3 Contractual mistake and misrepresentation

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1. Introduction

A contractual mistake is the misperception of a party which induces him to enter into a contract. Contractual mistakes can be divided into two groups, viz. common and unilateral mistakes. The former are the mistakes which are shared by both parties. The latter type comprises mistakes by one party only, for example, the seller knows that the cow being offered for sale is barren, but the buyer misbelieves that she is fertile. In most jurisdictions, the law of contract law does not enforce a contract concluded on the basis of a fundamental mistake.

From an economic perspective, a contractual mistake may lead to misallocation of resources by inducing the party to make an incorrect appraisal of the payoff derived from the transaction. However, this does not mean that the legal remedy for mistake is economically justified, because the law of contractual mistake also modifies the party’s incentives to search for and disclose information prior to the conclusion of the contract. For their part, scholars of law and economics have traditionally focused on how the law can be designed not only to improve allocative efficiency, but also to create incentives for the parties to undertake optimal search and disclosure of information. Section 2 provides a brief critical review of relevant economic theories of the law of contractual mistake.

From a legal perspective, misrepresentations can be categorised into three types: (i) fraudulent misrepresentation – a false statement is made intentionally by a contracting party for the purpose of inducing another to contract with him; (ii) negligent misrepresentation – a false statement results from a party’s failure to take reasonable care when making it; (iii) innocent misrepresentation – a false statement is made by the contracting party, even though he has taken reasonable care. Economic considerations vary with the type of misrepresentation. For fraudulent misrepresentation, the economic question is how the law can be designed to deter parties optimally from deceiving. Moving onto negligent misrepresentation, the economic consideration focuses on adjustment of the law to induce the representor to take socially optimal care. Finally, in the case of innocent misrepresentation, the emphasis is directed to the representee. Because an innocent misrepresentation cannot be avoided by the representor taking socially optimal care, the law should be used to induce the representee to...
take optimal precautions. All of the above issues are discussed in Sections 3 and 4.

2. Contractual Mistakes

2.1. Allocative Efficiency and Contractual Mistake

Allocative efficiency requires resources to move from lower to higher value users. Efficiency is achieved when the resources move to the highest value user (Ogus, 2006, p. 27). From an economic perspective, a contract is viewed as a device for resource allocation. It is generally assumed that contracts can achieve allocative efficiency to move the goods to their highest value user, as well as ensuring that each step in the allocation process is a Pareto improvement. However, success in achieving allocative efficiency by contracting depends on the fundamental assumption that each contracting party correctly assesses the payoff arising from the transaction. A mistake can induce the party to make incorrect calculations, thereby causing a misallocation of resources which moves the goods from a high value to a lower value user.

Let $V$ and $E$ be the subjective values of goods for the seller and buyer respectively. $P$ stands for the contract price. If $E \geq P \geq V$, then any improvement generated by the contract is a Pareto improvement. But if the buyer mistakenly believes that $E > V$, while in fact $E < V$, the contract is not a Pareto improvement, as the buyer is made worse off, and the transaction is a misallocation of resources. Nonetheless, not every mistake causes misallocation. If the mistake merely induces the party to miscalculate $P$, but $E > V$ still holds, the mistake causes only a redistribution of wealth from one party to another, with no impact on allocative efficiency. Based upon this economic argument, an efficient law of contractual mistake should permit the rescission of contract only if the mistake leads to misallocation (Zhou, 2008a, pp. 328–32).

2.2. Incentives and the Law of Contractual Mistake

The relationship between incentives and the law of contractual mistake has been a predominant issue in the current law-and-economics literature. Academic attention has been directed to the question of how the law can be used to create the right incentives for the parties to acquire and disclose information prior to the conclusion of the contract.

Offering a legal remedy for contractual mistake can motivate parties to disclose private information. If the law permits a party to rescind a contract on the ground of mistake, the non-mistaken party will not realise the expected profit from the transaction. This creates an incentive for the non-mistaken party to disclose private information to save the other party
from making mistakes. As long as the cost of disclosure is lower than his expected profit from the transaction, the party will have an incentive to disclose.

But the legal remedy for contractual mistakes also creates a disincentive for the parties to acquire information in the first place. A party’s incentive to acquire information depends on his obtaining the property right to it in order to generate a profit. The legal remedy for mistakes deprives the party of the property right to his private information, as once the information is revealed to another, the party starting with an information advantage is unable to exclude the other from using it. Therefore, the economic question is how to balance the incentive to disclose against the disincentive to acquire information.

2.2.1. Deliberative acquisition v. casual acquisition

It is generally agreed that discussion of this issue starts with a groundbreaking paper by Kronman (1978), arguing that the law should offer legal remedy to the mistaken party for his mistake when the non-mistaken party acquires information casually, whereas it should not provide legal remedy if the information is acquired deliberately by the non-mistaken party. The rationale underlying this argument is as follows. Casual acquisition incurs no search cost to the non-mistaken party, so the legal remedy for mistake will not undermine his incentive to acquire information in the first place. If, by contrast, the information is deliberately acquired, there is a search cost to the party, so the legal remedy for mistake will create a disincentive for him to seek information (Kronman, 1978, p. 13).

Notwithstanding its great contribution to the literature, Kronman’s argument has three limitations. First, as Kronman’s interest is in the issue of how the law can create the incentive for information production, he overlooks the issue of how it affects the allocation of resources. According to him, the contract should be rescinded on the ground of mistake if the non-mistaken party acquired the information casually. But if the subjective value of the non-mistaken party is higher than that of the mistaken party, the rescission will result in misallocation of resources from the higher value user to the lower. Hence, Kronman’s approach may lead to the misallocation of resources (Zhou, 2008a, p. 332).

