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Information and Assumption Risks

INFORMATION AND ASSUMPTION HAZARDS

Incorrect Information, Processing, and Assumptions

Decisions about transactions are based on information or assumptions in lieu of information or a combination of both. Information, here used in the broadest sense, includes any thought communicated about a matter, the correctness of which can be verified at contract formation or later.

Collecting and evaluating information about a transaction always has a cost. In a complex transaction, where a party will never have all the information that might be compiled about that deal, its diligence costs must be controlled, especially because the marginal value of the information collected will decrease. A party must decide when it has sufficient information to make decisions about that deal. It will usually rely on such information unless the party doubts its reliability.

In the best case,

- all information on which a party relies is correct,
- it correctly investigates, evaluates, and processes whatever information is received, and
- any assumption on which it relies is correct.

In the worst case,

- any information on which a party relies is incorrect,
- it incorrectly processes some or all of the information, and
- any assumption on which it relies is incorrect.

Between these extremes are twenty-five other combinations of these three hazards. The simplest three are the focus of this chapter.

These three combinations are (1) reliance upon incorrect information, processed correctly, and not supplemented by assumptions; (2) reliance upon correct information incorrectly processed; and (3) little or no information, correct and correctly processed as far as it goes, but supplemented by an incorrect assumption upon which a party relies. In all instances, the hazard is the *reliance* upon such information or assumption. The causes of (1) are the counterparty or third parties, and the causes of (2) and (3) will be the party.

Following are cases that illustrate hazards (1), (2), and (3), respectively:

- *OnBank & Trust Company v. FDIC*[1]: A government agency became the conservator of an insolvent savings and loan association, transferred the mortgage loans the association had made to its customers into a trust, offered to sell interests in the trust, and described the loans in a prospectus that overstated the total principal amount of the loans by approximately $1,000,000, or two percent. The buyer relied upon the stated amount when bidding for the portfolio.
- *Smith v. Zimbalist*[2]: Zimbalist, a prominent violinist and collector of rare violins, visited Smith, another violin collector, inspected two of his violins, declared they were made by Stradivarius and Guarnerius, respectively, asked Smith what price he would accept for the violins, and agreed to pay $8,000 in installments. The buyer made and relied entirely upon his own evaluation of the violins. In fact, the violins were imitations. The information available, the violins, was incorrectly examined.
- *Backus v. MacLaury*[3]: A livestock breeder decided to bid at an auction on a calf he intended to use to breed a herd, though the calf was then too young for its fertility to be determined. No information about the fertility of that specific calf was available. Each bidder had to make an assumption that the calf was or might be or was not or might not be fertile. The assumption was knowingly made. A rational bidder who assumed the calf was fertile, as did the bidder in the case, would bid an amount higher than one who assumed otherwise. The latter might not bid at all. The bidder's assumption proved incorrect.

Benefit Misconceptions

A benefit is misconceived when its expected value or utility is more or less than can or will be realized. The misconceiving party may or may not be the one who will realize the benefit. A hazard occurs when a party relying upon such misconception expects to receive more value or utility than can or will be realized. A hazard should not occur because one party expects the other to receive less than can or will be realized unless it would

have realized extra value had such excess not accrued to the benefit of the other party or it could also have received more value in exchange without giving more.

A party misconceives a benefit because (1) the information the party receives and on which it relies about such benefit is incorrect, (2) the party incorrectly processes good information and relies upon its conclusion about such benefit, or (3) the party makes and relies upon an incorrect assumption about such benefit.

Following are two cases that illustrate reliance upon incorrect information, a feature of hazard (1):

- *OnBank & Trust Company v. FDIC*, which is previously described.[4] The prospectus overstated the total principal amount of the loans the buyer received.
- *Conti v. Winters*[5]: The seller stated the car had not been driven more than 3,500 miles, and the odometer read between 3,400 and 3,500 miles, when, in fact, the car had been driven more than 15,000 miles before being purchased by the seller.

Following are three cases that illustrate incorrect processing of information, a feature of hazard (2):

- *Smith v. Zimbalist*, which is previously described.[6] Both the seller and buyer wrongly concluded the violins were authentic and more valuable than they were.
- *Beachcomber Coins, Inc. v. Bosket*[7]: A coin dealer examined a dime purportedly minted in 1916 at Denver for 15 to 45 minutes and then paid the seller, another coin dealer, $500. The *D* on the dime had been counterfeited.[8] This case also illustrates scenario (1).
- *Tamplin v. James*[9]: Drawings made available at an auction described a parcel of real property as one of three lots occupied by a tenant. Without checking the drawings and specifications, a buyer offered to buy the parcel immediately after the auction on the mistaken belief that he was buying all the property occupied by the tenant— that is, all three lots. The buyer incorrectly concluded that because the tenant occupied three lots, all three were offered. He also failed to check his conclusion against the drawings.[10]

Following are four cases that illustrate incorrect assumptions, a feature of hazard (3):

- *Backus v. MacLaury*, which is previously described.[11]
- *Griffith v. Brymer*[12]: This case is summarized in chapter 3.[13] Griffith (G) agreed to hire a room from Brymer (B) to view King Edward VII's coronation procession. Unknown to either G or B, an hour earlier a decision had been reached to cancel the parade. The renter, having no information about and giving no thought to the prospect of a cancellation, assumed the parade remained scheduled.[14]
- *Hecht v. Batcheller*[15]: Two hours before a seller sold a promissory note to a buyer, the debtor on the note made an assignment for the benefit of creditors. The value of the note diminished, if not disappeared, with the debtor's assignment. Neither party knew of the debtor's insolvency at the time of the sale.[16] The buyer, having no information about the debtor's insolvency, assumed otherwise.
- *Grenall v. United of Omaha Life Ins. Co*[17]: This case is summarized in chapter 3.[18] Grenall paid a single, substantial premium for an annuity payable in monthly installments for the rest of her life. Being ignorant of her fatal illness, she assumed that she had no condition that would shorten the period over which she would receive annuity payments.

That the buyer in the first case knew of his assumption and the parties in the latter three did not does not change the hazard. None of the parties had any information about the condition adversely affecting the value or utility that was expected to be realized. He or she proceeded on the basis of an incorrect assumption.

Task Misconceptions

A task to be completed is misconceived when a party expects that such task can be completed when it cannot, when a different task will be completed, when a different method will be used to complete the task, or when the time, effort, or cost of completing a task will be different. All such possible misconceptions about a task, which might be referred to as task information and assumption hazards, can be categorized by each and a combination of the following three facts: whether the party who relies upon such information is the source of the incorrectness in the information or assumption, whether the party expected to complete the task is also the party relying upon erroneous information or assumption, and whether the task is to be completed for the party relying upon such information or another party.

First, such misconceptions occur because:

(1) the information a party receives about such task is incorrect,
(2) a party incorrectly processes information about such task, or
(3) a party makes an incorrect assumption about such task.

Second, the party who receives and relies upon incorrect information, incorrectly processes information, or makes an incorrect assumption will be either:

(a) the party who is expected complete the task or
(b) the other party (who is not expected to complete the task).

Both parties can receive and rely upon incorrect information, have incorrectly used information, or made an incorrect assumption, in each case about a task. That possibility is (a) and (b) combined. It is also the classic case of mutual mistake.[19] It is not here considered as a separate variation because each of the two variations of which it consists is separately considered. The three types of mistake or misconception can be combined with

the two variations to yield six information and assumption hazard scenarios: for example, hazard (1)(a) occurs when the party expected to complete a task receives incorrect information about that task.

Third, the hazards also vary with the party for whose benefit the task is being completed:

(i) The task is for the benefit of the party completing it and the result is adverse to it if completion is impractical, will not yield the anticipated benefit, or will be more onerous or costly than anticipated, or

(ii) the task is for the benefit of the party not completing it, and ignoring potential liability for breach by an obligor, the result is adverse in this scenario when it expects to complete a less onerous or costly task than the one it will or is required to complete.

Based on the three variables, a matrix of the twelve scenarios is conceivable. Each such scenario is referred to as follows by the combination of numbers and letters previously used. For example, scenario (1)(a) (ii) refers to a scenario where (1) incorrect information is (a) received and relied upon by the party completing the misconceived task (ii) for the benefit of the other party. For convenience, the description of these twelve scenarios are grouped into six categories as follows.

