farnsworth (2004: 495–500). Restitution may be performed by the consumer either by way of returning the physical good, or by way of paying its value. However, in many cases physical restitution is infeasible: the product may have perished, or have been consumed, or is a service, or an intangible, and therefore cannot be given back.

[8] We discuss this in Section 4.2.

[9] The case of perfect competition is not specifically examined, as the question of reliance in that case is moot. In a perfectly competitive environment, no consumer is ever willing to buy a product at a price exceeding the competitive level. This implies that all consumers who buy from the firm are relying consumers. As non-relying consumers are thus absent in this setting, the reliance restriction becomes redundant.

Please cite this article in press as: Klement, A., et al., Consumer Fraud, Misrepresentation and Reliance. International Review of Law and Economics (2017), https://doi.org/10.1016/j.irle.2017.11.003

دریافت فوری ← متن کامل مقاله

ISIArticles
مرجع مقالات تخصصی ایران

- ✓ امکان دانلود نسخه تمام متن مقالات انگلیسی
- ✓ امکان دانلود نسخه ترجمه شده مقالات
- ✓ پذیرش سفارش ترجمه تخصصی
- ✓ امکان جستجو در آرشیو جامعی از صدها موضوع و هزاران مقاله
- ✓ امکان دانلود رایگان ۲ صفحه اول هر مقاله
- ✓ امکان پرداخت اینترنتی با کلیه کارت های عضو شتاب
- ✓ دانلود فوری مقاله پس از پرداخت آنلاین
- ✓ پشتیبانی کامل خرید با بهره مندی از سیستم هوشمند رهگیری سفارشات