Secondly, Kronman assumes that the behaviour of information acquisition is of a binary nature: the search cost is either zero or positive. However, this cannot be held in reality, as the cost structure of information acquisition is normally a continuum with zero at one end and infinity at the other. The search cost of a contracting party lies somewhere between these extremes. Therefore, it is impossible to distinguish deliberative acquisitions from casual ones. For example, the reason why the buyer
in a second-hand shop was able to recognise an authentic painting by a famous artist, which the seller did not identify, is that the buyer had spent many years in studying for a Ph.D. in art history. The question of whether the buyer’s tuition fees should be counted as a cost of information acquisition is a difficult one. In theory, searching behaviour should be seen as a continuum rather than a binary phenomenon. The question to be asked is not whether the information was acquired deliberately or casually, but what is the optimal level of search cost which can be achieved by setting the marginal search cost equal to the marginal benefit. Unfortunately, given information deficiency, this theoretical analysis has barely any practical value.

Thirdly, Kronman assumes that the more information is available, the better it will be for society, but this is not always true. In the first place, duplication of information will generate a cost to society. Thus, account should be taken of what is the optimal amount of information. Again, in theory, it would be at the level where the marginal benefit from the production of information equals the marginal production cost. In addition, from the standpoint of society as a whole, not every piece of information is valuable. Some has only a distributive effect without improving allocative efficiency, while what is valuable to society is information which can enhance allocative efficiency.

2.2.2. Productive v. redistributive information

Another approach to the problem of incentives is to distinguish socially useful from useless information. Cooter and Ulen (2003, pp. 281–4) propose a distinction between productive and redistributive information. Productive information can be used to produce more wealth, for example, the discovery of a vaccine for polio or the discovery of a shipping route between Europe and China. In contrast, redistributive information creates a bargaining advantage that can be used to redistribute wealth in favour of the informed party; for instance, knowing before anyone else where a new road is to be built conveys a powerful advantage in property markets. Searching for redistributive information is socially wasteful. Therefore, Cooter and Ulen conclude that the law should discourage expenditure of resources on searching for redistributive information. One device to this end is to rescind the contract when one contracting party makes a unilateral mistake which is caused by the non-mistaken party’s non-disclosure of redistributive information.

The argument of Cooter and Ulen appears to be based on the earlier work of Hirshleifer (1971, p. 561), who made a distinction between ‘foreknowledge’ and ‘discovery’. Foreknowledge is knowledge that ‘will in due time, be evident to all’; it is information that ‘Nature will autonomously
reveal’ and which ‘involves only the value of priority in time of superior knowledge’. This type of information leads only to redistribution of wealth, without increasing social welfare. Discovery, by contrast, is ‘the recognition of something that possibly already exists, though [it will remain] hidden from view unless and until the discovery is made’ (Hirshleifer, 1971, p. 562). Discovered information can generate both private gains to the owner of information and social wealth. Although Cooter and Ulen use different terminology, the theme of their argument is much the same as that of Hirshleifer, in that both seek to distinguish socially valuable from socially valueless information and suggest that the law should provide disincentives for acquisition of the latter.

But the shortcoming of Cooter and Ulen’s approach is also obvious. In the context of contract law, it is impossible to draw a clear-cut distinction between productive and redistributive information: in most cases, it is both. Recall their earlier example: they argue that information on the discovery of a shipping route from Europe to China is productive. But this information can also be redistributive. Imagine a contractual relation between a Chinese exporter and a European importer. Assume now that the Chinese importer knows of a new route; this information could reduce his transportation costs substantially. If his European partner learns of this information, he will not purchase the goods unless the Chinese firm agrees to lower the price. But if the Chinese party conceals this information from the European buyer, he can charge the same price and make a higher profit. Thus, the information on the new route redistributes wealth in the form of contract price from the European firm to the Chinese firm.

Conversely, the redistributive information may be of a productive kind. Cooter and Ulen take the information concerning the intended building of a new road as an example of redistributive information, but it may be productive as well. If the owner of land adjacent to the road uses it for a purely residential purpose, the new highway will reduce his subjective value on the land, because of noise generated by passing vehicles. The sooner he has the information, the sooner he will be able to sell the land to a person who values it more highly and buy a new home. Thus, information of this kind can speed up the process of resource allocation to the highest value user (Eisenberg, 2003a, pp. 1666–73).

2.2.3. The remedy-based approach Instead of focusing on the type of mistake, the remedy-based approach aligns the parties’ incentive via adjustment of the legal remedy for mistakes: rescission. It is suggested that if one party makes a contractual mistake, the law should give discretion to the mistaken party to decide whether or not to rescind the contract; if the mistaken party chooses to rescind the contract, that party should pay
the other party for the expectation loss in order to put the latter into the position he or she would have been in if the contract had been perfectly performed. The expectation loss is measured in the same way as damages for breach of contract (Zhou, 2008a, p. 336).

In the light of this approach, if the mistaken party rescinds the contract, he should compensate the non-mistaken party for his expectation loss. This is just equal to his subjective value – the price at which he would sell the goods. A rational party will have the incentive to rescind the contract for the mistake only if his subjective value exceeds the other party’s expectation losses; otherwise, he will choose not to rescind. Consequently, other things being equal, it can be ensured that as long as the mistaken party rescinds the contract, his subjective value will be higher than that of the non-mistaken party and the rescission is allocatively efficient. If the mistaken party waives the right of rescission, it is implied that his subjective value is lower than that of the non-mistaken party, so that it is now enforcement of the contract which is allocatively efficient. Therefore, theoretically speaking, the remedy-based approach does not result in misallocation of resources. In addition, it can create a sufficient incentive for acquisition of information. Under the remedy-based rule, if the contract is rescinded for a mistake, the non-mistaken party can claim the expectation loss from the mistaken party. Hence, after receiving compensation from the latter, the former would be put into the position in which he would have been had the contract been perfectly performed. The remedy-based approach allows the party to capture all of the profits derived from his private information, thereby creating a sufficient incentive for him to acquire information (Zhou, 2008a, pp. 336–8).