(1) *Incorrect information about a task received by party completing it*: The first two scenarios are receipt by a party of incorrect information about the task it is expected to complete. The source of the incorrect information may be the other party or a third party. These are scenarios (1)(a) (i) and (ii). Following are two illustrations of these scenarios:

- *J.I. Hass Co., Inc. v. Jones-Teer*[20]: A contractor advised a successor subcontractor that the work by the prior subcontractor, who had been terminated, was satisfactory. The new subcontractor agreed to finish the work of that prior subcontractor for a fixed price. In fact, much of the prior subcontractor's work was unsatisfactory and had to be redone.[21]
- *In re Schenck Tours, Inc.*[22]: A party bid on a parcel of real property based on an estimate received from its expert that the costs of remediating pollution of the parcel would be approximately $250,000. It learned from another bidder that the cost was more likely $2.5 million.

In the first case, the subcontractor was an obligor whose obligation to the contractor was to complete the predecessor's unfinished work. This is scenario (1)(a)(ii) (where the party completing the task for the other party's benefit receives and relies upon incorrect information). In the second, remediation was not an obligation, though it was necessary for the buyer to use the parcel after it had paid for it and thus to realize its benefit. Its obligation to its seller was to pay the price. The buyer was not an obligor but a party having to complete a task to realize a benefit. This is scenario (1)(a)(i) (where a party completing a task for its own benefit receives and relies upon incorrect information). Also, in the first case, the subcontractor received incorrect information from its counterparty, whereas in the second the buyer received it from its expert. Here we treat the buyer and its consultant as independent parties. In each case, the task was incorrectly described to the party obligated or otherwise expected to complete it.

(2) *Incorrect information about a task received by party not completing it*: The second two scenarios are receipt by a party of incorrect information about the task the other party is expected to complete. These are scenarios (1) (b)(i) and (ii). Scenario (1)(b)(i) (a party completes a task for its benefit while the other party relies upon incorrect information about that task) can occur but should not create a risk to the party receiving incorrect information. Its reliance upon the incorrect information neither diminishes its benefits nor alters its tasks or their completion costs.

CERAbio LLC v. Wright Medical Technology, Inc.[23] illustrates these scenarios. A company sold its business for two payments of $1.5 million each and royalties, the first payment to be made at closing and the second when the buyer had verified that its sole product could be made following the protocol agreed by the parties. After closing, the parties learned the sole supplier of a key ingredient used to make the product no longer supplied it. The seller believed that with an immaterial change to the protocol and the use of a new ingredient the product could be produced. The buyer was unwilling to make the change.[24] The seller was not obligated to run a test protocol. Its doing so satisfied a condition that obligated the buyer to make the second payment. Completion of the task thus contributed to the seller's ultimate benefit realization: receipt of the full price. This aspect of the case illustrates scenario (1)(b)(i): the buyer had incorrect information about a task the seller would perform for its own benefit. Running the test protocol also benefited the buyer by proving the product could be produced. This aspect of the case illustrates scenario (1)(b)(ii): the buyer, based on incorrect information received from the seller about the protocol, expected the seller to complete the protocol specified in the agreement, not an alternative workaround, to prove for the buyer's benefit that the product could be produced.

(3) *Information about a task processed incorrectly by party completing it*: The fifth and sixth scenarios are the incorrect use of information by a party about a task it is expected to complete. These are scenarios (2)(a)(i) and (ii). Following are cases that illustrate these scenarios:

- *White v. Berrenda Mesa Water District of Kern County*[25]: A contractor misread the technical data about the condition of a site on which construction was to be undertaken and underestimated the scope of work. The data were good, but the reading was faulty.[26]
- *Bowser, Inc. v. Hamilton Glass Co.*[27]: A subcontractor agreed to fabricate glass reflectors in conformity with specifications provided by the contractor but misunderstood the reference to "Spec. 93-24794." Thinking it was a parts number and not the specification for the glass, the subcontractor produced reflectors that did not conform.[28]
- *Covich v. Chambers*[29]: Before buying a site on which he intended to build a residential neighborhood, the buyer walked the perimeter of the site and noticed that gravel had been excavated and that a swamp was located nearby. He chose not to dig test holes or to perform percolation tests to determine the water table. After his purchase, he found the water table unsuitable for sewage and septic systems. His investigation of the site was to determine its suitability for development, the benefit of his purchase, not to benefit the seller or to confirm any statements by the seller about the site. He thus incorrectly assessed conditions that materially affected completion of a task he had to complete to realize that benefit.[30]

The first two cases illustrate scenario (2)(a)(ii) (party having to complete a task for the benefit of the other party incorrectly uses information to define that task). In each case, the contractor incorrectly used the available information and, as a result, incorrectly defined the work it had to complete as an obligation performed to benefit the other party. The last case illustrates scenario (2)(a)(i) (party having to complete the task for its benefit incorrectly uses information to define that task): the buyer's inept investigation led to a conclusion that development of the site—a task the buyer had to complete—was feasible at its estimated costs and would thus yield the anticipated benefits.

(4) *Information about a task processed incorrectly by party not completing it*: The seventh and eighth scenarios are incorrect processing by a party of information about the task the other party is expected to complete. These are scenarios (2)(b)(i) and (ii). Scenario (2)(b)(i) (a party completes a task for its benefit while the other party erroneously processes good information about that task) can also occur but should not create a risk to the party incorrectly processing information. Its reliance on the incorrect information neither diminishes its benefits nor alters its tasks or their completion costs.

U.S. v. Spearin[31] illustrates scenario (2)(b)(ii). A government agency provided plans and specifications it prepared for work to be completed by a contractor. The work included diversion and relocation of a section of a sewer, which increased stress on a dam in the sewer system not mentioned in the plans or specifications. The pressure of heavy rains and a high tide broke the dam. Because the dam was not shown in the plans, the contractor did not include in the scope of the project any work that would support the dam. The agency was the party not completing the task that incorrectly prepared the drawings and specifications used by the contractor.[32]

(5) *Incorrect assumption by party completing a task*: The ninth and tenth scenarios are incorrect assumptions by parties about the tasks they must complete. These are scenarios (3)(a)(i) and (ii). Such an assumption is adverse to that party when it assumes that such task will be less onerous or costly than it will be or is required to be. The following three cases illustrate these scenarios:

- *Mineral Park Land Co. v. Howard*[33]: A contractor agreed to take from an owner's land all of the gravel and earth needed for certain construction work. After the contractor had removed approximately half the gravel it required, it took the balance from another source because, even though the owner's land contained enough material to satisfy the balance under the contract, it was below the water level and the cost of extracting it would have been ten or twelve times as much as the usual cost, and it would require drying at great expense and delay. At contract formation, the contractor had no information about the condition of the subsurface and assumed it was the same as the surface.[34]
- *General Dynamics Corp. v. U.S.*[35]: A contractor agreed to build a stealth fighter aircraft for a fixed price but later asked the government to modify the contract to a cost-plus reimbursement contract when it found its costs were likely to exceed the price and the government had not shared its "superior knowledge" about the technology. The government responded it did not have to disclose its superior knowledge because such information was a state secret.[36] The contractor had not received all relevant information about the technology from the government. Either it mistakenly used what information it had or, more likely, made an assumption about the technology.
- *WRI/Raleigh, L.P. v. Shaikh*[37]: A tenant intended to convert vacant space in a shopping center into a restaurant and signed a lease, but he changed his mind when he soon learned he would have to install a grease trap considerably larger and more expensive than the one he believed the local codes required. The tenant had not inquired about what size of grease trap the codes required and assumed a smaller one would comply.[38]

The parties completing the tasks in the first two cases are obligors and their completion are performances of their respective obligations. This is scenario (3)(a)(ii) (party makes an incorrect assumption about a task it will complete for the other party's benefit). The party completing its task in the third case is not obligated to do so. Installing the grease trap was one of the tasks that had to be completed by the tenant to convert the vacant space into a restaurant, enabling the tenant to realize the anticipated benefits. This is scenario (3)(a)(i) (party makes an incorrect assumption about a task it will complete for its benefit). Its obligation to its landlord was to pay rent. Still, the three cases illustrate a party who is expected to complete a task and has no or insufficient information about it or an applicable condition and makes an incorrect assumption.

(6) *Incorrect assumption by party not completing a task*: The eleventh and twelfth scenarios are incorrect assumptions by a party about what the other party's tasks include. These are scenarios (3)(b)(i) and (ii). Scenario (3)(b)(i) (a party completes a task for its benefit while the other party makes an incorrect assumption about that task) can also occur, but it should not create a risk to the party making the incorrect assumption. Its reliance on the incorrect information neither diminishes its benefits nor alters its tasks or their completion costs. The following two cases illustrate scenario (3)(b)(ii):

- *Smith v. Hughes*[39]: A farmer asked a manager of a horse training facility if he would like to buy oats, showing him a sample. The manager did not inspect the sample but wrote to say he would buy the whole lot at a specified price. The oats were new, not old as the manager expected. Though offered a sample, the manager proceeded with no information about the nature of the oats.[40] He must have assumed the oats the seller would deliver would be old.
- *Meda AB v. 3M Co.*[41]: A buyer of a worldwide pharmaceutical business did not ask the seller if it or its French subsidiary had any understandings with the French regulatory authorities about how the subsidiary would price a specific drug in France. Nor did the seller mention such understandings. The buyer thus had no information about the regulation of such price in France and believed none existed. While the case could be viewed as one where the available information was incorrectly processed, because the buyer did not seek any information about the understanding, treating it as one where the party made an incorrect assumption about the business the seller would deliver is also appropriate.[42]

Condition and Contingency Misconceptions

Everything previously said about how incorrect information, incorrect use of information, and incorrect assumptions affect expectations about benefits and tasks can be repeated for conditions and contingencies. Because it receives and relies upon incorrect information, it incorrectly uses correct information or forms an incorrect assumption, a party may suppose that a condition that must exist or not exist or a contingency that must

occur or not occur for a benefit to be realized or a task to be completed does or does not exist or will or will not occur. *Griffith v. Brymer*[43] and *Krell v. Henry*,[44] which were described in chapter 3 as examples of condition and contingency oversight,[45] respectively, also illustrate incorrect assumptions about conditions and contingencies. For the renter in the former case, the transaction was premised upon a condition that the parade was still scheduled, and in the latter upon a contingency that the parade would be held as scheduled.

Presidio Enterprises, Inc. v. Warner Bros. Distributing Corp.[46] illustrates how incorrect information about a contingency affects benefit realization. Warner touted the movie *Swarm*—a movie about the invasion of killer bees from South America into Texas, with a cast that included such famous names as Michael Caine, Richard Chamberlain, Olivia de Havilland, Patty Duke Astin, Henry Fonda, Ben Johnson, Slim Pickens, Katharine Ross, and Richard Widmark—as the "blockbuster" of the summer of 1978. The movie flopped. Warner's statements about the famous names and the story were correct. Its conclusion that the movie would be a hit, based on those facts, was wildly incorrect. The distributor formed expectations about the likely revenue from its distribution of the movie based on Warner's promotional statements and paid Warner accordingly. Like all information about future events, however, its incorrectness could not be known until the time for such event to occur had passed. The hazard in the case was reliance upon information about the likely occurrence of the contingency, which in hindsight proved to be incorrect. Because financial projections often prove to be more optimistic than warranted, when tested by future events, reliance upon such forecasts is considered hazardous.

The matrix of twelve information and assumption hazards that affect expectations about tasks may be replicated for expectations and assumptions about conditions and contingencies, the existence or occurrence of which is essential to completion of a task as anticipated. The extent of the pollution in *In re Schenck Tours, Inc.*,[47] the suitability of the site in *Covich v. Chambers*,[48] and the condition of the subsurface in *Mineral Park Land Co. v. Howard*[49] are examples of incorrect information about a condition, incorrect use of correct information about a condition, and an incorrect assumption about a condition, respectively. These are versions of the hazards described as scenarios (1)(a)(i), (2)(a)(i), and (3)(a)(ii), respectively.

Fraud, Nondisclosure, and Mistake

So far, we have seen how a party's reliance upon incorrect information and assumptions and incorrect use of information can be a hazard to the party who relies on the same. Such information and assumptions are also a hazard to the other party otherwise unaffected by the hazard because the affected party may be able to rescind the contract and claim fraud. This risk will be of little concern to the con artist who hopes to get away with his deception. A legitimate enterprise, however, will be concerned about loss of the expected bargain if the contract is rescinded, liability for misrepresentation and fraud, and harm to its reputation. An understanding of these risks in a transaction requires careful consideration of how the legal principles of unilateral and mutual mistake; inadvertent, negligent, and intentional misrepresentation; fraud; and concealment may apply.

Incorrect Information Received by Party. A party that receives and relies upon incorrect information may be able to rescind the contract and claim damages for inadvertent, negligent, or intentional misrepresentation or fraud because of such incorrect information. The following two cases illustrate these risks:

- *Bentley v. Slavik*[50]: A violin seller told the buyer he was selling an Auguste Sebastien Philippe Bernardel violin made in 1835 with an appraised value ranging from $15,000 to $20,000, facts he honestly but wrongly believed were true as they had been certified by a reputable violin maker, authenticator, and appraiser, and he had no expertise to conclude otherwise. The buyer successfully rescinded the contract when it learned of the error.[51]
- *Hollerman v. F.H. Peavey & Co.*[52]: A franchisor prepared and circulated a brochure soliciting participation in a chicken-breeding program stating that participation "will return to the careful broiler raiser an income roughly equal to half as much as is obtained from an average size farm in the Midwest—and it will do so for about six hours of one person's attention daily." An unsuccessful participant successfully claimed the brochure was fraudulent.[53]

Information Incorrectly Used by Party. A party that incorrectly uses information may likewise be able to rescind the contract. Following are two cases that illustrate this outcome:

- *White v. Berrenda Mesa Water District of Kern County*[54]: This case is previously summarized.[55] A contractor who misread the technical data about the condition of a site on which construction was to be undertaken and underestimated the scope of work was allowed to rescind his bid.[56]
- *Consolidated Rail Corp. v. Portlight, Inc.*[57]: An importer recovered $140,521 from its insurer for the loss of 68 cartons of a 368-carton shipment. The insurer in turn claimed against the carrier, which settled for $120,302.53. It later discovered that the bill of lading limited its liability to $500 per carton, for a total liability of $33,500, and successfully rescinded the settlement.[58] The carrier had overlooked or incorrectly identified and examined the documents available to it before agreeing to the settlement.

Incorrect Assumption Made by a Party. A party that makes an incorrect assumption may be able to rescind the contract for unilateral or mutual mistake of fact or claim damages for fraud or concealment.

- *Richfield Bank and Trust Co. v. Sjogren*[59]: Buyers of purification units borrowed the moneys to pay for their purchase from a bank. The bank also had the seller as a customer and knew the latter was insolvent. The seller failed to deliver units because of its insolvency. When the bank sued the buyers on the promissory note received for the loan, the buyers successfully claimed the bank had induced them by fraudulently failing to disclose the seller's insolvency that the bank knew of when the loan was made. The buyers had no information one way or the other about the seller's insolvency and assumed it to be solvent.[60]

- *Transdigm Inc. v. Alcoa Global Fasteners, Inc.*[61]: In the course of its diligence in a business acquisition, Alcoa identified the importance of the target's sales to one customer and asked Transdigm, the seller, about the target's relationship with its customers, in particular, if the payment terms included rebates. Transdigm knew that a principal customer would reduce its purchases by fifty percent and receive a five percent rebate but did not disclose this information to Alcoa when responding. Alcoa assumed no such rebate was given by the target to its principal customer. When Alcoa learned of these facts after the closing, it successfully claimed fraud by active concealment.[62]

INFORMATION AND ASSUMPTION RISK MANAGEMENT

In the absence of express terms in the contract, the law of intentional, negligent, and inadvertent misrepresentation; express and implied warranty; fraud; and unilateral and mutual mistake allocate the information and assumption risks in a transaction. For example, in *U.S. v. Spearin*,[63] previously summarized,[64] the contractor successfully claimed the government agency that had provided the plans and specifications it prepared for work to be completed by a contractor impliedly warranted their correctness. The contractual rules that implied the additional term, the warranty, allocated the risk that the drawings were incorrect to the government agency. In *Consolidated Rail Corp.*,[65] also previously summarized,[66] the carrier's oversight of the limitation on its liability in the bill of lading was held to be a mutual mistake of fact that entitled it to rescind the settlement. The rules applicable to mutual mistake allocated responsibility for the risk of the carrier's mistaken examination of the documents to the insurer since the settlement could be unwound. In *Presidio Enterprises, Inc.*,[67] the rule that no liability for fraud or misrepresentation lie for opinions about the occurrence of contingencies allocated to the distributor responsibility for the risk that Warner's touting of the film as a blockbuster would prove incorrect. Expressly stated warranties, disclaimers, antireliance clauses, merger clauses, waivers of defenses, amendments, and termination rights, when effective, can trump or modify the risk allocations implied in the fraud, misrepresentation, and mistake rules.