2.2.4. Voluntary disclosure

Another theory suggests that even without legal intervention, a seller may still have an incentive to disclose private information (Beales et al., 1981; Wonnell, 1991), since disclosure of information can help sellers to distinguish themselves from other sellers of homogeneous goods. In the absence of information, buyers are likely to view all brands as of equivalent value, when they actually differ. Thus, sellers of above-average brands are incentivised to reveal the special qualities or features of their goods in order to distinguish them from below-average competitors. Given these disclosures, buyers might begin to perceive that the average value of non-disclosing sellers is lower. This perception would in turn create a new incentive for those of the remaining non-disclosing seller whose goods are above the average to disclose their advantages. This would again lower the average of non-disclosing sellers and so on, until every seller disclosed (Beales et al., 1981). Nonetheless, the application of this argument is limited. First, it is assumed that the
market is competitive and that buyers are competent to process the information, which is obviously not always true in reality. Secondly, the seller only has incentives to disclose information which can increase the contract price, and has no incentive to disclose information which will reduce it. Normally, it is the latter kind of information which is needed to prevent buyers’ mistakes. Therefore, despite the incentive of voluntary disclosure, legal intervention is still necessary.

2.2.5. A competitive model  Most of the above analysis is based upon the two-party model that assumes no competition between sellers, so that the incentive for acquisition of information is only to compete with another party to capture a greater share of the contract surplus. Therefore, mandatory disclosure of private information undermines the incentive to search for information. However, this conclusion has to be modified if the assumption of competitive market conditions is integrated into the analysis.

Grosskopf and Medina (2006) suggest that furnishing relief for contract mistakes does not always undermine the contracting party’s incentive to acquire information, because the motive for acquisition of information is sometimes driven by obtaining a competitive advantage over other contractors. For example, in a competitive market, firms have a strong incentive to acquire information in relation to consumers’ preferences in order to improve the quality of their goods or services; an incentive which is not affected by the rules of mistake in contract law. Therefore, the authors provide two general propositions. First, the law should distinguish conventional information which the contractor gathers to beat other competitors from exceptional information which the contractor found when searching other than for that purpose. Offering relief for a mistake in the former case will not weaken the contractor’s incentive to gather information. Secondly, the contractor’s incentive for gathering conventional information could be undermined in the market where other competitors can freely use his information. Therefore, the law should be adjusted to solve this type of free-rider problem by excluding other competitors from accessing the information. For example, in a contract on tender, the seller should be prohibited from revealing information in a tender by one party to other competitors (Grosskopf and Medina, 2006).

2.3. Common Mistake Rule v. Unilateral Mistake Rule

Another important question in relation to the law of contractual mistake is whether the law should adopt the common mistake rule or the unilateral mistake rule. Under the former, the contract is void only if both parties
are mistaken, while under the latter, it can be void even if only one party is mistaken. Both efficiency features and the parties’ incentives under the common mistake rule differ from those under the unilateral mistake rule.

Because there are more mistaken contracts to rescind under the unilateral mistake rule, it is appropriate to assume that other things being equal, this rule is more efficient, if a mistaken contract is more likely to cause a misallocation of resources, because the more mistaken contracts are rescinded, the more misallocations are corrected. Conversely, if a mistake is unlikely to result in a misallocation, the common mistake rule is superior to the unilateral one, as the rescission of a mistaken contract which generates no misallocation will, in itself, be a misallocation of resources (Rasmusen and Ayres, 1993, p. 309; Zhou, 2008b, p. 259).

As to the incentive to disclose, both parties under the unilateral mistake rule will have the incentive to disclose their private information. If one party intends to exploit the other’s mistake by concealing private information which might prevent the latter from making the mistake, the contract will be void on the grounds of the unilateral mistake, so the former will be unable to make a profit from concealing his private information. This in turn motivates him to disclose his private information. Under the common mistake rule, by contrast, he has no incentive to disclose, because now the contract is held void and unenforceable if and only if both parties are mistaken. If either party can make a profit from the other’s mistake by concealing private information, he will not disclose, because the contract cannot be void for the reason that only one party is mistaken. Therefore, the best strategy for him is to conceal such information (Rasmusen and Ayres, 1993, p. 309; Wonnell, 1991, p. 329).

Turning to the incentive to acquire information, it is clear that neither party has such an incentive under the unilateral mistake rule, which creates an incentive to disclose, prohibiting the exploitation of private information. Therefore, there is no incentive to acquire such information in the first place.

Although a party is allowed to benefit from using his private information under the common mistake rule, his incentive to acquire information is unpredictable. To illustrate, assume that a buyer is willing to buy both high and low quality goods, but that he will offer a higher price for the former. If the seller does not know whether the goods which he is about to sell are of good or bad quality, does he have an incentive to investigate under the common mistake rule? Probably not, because he can always charge the buyer an average price, which is higher than the price for poor quality goods. If they are discovered to be of good quality ex post, the seller can always rescind the contract if the buyer was unaware of the true quality. However, if the buyer is informed by acquiring private
information in the first place, the seller faces the risk of selling high quality goods at an average price, which is less than they are worth. Thus, he will seek information if the buyer does so. From the buyer’s point of view, he has an incentive to search only if the seller does not search, because if the seller can distinguish high quality goods from poor ones by acquiring extra information, the seller will charge a different price for different quality goods. There is thus no need for the buyer to search. If the seller does not search, there is a risk for the buyer of purchasing poor quality goods at the average price, which is more than they are worth. Therefore, the buyer has the incentive to search only if the seller does not do so. This is a coordination game, in which some sellers and buyers will search for information, while others will not (Rasmusen and Ayres, 1993, p. 329).