Diligence

The appropriate investigation of information about benefits, tasks, conditions, and contingencies varies with the complexity and importance of the transaction to the parties. A party can investigate conditions that are knowable before or at contract formation. *Smith v. Hughes*[68] is the clearest illustration of a case where all the diligence that was needed lie in the buyer's hands; he had only to look at them. Conditions that are unknowable at contract formation can be investigated but cannot be proved or disproved at that time. Similarly, the probability that a contingency will occur can be investigated but not proved or disproved with certainty at contract formation. The diligence appropriate for any type or specific transaction is outside the scope of this text.

Diligence is the most important mitigation of misrepresentation, fraud, and concealment risks. Asking a party to assume responsibility for losses that will result from its fraud will have little value, except where that party is able and willing to compensate the defrauded party for those losses. This will be the case in a legitimate business transaction since neither party expects at contract formation to perpetrate a fraud on the other. It will not be so when fraud is central to the deal. The con perpetrating the fraud will hope to escape with the proceeds of its deceit. Absent a guaranty or similar instrument from a reliable third party, diligence is the only tool for detecting and protecting the innocent party against such a scheme.[69]

Warranties

With reference to a contract, a warranty is an "express or implied promise that something in furtherance of the contract is guaranteed by one of the contracting parties."[70] A representation is defined as "[a] presentation of fact—either by words or conduct—made to induce someone to act, esp. to enter into a contract; esp. the manifestation to another that a fact, including a state of mind exists."[71] For convenience, the following discussion treats warranties and representations interchangeably.[72] Each confirms to the party benefiting from the representation or warranty that a party, benefit, task, condition, or contingency is or will be as represented or warranted. The party giving the warranty assumes responsibility for the risk that the matter proves to be otherwise.

Warranties can be used to allocate the information and assumption risks previously described. A warranty may be expansive, warranting that a benefit will be realized or a task can or will be completed or limited to warranting the existence of a condition that must exist or the occurrence of a contingency that must occur for a benefit to be realized or a task to be completed. A warranty that a task the warrantee will complete for its own benefit can be completed and will contribute toward benefit realization as expected allocates responsibility for the risks in scenarios (1)(a)(i), (2)(a)(i), and (3)(a)(i) to the warrantor. A warranty that a task the warrantee will complete for the warrantor's benefit can be completed as warranted allocates responsibility for the risks in scenarios (1)(a) (ii), (2)(a)(ii), and (3)(a)(ii) to the warrantor. A warranty that a task that the warrantor will complete for the benefit of the warrantee can be completed and, when completed, will contribute to the warrantee's benefit realization as expected allocates responsibility for the risks in scenarios (1)(b)(ii), (2)(b)(ii), and (3)(b)(ii) to the warrantor. Such warranties cover all the information and assumption hazard scenarios previously described, except scenarios 1(b)(i), 2(b)(i), and (3)(b)(i), which we have seen are not hazards.

A party aware of an assumption it makes can have a warranty affirm the assumed fact as true. The warranty assures the warrantee that the matter will be as assumed just as a warranty assures the warrantee that information about a matter is or will be as described. A party unaware of an assumption it makes about a matter cannot describe such an assumption and ask that the other party give an assurance that it exists as assumed. At best, a party unaware of an assumption it makes may ask for a broad assurance that other matters that would or might affect its decision to proceed with the transaction do not exist or will not occur. By giving such a warranty, the warrantor assumes responsibility for the risk that such matters exist or will occur. Warranties that allocate responsibility for the risks in scenarios (3)(a) and (b) will differ, depending whether the warrantee is aware of the assumption it makes and is warranted.

The following cases illustrate the warranties previously described:

- *Hollerman v. F.H. Peavey & Co.*[73]: This case is previously summarized.[74] The statement that participation in a chicken-breeding program "will return to the careful broiler raiser an income roughly equal to half as much as is obtained from an average size farm in the Midwest" was a warranty or representation that such benefit would be realized.[75] The case illustrates a warranty that a specific benefit will be

realized. It allocated to the warrantor responsibility for the risk that the information upon which the warrantee relied about the benefit was incorrect.

- *Rhone Poulenc Rorer Pharmaceuticals, Inc. v. Newman Glass Works*[76]: An office building owner contracted with a general contractor to install glass curtainwalls, specifying that the glass had to be made by one of three named manufacturers and conform to the specifications for size, thickness, and coating, depending upon the choice of manufacturer. The coating for the manufacturer whose glass was chosen was, as it had to be, attached with a glue the product literature for which stated could normally be expected to perform in temperatures exceeding 180 degrees Fahrenheit. The contract also warranted the work would be "free from faults and defects" and obligated the contractor to remove all work the owner and its architect condemned "as unsound, defective or improper." The general contractor contracted with a subcontractor to procure and install such windows, including in its contract the specifications and warranties included in the contract with the owner. The subcontractor purchased and installed the windows in compliance with the specifications, but before the work was completed the coating began to delaminate from the glass. By warranting that the work would be free from defects, the subcontractor assumed responsibility for the defects in the window specifications.[77] The case illustrates how a warranty can allocate responsibility for the information risk in scenario (1)(a)(ii) (warrantor warrants correctness of incorrect information it received about a task the warrantor must complete for the warrantee's benefit). Had the subcontractor not so warranted the outcome, the contractor would have impliedly warranted the specifications, and the case would have been an example of a warranty allocating responsibility for the risk in scenario (1)(b)(ii) (warrantor warrants correctness of incorrect information about a task the warrantee must complete for the warrantor's benefit).
- *Kraft Foods North America, Inc. v. Banner Engineering & Sales, Inc.*[78]: Banner, an engineering firm, supplied insulated pipe joint kits to be used by Kraft, a food manufacturer, in its installation of stainless steel tubing and other equipment to transport low-trans-fat oils to various parts of its food manufacturing plant. The engineering firm included general information about how to assemble the pipe kits, stating the maximum torque to be used. Kraft followed the directions in the general information, using the maximum torque. The result was that food produced using the new tubing was contaminated. A lighter torqueing would have been sufficient and avoided the resulting damage to the product. Banner warranted that the information provided with the kits was suitable for Kraft's purposes. The case illustrates how a warranty can allocate responsibility for the information risk in scenario (1) (a)(i) (warrantor warrants correctness of incorrect information about a task the warrantee must complete for its own benefit).
- *Merrill Lynch & Co. Inc. v. Allegheny Energy, Inc.*[79]: A seller of a commodity trading business warranted that the information provided to the buyer "in the aggregate, includes all information known to the Sellers which, in their reasonable judgment exercised in good faith, is appropriate for the Purchasers to evaluate [the target's] . . . trading positions and trading operations." The seller failed to disclose that the target's chief executive officer had embezzled $43 million from the target and had influenced the preparation of the flawed financial statements provided to the buyer. Whether the warranty was breached by the failure to disclose these facts had to be decided by trial.[80] Note that the warranty in the case was limited to what the seller knew and reasonably should disclose. It did not cover matters assumed by the buyer of which the seller was unaware or matters the seller reasonably decided it did not have to disclose. The case illustrates how a warranty can thus partially allocate responsibility for the risk in scenario (3)(b) (ii). It also illustrates how the form of warranty used to allocate responsibility for the risk that a warrantee has made an unknown, incorrect assumption differs from the form of warranty used to allocate comparable risks in the other scenarios.

Disclaimers and Related Terms

When effective, disclaimers of representations and warranties, antireliance clauses, and merger and integration clauses allocate responsibility for the risks previously described to the parties who rely upon incorrect information and assumptions or who incorrectly process information. They also limit misrepresentation, fraud, and fraudulent concealment claims. Parties who accept disclaimers and similar terms, but rely upon information or assumptions, hope that the completed task will conform to their expectations—that the information on which they formed such expectations and any assumptions they may have made are correct—but the other parties are not committed to ensuring this will be so and are not liable for breach of warranty, misrepresentation, fraud, and fraudulent concealment.

Disclaimer. A disclaimer—words or conduct that tend to negate or limit a warranty or representation[81]—can negate any warranty that information received is correct, that the recipient of information has correctly processed it, and that an assumption is correct. Such a disclaimer allocates responsibility for the information and assumption risks, as follows:

- First, any warranty that *any benefits will be realized or that the benefits will have any value or utility* can be disclaimed. Such disclaimer allocates to the putative warrantee responsibility for the risk that any information and assumptions upon which it may have relied about such benefits may be incorrect.
- Second, any warranty that *a task a warrantee will complete for its own benefit* can be completed or will contribute toward benefit realization as expected can be disclaimed. Such a disclaimer allocates to the putative warrantee responsibility for the risks in scenarios (1)(a)(i) and (2)(a)(i) and, to the extent the warrantor may have warranted an assumption upon which the warrantee relies that it can complete a task for its own benefit, (3)(a)(i).
- Third, any warranty that *a task a warrantor will complete for a warrantee's benefit* can be completed can be disclaimed. Such a disclaimer allocates responsibility for the risks in scenarios (1)(a) (ii) and (2)(a)(ii) and, to the extent a party may have warranted an assumption by the other party that the latter can complete a task for warrantor's benefit, scenario (3)(a)(ii).
- Fourth, any warranty that *a task that will be completed by the warrantee for the benefit of the warrantor* can be completed or will contribute to the latter's benefit realization can be disclaimed. Such disclaimer allocates responsibility for the information and assumption risks in scenarios (1)(b)(ii) and (2)(b)(ii) and, to the extent the warrantor may have warranted an assumption by the warrantee that the latter can complete a task for warrantor's benefit, scenario (3)(b)(ii).

Such disclaimers cover all the information and assumption hazard scenarios previously described, except scenarios (1)(b)(i), (2)(b)(i), and (3)(b)(i), which we have seen are not hazards, and incorrect assumptions that have not been warranted. A disclaimer of warranties is inapplicable to assumptions that are not warranted. Assumptions, as we have seen, can be made knowingly and unknowingly at contract formation by one or both parties. Disclaimers may be insufficient to negate unilateral and mutual mistake and concealment defenses that may be available in such cases. When effective to cut off warranty claims, disclaimers may also be sufficient to eliminate certain but not necessarily all misrepresentation and fraud claims.

The following cases illustrate how effective and ineffective disclaimers may be to allocate responsibility for the risks that a party may have relied upon incorrect information or an incorrect assumption:

- *UniCredito Italiano SpA v. JP Morgan Chase Bank*[82]: Enron's officers created special purpose offshore entities that bought commodities from Enron. When the prices of such commodities dropped below agreed amounts, Enron had to repurchase them. These transactions were, in reality, disguised loans to Enron, the effect of which was to give Enron the appearance of being financially stronger than it was. JP Morgan Chase Bank (JPMC) purchased ownership interests in the offshore entities and arranged syndicated loans to Enron, aggregating to $4.5 billion. UniCredito Italiano (UCI) participated as a syndicated lender in these loans but had no information about the transactions with the offshore entities or JPMC's participation therein. The credit agreement expressly disclaimed any duty by JPMC to provide information to the participant banks: "The Paying Agent shall not have any duty or responsibility, either initially or on a continuing basis, to provide any Bank or the holder of any Note with any credit or other information with respect thereto, whether coming into its possession before the making of the Advances or at any time or times thereafter."[83] The disclaimers were effective to shield JPMC from liability for negligent misrepresentation and fraud for failing to disclose what it knew about the Enron entities and the transactions.[84] UCI received incorrect information about the Enron entities, their financial condition, and the transactions. The value it received for the fees and interest charged to Enron was less than it would have been had UCI known of the true state of affairs. UCI had no information about JPMC's investments in the offshore entities and assumed the latter's role was limited to arranging the loans. The case illustrates how a disclaimer may be effective to allocate to a party responsibility for the risk it is acting upon the basis of incorrect information and an incorrect assumption of which it is unaware.[85]
- *Stambovsky v. Ackley*[86]: After contract formation but before closing, a house buyer learned the subject property was reputedly occupied by poltergeists, a fact known to the seller, who had reported her sightings to the local press and *Reader's Digest* on three occasions during the nine years before the sale. The report of the case refers to but does not quote in full the merger, antireliance and "as-is" clauses, the latter two of which are equivalent to a warranty disclaimer. The antireliance clause or disclaimer stated, in part, that the buyer had not relied upon any representations as to the condition of the property or "any other matter or things affecting or relating to the aforesaid premises."[87] On one view, the clause did not extend to paranormal phenomena and was insufficient to negate the duty to disclose the house's reputation to the buyer.[88] The buyer gave no thought to whether the house was reputed to be haunted and assumed it was not.[89] Responsibility for the risk that the buyer's assumption about paranormal phenomena was incorrect remained with the seller. The case also illustrates how disclaimers and antireliance clauses may be ineffective to allocate responsibility for incorrect information and assumption risks to the party relying upon such information and assumptions.[90]

Antireliance Clause. An antireliance or nonreliance clause (hereinafter referred to as an antireliance clause) is a promise by a promisor that it will not claim that it has relied upon any information it received from or was provided on behalf of the other party.[91] An antireliance clause disclaims reliance upon information received from one or more sources. A claim for breach of warranty or misrepresentation rests upon a causal connection between the breach or misrepresentation and the loss suffered by the warrantee: reliance upon the correctness of warranted or represented information. An antireliance clause severs that link since the party cannot claim it was entitled to rely upon such information. An antireliance clause is limited to allocating responsibility for the information risks in scenarios (1)(a) or 1(b), where incorrect information has been received, or combinations of hazards where the scenarios occur. A party that accepts an antireliance clause but still relies upon representations or warranties not expressly stated in the contract assumes responsibility for the risk they may be incorrect. An antireliance clause should also bar certain claims of fraud and misrepresentation. Because the other hazards do not result from the use of incorrect information, the antireliance clause is inapplicable. An antireliance clause does not override express warranties and, in some instances, a duty to disclose to a party that it is relying upon incorrect information or assumptions.

The following illustrate how an antireliance clause allocates responsibility for information risks:

- *Schlumberger Technology Corp. v. Swanson*[92]: Sellers sold their interests in a diamond mine joint venture and stated they were not relying upon any statement or representation by the buyer. When they later learned the diamond mine's prospects were much better than they anticipated at the time of the sale, they claimed misrepresentation. The report of the case does not describe what the buyers allegedly misrepresented, but the antireliance clause barred any such claim.[93] The antireliance clause allocated responsibility for the risk of the buyers' misrepresentation to the sellers.
- *Green Construction Co. v. Kansas Power & Light Co.*[94]: A utility provided bidders on a dam construction project with a report on the site from which soil was to be excavated but stated, in the conditions for submitting bids, that each bidder was responsible for investigating the site. The moisture content of the soil was critical to the stability of the dam. The clause read,

  > [i]t must be understood and agreed that all such factors have been properly investigated and considered in the preparation of every proposal submitted, as there will be no subsequent financial adjustment, to any contract awarded thereunder, which is based on the lack of such prior information or its effect on the cost of the work."[95]

  The soil had more moisture content than indicated in the report and was allowed under the specifications; as a result, the dam, when constructed, developed cracks that could not be repaired. The utility had to replace the dam. The antireliance clause barred the contractor's

claim that the soils report impliedly warranted that the soil had the moisture content stated in the report and that the error in the report necessitated a material change in the scope of work, entitling it to the contract price and extra costs.[96] The case illustrates a combination of scenarios (1)(a)(ii) and (2)(a) (ii): the contractor received incorrect information (the moisture content of the soil) about a condition material to the task it was to perform for the utility's benefit (using the soil to build a dam) but also incorrectly used the information available to it by not investigating its correctness when advised that it must do so. The antireliance clause allocated responsibility for the combined risks to the contractor.