It is also argued that compared with the common mistake rule, the unilateral version enjoys the advantage of saving the transaction cost in negotiating a contract clause to avoid mistakes when there is information asymmetry between the contracting parties (Smith and Smith, 1990). Consider the example of a seller who contracts to sell a ring to a buyer. If the stone is a real diamond, he will sell it at £1,000; if not, the price will be £200. If the seller does not know the quality of the ring, he will shift the risk to the buyer by reflecting the possibility of the stone not being a diamond in the contract price, offering it at £600 (£200 × 0.5 + £1,000 × 0.5). If he does have information indicating that the stone is a diamond, he will charge the buyer £1,000 and provide a warranty to that effect in the contract. Therefore, all sellers with superior information will distinguish themselves by including such a warranty in the contract. Crucially, any seller having information indicating that the stone in his ring is not a diamond has an incentive to conceal that information and attempt to sell the ring at £600, in competition with those sellers who have no information superiority (Smith and Smith, 1990, p. 478). Consequently, sellers of rings of unknown quality have to face the free-rider problem if they choose to shift the risk of ignorance to the buyer by discounting the contract price. However, if the buyer agrees to purchase the ring at £200 and adds a clause in the contract which allows the seller to rescind the contract in the case where the stone turns out to be a real diamond, sellers of rings of unknown quality would definitely prefer to accept such a clause rather than discounting the contract price, because this saves them from being free ridden by sellers of false diamond rings. The unilateral mistake rule functions as an ‘off-the-rack’ provision to an incomplete ‘bargained-for’ contract that stipulates that if the seller is mistaken about some essential fact, he will get the goods back and the buyer the money. This saves the seller’s transaction cost in negotiating such a clause with the buyer. In contrast, if the common mistake rule applies, the buyer may argue that he
does not share the mistake. The seller cannot rescind the contract when the stone turns out to be a diamond. Consequently, the warranty function of the mistake rule is ineffective. Therefore, the unilateral mistake rule can save more transaction costs than the common mistake rule when there is an information asymmetry between the contracting parties.

2.4. Cross-purpose Mistakes

A cross-purpose mistake is a special type of common mistake which occurs where one party intends to contract for one thing and the other party for another. The classic example is the English case of *Raffles v. Wichelhaus* (1864, 15 ER 375), where the parties entered into a contract for the sale of cotton on a ship, the Peerless. In fact, there were two ships named Peerless, one (Peerless I) which departed in October and the other (Peerless II) in December. Notwithstanding the case report does not document explicitly, it seems that the buyer believed himself to be purchasing the cotton on Peerless I, and the seller believed that he had contracted to sell that on Peerless II. The court refused to enforce the contract on the grounds of the mutual misunderstanding as to the subject matter of the contract between the parties.

From an economic perspective, the judgment of *Raffles v. Wichelhaus* is inefficient, because it creates a chance for parties to behave opportunistically. Assume that the market price for cotton drops significantly after the conclusion of the contract. It would not be unreasonable to infer that the buyer would not demand delivery when the Peerless I docked in Liverpool on 18 February 1863. When the seller tendered the delivery of cotton on Peerless II, which arrived two months later, the buyer would claim that there was a cross-purpose and the contract was unenforceable. The rule of cross-purpose mistake thus allows opportunist behaviour for a contracting party to escape a bad bargain.

To solve this problem, a no-retraction principle is suggested (Ben-Shahar, 2004). According to this rule, a party who manifests a willingness to enter into a contract at given terms should not be able to retract freely from this (Ben-Shahar, 2004, p. 1830). Instead of judicially declaring the contract void when there is a cross-purpose mistake as to the subject matter, the court should allow either party who claims that the contract is valid to enforce the contractual terms claimed by the other party. Recall the Peerless case. If the seller intends to enforce the contract, the contract terms as to the subject matter should be Peerless I, which is what the buyer claimed it to be. Under this proposed rule, the buyer is unable to escape a bad bargain by exploiting the common mistake rule to argue that the contract is void on the grounds of mutual misunderstanding (Ben-Shahar, 2004, p. 1856).
3. Fraudulent Misrepresentation

Fraudulent misrepresentation is the intentional passing of false information by one party to induce another party to contract with him. Such misrepresentation is socially undesirable not only because it can lead to misallocation of resources, just as a contractual mistake does, but also because it generates real social costs (Mahoney, 1992). First, it generates precautionary costs, which are defined as the money, effort and time used by the representee to prevent fraudulent misrepresentation. Secondly, the resources invested in a fraudulent misrepresentation constitute a social waste. Fraudulent misrepresentation is a type of opportunistic behaviour. It does not increase social welfare, but merely transfers existing wealth between the contracting parties. Thus, the more the parties spend on fraudulent misrepresentation to capture a greater share of contract surplus, the less surplus will remain. Any resource used in this way is totally wasted from a social standpoint (Zhou, 2007, pp. 86–8). Therefore, the law should deter fraudulent misrepresentation (Craswell, 2006, p. 600).

3.1. Legal Deterrence of Fraudulent Misrepresentation

According to Becker’s theory of legal deterrence (Becker, 1976), the law will create effective deterrence if the following inequality is satisfied.

\[ D \geq |P - V| \]  

Here, \( D \) represents the private legal remedy for fraudulent misrepresentation, which can refer to either damages or rescission. The right-hand side of the formula is the representor’s net gain from the fraudulent misrepresentation: \( P \) stands for the contract price and \( V \) for the maximum amount the representee would be willing to pay or the minimum he would accept on the basis of true information. If the seller is the representor and lies to the buyer, he is able to charge him a higher price than if he tells the truth. If the buyer is an untruthful representor, he is able to pay a lower price than the seller would be willing to accept on the basis of true information. The representor’s gain from the fraudulent misrepresentation can thus be written as the difference between the contract price and the maximum the representee would be willing to pay or the minimum he would accept on the basis of true information, viz. \( |P - V| \).