Merger Clause. An integration or a merger clause is a "contractual provision stating that the contract represents the parties' complete and final agreement and supersedes all informal understandings and oral agreements relating to the subject matter of the contract."[97] We are not here concerned with the effectiveness of an oral agreement reached after contract formation but with information exchanged prior to that time. That information may be incorrect or incorrectly used. A merger clause excludes as evidence of the terms of the contract all prior express agreements, representations, and warranties not included in a written agreement. A party that relies upon such agreements, representations, and warranties assumes responsibility for the risk they are incorrect. Like an antireliance clause, a merger clause applies only to information given prior to or at contract formation, which are scenarios (1)(a) and (1)(b) when such information is incorrect. Whereas a merger clause negates express warranties and representations not stated in the contract, an expansive disclaimer negates all warranties and representations not stated as express warranties therein.[98]

Waiver of Defenses. A party may agree that its obligation in a contract is absolute and unconditional, the effect of which is to bar such party from asserting any defense it may have that would otherwise permit it to refuse to perform. A party that agrees to such a waiver assumes responsibility for the risk that information about its anticipated benefits or the tasks to be completed may be incorrect; it may have incorrectly used information, or made incorrect assumptions about anticipated benefits and tasks. It also assumes responsibility for the risk that the other party may know of its reliance upon such information or assumption and not have notified it thereof. The waiver can extend to fraud, misrepresentation, and mistake claims, including claims that a party was fraudulently induced to enter into the contract.[99]

MBIA Insurance Corp. v. Royal Indemnity Co.[100] illustrates how such a waiver of defenses allocates responsibility for information and assumption risks. A bank bought student loans from a company that specialized in making such loans but had falsified the student borrowers' creditworthiness and employment history; it conspired with schools to generate as many loans as possible by altering or forging loan documents. The bank obtained policies insuring repayment of such loans. The insurer issued the policies based, in part, on representations from the company that the student loans had been made in compliance with applicable law and regulation. The policies waived in broadest possible terms all defenses the insurer might have against payment of claims under the policies.[101] The insurer sued for rescission of the policies, claiming fraudulent inducement. In turn, the bank sued the insurer, claiming breach. The trial court awarded the bank summary judgment, based on the waivers. The appeal court affirmed in part, holding the waivers precluded the insurer from asserting fraud as a defense to payment under the policies.[102] The insurer, by agreeing to the broad waiver of defenses, assumed responsibility for the risk that the originator might have provided incorrect information about the insured loans.

Limitations on Disclaimers and Similar Terms. None of the terms that enable a party to limit its liability for breach of warranty and inadvertent, negligent, and intentional misrepresentation and fraud, such as disclaimers, are fully effective in all circumstances. Such limitations, which vary among the jurisdictions, must be understood by anyone attempting to use such terms to allocate responsibility for information and assumption risks.

Following are cases that illustrate such limitations:

- *OnBank & Trust Co. v. FDIC*[103]: This case is previously summarized.[104] The prospectus also included clear disclaimers and antireliance language: the trust interests were being sold "as-is" and "without any representation or warranty except as expressly provided" in the agreement and "without recourse" against the seller;[105] the buyer was not relying upon any information received from the seller.[106] When the buyer discovered the error, it sued the seller, claiming that the seller, as servicer of the mortgage loans, knew of the discrepancy and should have disclosed it. The seller moved for summary judgment, arguing that any reliance by the buyer was unreasonable in view of the disclaimer and antireliance language. The court dismissed the motion, holding that a number of factual issues had to be tried: what each party knew during the transaction.[107] The case illustrates how an express warranty—the total value of the loans in this case—was not automatically trumped by a disclaimer.
- *McRae v. Commonwealth Disposals Commission*[108]: Upon learning that a vessel of some nature had been abandoned off the coast of New Guinea, a government commission advertised the sale of the vessel as "an oil tanker lying on Jourmaund Reef, which is approximately 100 miles North of Samarai. The vessel is said to contain oil." In fact, the vessel was a barge, as the buyer discovered after he incurred some cost mistakenly searching for a tanker. The commission was willing to refund the price paid by the buyer, but the buyer also wanted compensation for his costs of searching for the vessel and sued when denied such compensation. The terms of the sale included a clear disclaimer: "While every effort shall be made to describe the property correctly, the Commonwealth shall not be liable for compensation or otherwise by reason of any misdescription or alleged variation of property delivered, from sample or property inspected."[109] Other clauses stated that the goods "are sold as and where they lie with all faults" and no warranty is given as to "condition description quality or otherwise."[110] These disclaimers, the Australian High Court held, however, did not override by the "promise by the Commission that there was a tanker in the position specified."[111]
- *Norton v. Popolos*[112]: A seller agreed to sell, and a buyer agreed to buy, a lot in an industrial park. The buyer explained he intended to store petroleum products in barrels and tanks. The seller indicated that the property was subject to restrictions, a copy of which he said he would supply but never did before the contract was signed. When the buyer learned that special approval of the local building committee would be

required for the intended use, he applied for but was denied that approval. He demanded the return of his deposit and attorney's fees. Because the contract included a merger clause and a contingency that the property may have a specific zoning designation, which it had, but did not include any representation or warranty as to the restrictions on its use, the trial court held for the seller. The Delaware Supreme Court reversed, holding the seller had innocently misrepresented the zoning designation by not disclosing that the restrictions that required the special approval of the local building committee. Referring to the antireliance clause as a merger clause, the court said the "better rule" is that "even if a sales contract contains a merger clause, a buyer may rescind the contract if it resulted from an innocent but material misrepresentation by a seller."[113] The antireliance clause was ineffective to allocate to the buyer responsibility for the risk the seller had provided incorrect information.

- *Stambovsky*[114]: This case, which is previously summarized,[115] illustrates how a disclaimer or antireliance clause may be ineffective to allocate to a party responsibility for the risk it is acting upon the basis of an incorrect assumption about anticipated benefits of which the other party is aware.[116]

Amendments

An amendment can correct an incorrect description of or an incorrect assumption about a benefit or task. An amendment procedure favors a party by allowing it to revise the details of the tasks that must be completed. This will be the obligor in scenarios (1)(a)(ii), (2)(a)(ii), and (3)(a)(ii): the party charged with completing the task for the benefit of the other party has incorrect information, has incorrectly used information, or made an incorrect assumption about a task, respectively. After contract formation, it discovers it cannot complete the task as expected. An amendment or change order procedure allows the obligor to correct the description of the task. An amendment procedure will favor the obligee in scenarios (1)(b)(ii), (2)(b)(ii), and (3)(b)(ii): the obligee has incorrect information, has incorrectly used information, or made an incorrect assumption about such task, respectively. After contract formation, it discovers the task cannot be completed or will not yield the desired benefit, in each case, as expected. An amendment or change order procedure allows the obligee to correct the description of the task. An amendment procedure is unnecessary for scenarios (1)(a) (i), (2)(b)(i), and (3)(b)(i): in these scenarios, after contract formation a party discovers that a task it will complete for its own benefit, usually after the other party has performed its obligations, cannot be completed as expected or will not yield the desired benefits. But since it can choose whether and how to complete such task, a contractual amendment procedure is unnecessary.

The amendment procedure allocates responsibility for information and assumption risks to a party to the extent it has no control over the amendment and must bear responsibility for the increased risks that the amended task cannot be performed and increased costs in performing. If an obligor can revise the details of a task it must complete in scenarios (1)(a)(ii), (2)(a)(ii), and (3)(a)(ii), such changes are adverse to the obligee, and no compensation is given to the obligee for suffering such diminution, the obligee bears responsibility for the information and assumption risks. If an obligee can revise the details of a task the other party must complete in scenarios (1)(b)(ii), (2)(b)(ii), and (3)(b)(ii), such changes are adverse to the obligor, and no compensation is given to the obligor for incurring such incremental risk and cost, the obligor bears responsibility for the information and assumption risks.

The following illustrate how an amendment procedure allocates information and assumption risks:

- *Marriott Corp. v. Dasta Construction Co.*[117]: This case is described in chapter 3.[118] The case combines scenarios (1)(b)(ii) and (2)(b)(ii), and possibly (3)(b)(ii): Marriott was the obligee, the contractor the obligor, and Marriott's ability to correct errors in and embellish the plans and specifications as the work progressed the amendment procedure. Such errors could have been incorrect information Marriott had received, errors by it while developing the design and specifications, and incorrect assumptions about the conditions at the site. Since it controlled the process for changing the plans and specifications and the contractor was not entitled to extra time or cost, the procedure allocated nearly the entirety of responsibility for these information and assumption risks to the contractor.
- *Net2Globe Int'l, Inc. v. Time Warner Telecom of New York*[119]: Time Warner Telecom of New York (TWTNY) was a domestic carrier that owned no international cables or routes of its own and subcontracted with international carriers for international service to its customers. Net2Globe Int'l (NG2) was a reseller whose customers' communications were carried by TWTNY. The contracts between TWTNY and N2G incorporated the domestic carrier's applicable tariffs. The tariffs stated fixed rates for the reseller's customers' calls. One tariff, however, reserved to the domestic carrier

> the right to discontinue service, limit service, or to impose requirements as required to meet changing regulatory or statutory rules and standards, or when such rules and standards have an adverse material affect [sic] on the business or economic feasibility of providing service, as determined by the Company in its reasoned judgment.

After contract formation, TWTNY discovered that the rate subcontractors charged it for international calls to cellular phones was almost five times the rates for routing international calls to land lines. TWTNY passed such higher charges through to N2G, based on the quoted tariff.[120] The case illustrates scenario (3)(b)(ii): TWTNY seemingly had no information about the subcontractors' right to charge the higher rate and assumed the subcontractors' charges for calls to landline and cellular phones were the same. TWTNY was the obligee, N2G the obligor, and TWTNY's right to change the rate a limited right to modify N2G's obligation. Responsibility for the incorrectness of TWTNY's assumption about its subcontractors' rates was thereby allocated to N2G.

Termination

Termination of a contract can mitigate the potential losses likely to result from the hazards described in this chapter just as it can stem the losses that might result from other hazards. A termination right favors an obligor in scenarios (1)(a)(ii), (2)(a)(ii), and (3)(a)(ii): a party has agreed to perform an obligation based upon incorrect information, incorrectly used information, or an incorrect assumption about a task. After contract formation it discovers it cannot complete the task as expected. Termination allows it to avoid completion of the task. A termination right favors the obligee in scenarios (1)(b)(ii), (2)(b)(ii), and (3)(b)(ii): the obligee has agreed to the obligor's performing an obligation based upon incorrect information, incorrectly used information or an incorrect assumption. After contract formation the obligee discovers the task cannot be completed

or will not yield the desired benefit, in each case, as expected. Termination allows the obligee to mitigate its losses by stopping further performance by it and the obligor. The comments in chapter 3 about termination rights generally apply to such termination rights.

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1 967 F. Supp. 81 (W.D.N.Y. 1997).

2 2 Cal.App.2d 324, 38 P.2d 170 (Cal. App. 1934).

3 278 A.D. 504, 106 NYS 2d 401 (N.Y. App. 1951).

4 *See* text accompanying note 1.

5 86 RI 456, 136 A.2d 622 (R.I. 1957).

6 *See* text accompanying note 2.

7 166 N.J. Super. 442, 400 A.2d 78 (N.J. 1979).

8 The buyer sued for rescission when he discovered the error, claiming mutual mistake of fact. The trial court held that, had the parties been aware of any uncertainty about the authenticity of the coin, the risk would have been assumed by one of the parties; however, because they had no doubt of its authenticity, neither party assumed the risk it was not authentic and the buyer was entitled to rescission, even if its investigation had been negligent.

9 (1880) 15 Ch.D. 215; 43 L.T. 520; 29 W.R. 311, aff'd 215 Ch.D. 219 (Ch. Div. 1880).

10 In an action for specific performance by the seller, Baggallay L.J., deciding in favor of the seller, held the buyer was not justified in relying upon the fact that the lots were occupied without checking the drawings or specifications.

11 *See* text accompanying note 3.

12 19 T.L.R. 434 (1903).

13 *See* text accompanying ch. 3, notes 49–52.

14 Justice Wright held the agreement was made on the missupposition of facts and void.

15 167 Mass. 335, 17 N.E. 651, 9 Am. St. Rep. 708 (Mass. 1888).

16 The buyer sued for rescission, claiming mutual mistake of fact; the court rendered judgment in its favor; and the seller successfully appealed to the Massachusetts Supreme Court, which held that because the mistaken assumption was not about the "existence or identity of the thing sold," the buyer was not entitled to rescission.

17 165 Cal. App.4th 188, 2007 N.Y. Slip Op. 09545 (Cal. App. 2008).

18 *See* text accompanying ch. 3, notes 53 and 54.

19 *E.g.*, Sherwood v. Walker, 66 Mich. 568, 22 N.W. 919 (Mich. 1887), limited to its facts in Lenawee County Bd. of Health v. Messerly, 331 N.W.2d 203, 209 (Mich. 1982).

20 755 F.2d 1264 (6th Cir. 1985).

21 When the subcontractor found it had to correct the prior subcontractor's work to proceed with its work, it claimed it was entitled to receive $500,000 additional compensation for correcting defects in the painting work of the prior subcontractor and sued for breach of contract. The trial court found the contractor misrepresented the prior subcontractor's work, though it had not done so fraudulently, awarding the subcontractor a judgment of $17,920. The appeal court reversed the judgment, holding that the subcontractor had reason to know of the defects before it signed the subcontract.

22 69 B.R. 906 (E.D. N.Y. 1987).

23 410 F.3d 981 (7th Cir. 2005).

24 The buyer was unwilling to make the change and claimed fraud. The seller sued for the second payment and royalties, and the buyer counterclaimed for fraud. The trial court dismissed the buyer's claim and the jury awarded a verdict in favor of the seller.

25 7 Cal. App.3d 894, 87 Cal. Rptr. 338 (Cal. App. 1970).

26 For discussion of the outcome of the case, *see* the text accompanying notes 54–56.

27 207 F.2d 341 (7th Cir. 1953).

28 When sued by the contractor for its additional costs in obtaining the reflectors from another source, the subcontractor claimed its error was an excusable mutual or unilateral mistake of fact. The trial court awarded a judgment in favor of the contractor and the appeal court confirmed, holding, "so far as the terms of the contract are concerned, there was no mistake. There is a plain agreement to manufacture the article according to certain specifications. This the defendant promised to do and this it failed to do."

29 8 Mass. App. Ct. 740, 397 N.E.2d 1115 (Mass. App. 1979).

30 The buyer sought rescission, based on mutual mistake. The court found the mistake was not mutual: "Covich did not rely on anyone else's knowledge, representations or belief as to the controlling facts concerning the water table; and that in failing to insert a similar condition in the purchase and sale agreement, Covich voluntarily assumed the risk as part of his bargain that the land might not have adequate drainage for the necessary septic systems." *Id*. at 750.

31 248 U.S. 132, 54 Ct. Cl. 187, 39 S.Ct. 59, 63 L.Ed. 166 (1918).

32 The government insisted that the contractor remedy the problem, and after more than a year of negotiations, during which the contractor refused to assume responsibility, the government annulled the contract. The contractor sued for sums owing to it and was awarded a judgment by the Court of Claims, which was affirmed by the Supreme Court. Justice Brandeis held "the articles [in the contract] prescribing the character, dimensions and location of the sewer imported a warranty that, if the specifications were complied with, the sewer would be adequate." *Id*. at 137. That warranty overrode the contractor's obligations to inspect and determine the conditions at the site.

33 172 Cal. 289, 156 P. 458, L.R.A. 1916 F. 1 (Cal. 1916).

34 The California Supreme Court held the contractor's failure to take the balance under the contract was excused because "where the difference in cost is so great as here, and has the effect, as found, of making performance impracticable, the situation is not different from that of a total absence of earth and gravel." 172 Cal. at 293.

35 563 U.S. 478, 179 L. Ed. 2d 957, 131 S.Ct. 1900 (2011).