In reality, the enforcement of private legal remedies is not perfect, so to make this model more workable, we must add a coefficient \( q \), representing the probability of private legal enforcement. Unlike public legal enforcement, private enforcement relies entirely on the victim to bring a legal action against the injurer. In order for private legal remedies to deter fraudulent misrepresentation effectively, the representee needs not only to
learn the truth, but must also convince the court of the representor’s mis-
representation. Due to the information asymmetry and the representee’s
cognitive limitations, he may fail to find out that the representor is lying,
or he may be unable to convince the court. In addition, high litigation
costs may prohibit the representee from bringing an action. Therefore,
in reality \( q \) is always less than one. The deterrence model of private legal
remedy for fraudulent misrepresentation can now be rewritten as:

\[
Dq \geq |P - V|
\]  (3.2)

From a policy perspective, this model indicates that the law can prevent
fraudulent misrepresentation by influencing the potential representor’s
decision \textit{ex ante}, either by raising the probability of private enforcement
or by raising the damages recoverable by the representee (Zhou, 2007;
Craswell, 1999).

However, the use of private legal remedy to regulate fraudulent misrep-
resentation is not free; it also generates costs to society. Two types of cost
associated with private legal remedy can be easily identified, viz. adminis-
trative cost and the cost of legal intervention. Administrative cost is that
incurred by the operation of legal rules. It includes the time and effort
spent by both representor and representee in pre-trial negotiations and in
the litigation itself, as well as the public operating expenses of the courts.
The cost of legal intervention is the loss of social welfare which would have
been derived from those potential transactions that are deterred by the
intervention of the law in the private contracting process (Zhou, 2008b,
pp. 82–6).

If the objective of the law is simply to create effective deterrence of
fraudulent misrepresentation, there is no need to consider the cost of legal
remedy. It does not matter whether the left-hand side of inequality (3.2)
is set equal to or higher than the right-hand side; in both cases, the gain
from fraudulent misrepresentation is eliminated, so the representor has
no incentive to lie. For the same reason, there is also no difference, for the
purpose of improving the deterrence, between raising \( D \) and increasing \( q \).

However, if it is assumed that the objective of the law is to improve
allocative (Kaldor-Hicks) efficiency, we must take the cost of applying
legal remedy into account. Indeed, much law-and-economics research
has convincingly shown that it is not always efficient to minimize a par-
ticular type of social cost by means of legal intervention, because of the
cost incurred by the legal instrument itself (Stigler, 1970); and this line of
argument is applicable to the law of fraudulent misrepresentation.

In general, it can be argued that an increase in the severity of legal sanc-
tion will improve deterrence, thus reducing the total number of acts of
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fraudulent misrepresentation and consequently lessening the social cost of fraud. But strict legal sanctions require a high level of legal intervention, which will raise both administrative costs and legal intervention costs. Applying the Kaldor-Hicks test, the law is efficient only if the cost generated by the law itself is outweighed by its benefit. In the current context, the law is efficient only if the social cost generated by fraudulent misrepresentation exceeds the aggregate of administrative cost and legal intervention cost. Therefore, it must be Kaldor-Hicks inefficient if the objective of the law is to eliminate fraudulent misrepresentation completely.

From an efficiency perspective, the law should balance the social costs arising from fraudulent misrepresentation against the aggregate of administrative cost and legal intervention cost. The optimal legal remedy will be one which minimizes both. Accordingly, the following three normative propositions can be offered:

1. If the cost incurred by the legal remedy exceeds the costs incurred by fraudulent misrepresentation, the remedy is not desirable in terms of efficiency.
2. If the same amount of reduction in the costs incurred by fraudulent misrepresentation can be achieved by different legal remedies, economic efficiency favours whichever generates the least cost to others.
3. If different legal remedies cost the same, economic efficiency prefers the one which makes the largest reduction in the cost incurred by fraudulent misrepresentation.

According to the above propositions, if the left-hand side of inequality (3.2) exceeds rather than equals the right-hand side, this will result in over-deterrence; consequently, the costs of private legal remedies will be unnecessarily increased. In addition, if the same level of deterrence can be achieved by increasing either $D$ or $q$, we should choose whichever method costs society less in terms of legal intervention (Zhou, 2008b, pp. 86–8).

3.2. Legal Remedies for Fraudulent Misrepresentation

Normally there are two private law remedies for a fraudulent misrepresentation, one in tort law and the other in contract law. In tort law, the representee is entitled to claim damages from the representor. The general principle of measuring damages for misrepresentation is to use financial compensation to put the representee in the position where he would have been had no fraudulent misrepresentation been made, that is to say, the representee can recover all of the consequential losses resulting from relying on the fraudulent misrepresentation. In some jurisdictions, such as
the USA, the representee may even claim punitive damages; the amount of damages recoverable will be subject to the jury’s discretion. Apart from damages in tort law, the representee is also entitled to rescind the contract on the grounds of fraudulent misrepresentation. As a general principle, once the contract is rescinded, each party is obligated to return to the other the value which he or she received from the other.

Despite a large amount of law-and-economics literature on legal remedies for breach of contract, scholars have not paid sufficient attention to the legal remedies for fraudulent misrepresentation. One economic issue in this regard is whether or not a private legal remedy can create effective deterrence. It is suggested that the deterrence of damages in tort law is more effective than the remedy of rescission in contract law (Zhou, 2006), because there is no upper limit to the level of damages, \( D \). If the probability of legal enforcement is imperfect \( (q < 1) \), \( D \) can always be increased to achieve \( Dq \geq |P - V| \) by setting \( D \geq |P - V|/q \). Notwithstanding a low \( q \) will undermine legal deterrence, effective deterrence can be restored by increasing \( D \). In contrast, in the case of rescission, \( D \) is constant; deterrence can be improved only by increasing \( q \). If the contract is rescinded on the grounds of misrepresentation, neither party can realise its expected interest from the contract. Thus \( D \), the liability cost to the party, equals his expected profit from the unconscionable contract, which is measured as his expected profit from the transaction, \( |P - V| \). If \( q = 1 \), the inequality \( Dq \geq |P - V| \) is satisfied. If \( q < 1 \), deterrence can be enhanced only by improving the legal enforcement, \( q \). Unlike the remedy of damages, under rescission, \( D \) is fixed. Therefore, deterrence cannot be improved by increasing \( D \). This is why, in terms of deterrence, damages are a preferable remedial alternative to rescission when legal enforcement is poor.

Craswell (1989) examines the relation between the representee’s reliance on the information presented by the representor and the magnitude of damages for fraudulent misrepresentation. He argues that neither expectation damages nor reliance damages can induce the representor to make true representation, nor induce the representee to place reasonable reliance on the representation made by the representor. The problem is attributable to the inelasticity between damages recoverable by the representee and the level of his reliance on the information provided by the representor. Under both the expectation damages and reliance damages rules, the representor’s incentive to deceive is unaffected by the rule, because whether or not he makes a fraudulent misrepresentation will not increase or decrease the amount of damages recoverable by the representee on the action of breach of contract. Furthermore, the representee can recover all of the reliance costs under both rules; he would therefore tend to over-rely on the representation.
Craswell therefore suggests that to solve this problem the amount of damages recoverable by the representee should be tied to the optimal level of reliance. That is to say, the law should hold the promisor liable for the value of the promisee’s expectation interest as it would have been if the promisee had chosen the optimal level of reliance, given everything the promisor had said about the probability of performance (Craswell, 1989, p. 367). Under this rule, the promisee can only recover the amount of damages up to the point where his reliance on the promisor’s statement is reasonable. This rule, therefore, can prevent the promisee’s over-reliance. On the other hand, if the promisor exaggerates the probability of performance, the reasonableness standard will also increase, so the damages recoverable by the promisee will also rise accordingly. This creates an incentive for the promisor not to misstate the probability of performance.

3.3. Determination of Fraudulent Intention
It is notoriously difficult to judge whether or not a misrepresentation is made fraudulently. Four main propositions are offered in the literature, none of which is perfect. As fraudulent misrepresentation is a type of intentional tort, the economic propositions for intentional tort are equally applicable. The first suggests that if a misrepresentation generates a high probability of misleading the representee, it should be treated as fraudulent (Zhou, 2009a; Landes and Posner, 1981, p. 129). It is true that a fraudulent misrepresentation is more likely to mislead the representee than a non-fraudulent one, but a misrepresentation with a low probability of misleading can also be made fraudulently. If the gains from the fraudulent misrepresentation are very great, even though the probability of misleading is low, it is reasonable to assume that the representor has an incentive to deceive, as long as the gain discounted by the probability exceeds his personal cost of making the misrepresentation. This proposition cannot offer a legal standard to cover all fraudulent misrepresentations.

The second proposition is that if the costs to the representor of avoiding the misrepresentation are negative, it should be held as having been fraudulently made (Zhou, 2009a; Landes and Posner, 1981, p. 139). A negative precautionary cost against misrepresentation indicates an investment in the misrepresentation by the representor, which is clearly convincing evidence of the intention to deceive. If the court had perfect information as to the cost to the representor of making the misrepresentation, this proposition would be a valuable criterion to determine the intention to defraud, but in reality, information asymmetry means that the court is unlikely to be able to assess this cost.

The third proposition is that if the representor’s precautionary cost against the misrepresentation is trivial relative to the representee’s resultant
losses, an intention to deceive should be found (Zhou, 2009a; Landes and Posner, 1981, p. 133). This proposition does not intend to capture all types of fraudulent misrepresentation, but only one type, reckless misrepresentation. A misrepresentation made recklessly amounts to a fraudulent misrepresentation. The classical example is one who fails to disclose the false element in a statement he has made when realising it later.

Like the third proposition, the fourth does not intend to provide a legal standard for all fraudulent misrepresentations. It focuses on another type of fraud, promissory misrepresentation (Ayres and Klass, 2005). Courts are often very cautious about assigning legal liability to a misrepresentation of promise. For example, in the UK, a misrepresentation as to a promise in the future is not actionable, unless it is made intentionally. The primary worry of courts is the chilling effect on informational behaviour caused by legal errors. Compared with a misrepresentation of existing fact, it is more difficult to determine whether or not the representor intended to perform his or her promise at the time of representing. Frequently incorrect judgments of intention by courts will increase the liability cost to the representor, which will deter parties from making any statement as to the future. It is reasonably assumed that on average the benefit to society derived from useful but not wholly accurate statements as to the future would exceed the cost generated by promissory misrepresentation. Ayres and Klass (2005, pp. 9–12) argue that this difficulty is caused by the binary approach to determining the intention of fraud in the current law. According to this approach, a promissory misrepresentation would be held either true or false, with no shading between the two. This is contradictory to the way in which parties actually make promissory representations. In fact, the probability of performing is a continuum from zero at one end, gradually increasing to 100 per cent at the other. The binary approach assumes that there are only two types of promise, those which the promisor intends to perform and those where there is the intention not to perform. It fails to take the probability of performance into account. There is, in fact, a third type of promise, where the party is uncertain of his intention, neither intending to perform nor intending not to. The improvement suggested by Ayres and Klass is that the court should adopt a continuum approach to promissory misrepresentation by taking into account the representor’s belief as to the probability of performance. A promise would then be held fraudulent and draconian legal sanctions (punitive damages and criminal law sanctions) would ensue only if the promisor knowingly or recklessly misrepresented the probability of performance (Ayres and Klass, 2005, pp. 73–82). This approach releases from severe legal liability for fraudulent misrepresentation some promises which the promisor does not intend to perform, thereby reducing the chilling effect of the current law.
4. Non-fraudulent Misrepresentation

4.1. Negligent Misrepresentation
A negligent misrepresentation is a false statement which induces the representee to contract, as a result of the representor’s failure to take due care when making the statement. A fraudulent misrepresentation differs from a negligent one in the respect that the former is an intentional behaviour and the latter is not, but merely a careless statement. Unlike fraudulent misrepresentation, which is useless to society, a careless statement can be a piece of valuable information, because it may turn out to be true. A law which imposes a legal liability for every careless misrepresentation must be inefficient, as it will overcome, or at least undermine, the parties’ incentive to present information which is valuable but less accurate (Bishop, 1980, p. 360). Thus, the law of negligent misrepresentation should aim not to create a cost-effective deterrence of careless misrepresentation, rather to create an incentive for parties to take the socially optimal level of care when making a statement.

4.1.1. The optimal level of care
Let $H$ be the aggregate of the representee’s loss, the cost of legal intervention and the administrative cost, and let $p(x)$ be the probability of the representor making a careless misrepresentation which causes cost $H$, given a level of care $x$, where $p'(x) < 0$, $p''(x) > 0$, which indicates that a little more care taken by the representor would reduce the probability that his statement is a misrepresentation; but when the care taken by the representor reaches a given level, any additional care that he takes will only reduce the probability of his making a misrepresentation by a negligible amount. To be efficient, the law of negligent misrepresentation must minimize the total expected costs:

$$x + p(x)H$$  \hspace{1cm} \text{(3.3)}

Let $x^*$ denote the $x$ that minimises the value of equation 3.3. This is the socially optimal level of care which the representor should take. It is determined by the first-order condition $I = -p'(x)H$, which indicates that the marginal cost of care taken by the representor must equal the marginal benefit in terms of the reduction in expected costs generated by the misrepresentation. An efficient law of negligent misrepresentation should induce a party to take $x^*$ level of care when making a statement.

4.1.2. Negligent rule v. strict liability
There are two types of legal liability rule, negligent liability and strict liability, to induce the representor to take optimal care. Under negligent liability, the representor is held liable...
for the representee’s loss arising from relying on a careless misrepresentation only if he was negligent, that is, only if the level of care which he took was less than the level of due care provided by the law. However, under strict liability, the representor is liable for all of the representee’s losses resulting from relying on the misrepresentation.

It is argued that the negligence rule is preferable to strict liability for the purpose of inducing representors to take the optimal level of care. Under the strict liability rule, the representor will himself assess the \textit{ex ante} liability cost. To achieve the socially optimal level of care, it is crucial that he should take into account all of the costs resulting from the misrepresentation. But there is a disparity between his private cost and the social cost, which would lead him to take the privately optimal level of care rather than the socially optimal level. The representor’s private liability cost can be measured as the representee’s losses resulting from acting on the misrepresentation, plus the representor’s personal litigation cost when he is sued in the action of misrepresentation. But, from the standpoint of society as a whole, the total cost has three elements: the representee’s personal losses, the administrative costs, which comprise the litigation costs of both parties and the resources, effort and time spent by the court, and the cost of legal intervention. It is clear that in the representor’s calculation, he takes into account neither the administrative costs of the representee and the court, nor the cost of legal intervention. Indeed, the representor has no incentive to take account of these costs in his calculation of the \textit{ex ante} liability cost. Consequently, his personal optimal level of care falls short of the socially optimal level.

In contrast, under the negligence rule, it is for the court to decide what the optimal level of care is. It is normally perceived that courts have an informational advantage over representors as to the total cost generated by misrepresentation. The court can set the optimal level of care on the basis of all of the social costs resulting from the misrepresentation, then use a private legal sanction (damages or rescission) to induce the representor to take the socially optimal level of care. As long as the cost of private legal sanction is greater than the precautionary cost of optimal care, the representor will take optimal care. Under the negligence rule, there is no need for the representor to decide what amount of care is socially optimal; thus the negligence rule overcomes the problem of inadequate consideration by the representor of the total cost generated by the misrepresentation.

4.1.3. Legal errors under the negligence rule \hspace{1em} Judicial error in identifying negligence may always induce the representor to take excessive care, regardless of whether the court is more likely to misperceive an innocent
representor as negligent or a negligent one as innocent. Consider the following example (Shavell, 1987, p. 217). The probability of the representor’s careless statement being a misrepresentation that would cause a loss of £100 is related to the level of care, as shown in Table 3.1.

The socially optimal level of care, which is assumed to be due care, is moderate. If there were no chance of the court making an error in the assessment of the representor’s negligence, he would take moderate care at a cost of £3, rather than high care, because that would involve a greater cost (£5).

Suppose, however, that there is a 33 per cent chance that the court will misperceive care by one level and a 5 per cent chance that it will misperceive care by two levels. Therefore, there is a 33 per cent chance that no care would be seen by the court as moderate care and a 5 per cent chance that no care would be seen as high care. Further, there is a 33 per cent chance that moderate care would be seen by the court as none and a 33 per cent chance that moderate care would be seen as high care. There is also a 33 per cent chance that high care would be seen by the court as moderate and a 5 per cent chance that it would be seen as none.

In this situation, taking high care is the best decision by the representor. If he takes no care, his expected expenses will be $62\times15\times100 = 9.3$ (since he will mistakenly escape liability $33\% + 5\% = 38\%$ of the time). If he takes moderate care, his expected expenses will be $3 + 33\% \times 10\% \times 100 = 6.33$ (since he will mistakenly be found liable $33$ per cent of the time). Yet if he takes high care, his expected expenses will be only $5 + 5\% \times 9\% \times 100 = 5.45$ (since he will mistakenly be found liable only $5$ per cent of the time).

This example has two implications: (1) if taking more care reduces the chance of being found negligent by judicial error, the representor may decide to take more than due care, even where the chances of the court’s overestimating care are as large as the chances of their underestimating it; (2) despite the representor’s increasing his level of care, he may still face a positive risk (5 per cent) of being found negligent. Thus, judicial error in determining negligence is more likely to induce representors to take more

<table>
<thead>
<tr>
<th>Level of care</th>
<th>Cost of care (£)</th>
<th>Probability</th>
<th>Expected loss (£)</th>
<th>Total social loss (£)</th>
</tr>
</thead>
<tbody>
<tr>
<td>None</td>
<td>0</td>
<td>15%</td>
<td>15</td>
<td>15</td>
</tr>
<tr>
<td>Moderate</td>
<td>3</td>
<td>10%</td>
<td>10</td>
<td>13</td>
</tr>
<tr>
<td>High</td>
<td>5</td>
<td>9%</td>
<td>9</td>
<td>14</td>
</tr>
</tbody>
</table>

Table 3.1   Level of care and probability of £100 loss
care than the optimal level, regardless of whether the court is more likely to misperceive an innocent representor as negligent or a negligent one as innocent.

4.2. Innocent Misrepresentation

4.2.1. Economic features of innocent misrepresentation From an economic perspective, an innocent misrepresentation is a false statement which the representor cannot avoid by taking the socially optimal level of care. In other words, a misrepresentation is seen as made innocently if the marginal loss resulting from it is outweighed by the representor’s marginal precautionary cost. This is graphically illustrated in Figure 3.1.

The horizontal axis stands for the amount of precaution which the representor takes, while the vertical axis represents the probability of his statement being a misrepresentation. The line $ML$ is the marginal social loss generated by the misrepresentation, $MP$ is the marginal cost of precaution and $P^*$ is the standard of care which the law requires the representor to take. The socially optimal level of care is taken where $MP = -ML$. Zone $A$ is the area to the left of $P^*$ and Zone $B$ that to the right of $P^*$. Any misrepresentation in Zone $A$ will be held as negligent, because the actual

![Figure 3.1 Innocent misrepresentation](image-url)
level of care taken by the representor is lower than the socially optimal level, \( P^* \). By contrast, a misrepresentation in Zone \( B \) will be seen as innocent, because it could not have been avoided by the representor taking the socially optimal level of care.

Figure 3.1 shows the difference in economic features between a negligent misrepresentation and an innocent one: the former can be avoided by the representor taking the socially optimal level of care, but the latter cannot. In the case of negligent misrepresentation, the representor’s marginal precautionary cost is lower than the marginal social loss resulting from his misrepresentation. This implies that the social loss can be reduced by taking additional precautions. When the marginal precautionary cost rises to a level just equal to the marginal social loss, to take any further additional care will not reduce the social loss, but increase it. This would be the outcome of taking care against innocent misrepresentation, since the representor’s marginal precautionary cost is higher than the marginal social loss. Thus, the representor cannot avoid innocent misrepresentation by taking the socially optimal level of care; and from the standpoint of society, it is inefficient for him to take more care than \( P^* \) to avoid making an innocent misrepresentation. This economic analysis provides a valuable way of understanding the efficiency features of the law of innocent misrepresentation – it would be inefficient for the law to create an incentive for representors to take precautions against innocent misrepresentation. Innocent misrepresentation also has economic features which distinguish it from fraudulent misrepresentation. Unlike his fraudulent counterpart, the innocent representor does not intend to pursue the outcome of misrepresentation. Therefore, he does not deliberately cause the waste of resources in misleading the representee.

4.2.2. The no-liability rule and representee’s incentive

Since it is inefficient for the representor to take precautions against innocent misrepresentation, the economic question is how to use the law to create an incentive for the representee to take care. The legal device to achieve this objective is the no-liability rule, prohibiting representees from recovering the losses resulting from acting on innocent misrepresentation. The no-liability rule creates an incentive for the representee to take the level of care at which the marginal precautionary cost is just equal to the marginal decrease in his private loss caused by the innocent misrepresentation.

Although the no-liability rule can create a sufficient incentive to take care against innocent misrepresentation, this is by no means to say that it can lead the representee to take the socially optimal level of care. The main demerit of the no-liability rule is that it cannot always create a socially optimal incentive for the representee, as the actual level of care taken by
the representee under this rule is frequently higher than the socially optimal level. This is attributable to the difference between the social loss and the representee’s private loss occasioned by the innocent misrepresentation.

By way of illustration, take the English case of *Leaf v. International Galleries* (1950, 2KB 86). Mr Leaf purchased a picture of Salisbury Cathedral from International Galleries for £85. Prior to the sale, International Galleries made an innocent misrepresentation that the painting was by John Constable. Mr Leaf claimed for rescission of the contract and his claim was rejected by the Court of Appeal. Assume that if Mr Leaf had known that the painting was a copy, he would have been willing to pay only £15 for it. But International Galleries would not have been willing to sell the painting for less than £35, even though it was a copy. Thus, the innocent misrepresentation brought a private gain of £50 (£85 − £35) to International Galleries and a private loss of £70 (£85 − £15) to Mr Leaf. From the standpoint of society as a whole, it generated a social welfare loss of £20 (£70 − £50), which is measured as the difference between the private gain to International Galleries and the private loss to Mr Leaf. Assume further that the probability of the statement made by International Galleries being false was believed by Mr Leaf to be 10 percent. The *ex ante* social loss is £2 (£20×10 per cent). In other words, from the perspective of society, Mr Leaf should have invested no more than £2 in the precaution. However, in determining the amount of care to be taken, Mr Leaf will have taken his private loss rather than the social loss into consideration. In this case, the *ex ante* private loss to Mr Leaf would be £7 (£70×10 per cent), which is £5 more than the social loss of £2. It can thus be assumed that Mr Leaf would invest more in the precaution than the socially optimal care demanded.

This example shows that under the no-liability rule, if the social loss occasioned by the innocent misrepresentation is less than the private loss to the representee, the actual care taken by the representee will be higher than the socially optimal level. By the same token, the representee will take inadequate care if the social loss is higher than his private loss. The representee will take the socially optimal level of care only if the social loss is equal to his private loss (Brown, 1973). If we examine the outcome of misrepresentation in more detail, it is not difficult to see that most misrepresentations give rise to an adverse distributional effect on the parties, generating a gain to one party (the representor), but at the same time causing a loss to the other (the representee). In this case, the social welfare loss occasioned by the misrepresentation is lower than the representee’s private welfare loss. Thus it can be generally assumed that the actual care taken by the representee under the no-liability rule will be higher than the socially optimal level.
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