36 The contractor claimed it was entitled to additional payments up to the amount of its costs, and the government claimed repayment of a portion of the amount paid. The contractor claimed its default was excused by the government's failure to share its "superior knowledge" about the technology. The government claimed it did not have to disclose information about its superior knowledge because such information was a state secret. The Court of Federal Claims changed the termination for default to termination for convenience and awarded the contractor the amount it requested; the appeal court reversed; upon retrial the Court of Federal Claims upheld the default termination and denied adjudication of the superior knowledge defense; the appeal court reversed the default termination but upheld the denial of the adjudication of the superior knowledge defense; and on remand again the Court of Federal Claims allowed the default termination and the appeal court affirmed. The U.S. Supreme Court reversed, holding that neither party's claims could be adjudicated.

37 183 N.C. App. 249, 644 S.E.2d 245 (N.C. App. 2007).

38 The tenant claimed his performance was thus impossible and discharged. The court disagreed, holding that because a larger grease trap could be used, he was not excused from the lease. He incorrectly assumed, apparently not based on any information, that a smaller grease trap would be sufficient.

39 (1871) L.R. 6 Q.B. 597, 40 L.J.Q.B. 221, 25 L.T. 329, 19 W.R. 1059 (Q.B. 1871).

40 When he received the oats, the manager complained the oats were new, not old as he expected; the farmer refused to take back the oats and sued for breach of contract. The jury was instructed that if the word "old" had not been used in the communications between the parties, they should find for the manager if the farmer believed the manager was under the impression he was agreeing to buy old oats. The court found for the manager and the farmer appealed. The Queen's Bench reversed the verdict and ordered a new trial, holding the jury instruction failed to distinguish between "agreeing to take the oats under the belief that they were old, and agreeing to take the oats under the belief that the [farmer] plaintiff contracted that they were old." The manager was not entitled to a verdict in the former instance.

41 969 F. Supp.2d 360 (S.D.N.Y. 2013).

42 The buyer sued for fraud and concealment. Finding in favor of the seller, the court "finds that [the buyer's] Meda's diligence related to drug pricing was not thorough or meticulous. Indeed, though Meda was presented with thousands of documents in due diligence, it apparently never noticed the absence of European drug pricing agreements." *Id*. at 375.

43 *See* text accompanying ch. 3, note 49.

44 *Supra* ch. 1, note 24. *See* text accompanying ch. 3, notes 50 and 51.

45 *See* text accompanying ch. 3, notes 49–52.

46 784 F.2d 674 (5th Cir. 1986). Presidio paid Warner $65,000 for distribution rights for Swarm. When demand for the movie flopped and Presidio lost $56,000, it sued Warner for negligent misrepresentation, receiving a verdict for damages of $500,000, an amount that presumably included Presidio's expected profit of at least $450,000 from its box office receipts. The appellate court held, however, that whatever "blockbuster" meant, it was too vague to be actionable. More importantly, the statement about the potential success of the movie was "a prediction, not a statement of fact" and also not actionable. *Id*. at 680.

47 69 B.R. 906 (E.D. N.Y. 1987).

48 8 Mass. App. Ct. 740, 397 N.E.2d 1115 (Mass. App. 1979).

49 172 Cal. 289, 156 P. 458, L.R.A. 1916 F 1 (Cal. 1916).

50 663 F. Supp. 736 (S.D. Ill. 1987).

51 The court held the parties made a mutual mistake of fact that entitled the buyer to a refund of the difference between the amount paid on the price of the violin and its value. *See* also: Norton v. Popolos, 443 A.2d 1 (Del. 1982), summarized in text accompanying notes 112 and 113.

52 269 Minn. 221, 130 N.W.2d 534 (Minn. 1964).

53 The court held such statements, along with others, were evidence of fraud to be considered by a jury.

54 7 Cal.App.3d 894, 87 Cal. Rptr. 338 (Cal. App. 1970).

55 *See* text accompanying notes 25 and 26.

56 The contractor discovered the error after the bids were opened and he was awarded the contract; he requested the district to allow him to withdraw his bid and return his bond, and when the district refused, he sued for declaratory relief and rescission. The trial court denied him relief, but the appeal court reversed, holding the contractor's error was a "mistake of judgment," albeit negligent, that entitled him to rescission.

57 188 F.3d 93 (3d Cir. 1999).

58 The carrier claimed the release should be voided because of a mutual mistake of fact, a claim usually denied in cases concerning releases, since the very certainty they are supposed to bring to the dispute would be undermined; however, the court allowed the claim because the fact about the parties being mistaken concerned an existing condition, the cap on damages.

59 309 Minn. 362, 244 N.W.2d 648 (Minn. 1976).

60 The jury specifically found (1) seller's officers knew that they could not fulfill their contractual obligation to the buyers and (2) that bank's officer who approved the loan knew of the pertinent financial condition of the sellers and of the actions, concealment, and representations of the officers of the sellers in its dealings with the buyers. The bank appealed, and the Minnesota Supreme Court affirmed the verdict, holding the bank was obligated to disclose to the buyers its knowledge of the sellers' irretrievable insolvency.

61 2013 WL 2326881 (Del. Ch. 2013).

62 *See* Prairie Capital III, L.P. v. Double E Holding Corp., 135 A.3d 35, 54 (2015), which holds that the disclaimer need not use the word "omission."

63 248 U.S. 132, 54 Ct. Cl. 187, 39 S.Ct. 59, 63 L.Ed. 166 (1918).

64 *See* text accompanying notes 31 and 32.

65 188 F.3d 93 (3d Cir. 1999).

66 *See* text accompanying notes 57 and 58.

67 784 F.2d 674 (5th Cir. 1986).

68 *See* text accompanying notes 39 and 40.

69 For an example of insurance against fraud, *see* text accompanying notes 100–102.

70 BLACK'S LAW DICTIONARY (10th ed. 2014).

71 *Id*. at 1493.

72 A warranty differs from a representation: (a) a warranty is conclusively presumed to be material, whereas a representation is not; (b) a warranty must be strictly complied with, whereas substantial truth is sufficient for a representation; (c) a warranty is an essential part of a contract, whereas a representation is a collateral, usually an inducement; and (d) a warranty is usually written, whereas a representation may be oral or written. *Id*. at 1821.

73 269 Minn. 221, 130 N.W.2d 534 (Minn. 1964).

74 *See* text accompanying note 52.

75 The court held such statements, along with others, were evidence of fraud to be considered by a jury.

76 112 F.3d 695 (3d Cir. 1997).

77 The general contractor demanded that the subcontractor replace the defective windows, and when the subcontractor refused, sued for damages. The district court granted the subcontractor's summary judgment motion to dismiss the suit and its counterclaim against the contractor, but a divided appeals court reversed, holding that by expressly warranting that the windows would be free from faults and defects, the subcontract "explicitly allocated to [subcontractor] the risk that the glass would be defective." *Id*. at 697.

78 446 F. Supp.2d 551 (E.D. Va. 2006).

79 500 F.3d 171 (2nd Cir. 2007).

80 When sued by the seller for the purchase price, the buyer counterclaimed the seller had breached the warranty by failing to disclose the information about the chief executive officer. The trial court dismissed the counterclaim, and the appeal court reversed, holding the trial court had failed to find whether the warranty had been breached and if it had resulted in any diminution of the value of the target. *Id*. at 185.

81 *Supra* ch. 3, note 90.

82 288 F. Supp. 2d 485 (S.D.N.Y. 2003).

83 *Id*. at 491–92.

84 UCI sued JPMC for, inter alia, fraudulent concealment, breach of the duty of good faith and fair dealing, aiding and abetting fraud by Enron, negligent misrepresentation; JPMC moved to dismiss. The court dismissed the fraud and negligent misrepresentation claims, based on the provisions in the credit agreements summarized and quoted. "[E]ven if the bank Defendants had the knowledge the Complaint attributes to them, the banks had no duty to disclose it to Plaintiffs. Sophisticated parties such as Plaintiffs are held to the terms of their contracts." *Id*. at 499. The court also dismissed the argument that JPMC fell within the "peculiar knowledge exception." "Extension of the peculiar knowledge exception to defeat contractual allocations of risks away from the Defendant banks in this case because the principal (Enron) was particularly adept at concealment of its fraud would require at a minimum some factual basis for finding reasonable Plaintiffs reliance on parties on whom it agreed it would not rely in any respect in making the operative decisions." *Id*. at 501.

85 The credit agreement also included the usual boiler plate provisions stating, inter alia, the bank that issued letters of credit thereunder and its affiliates had the right to engage in transactions with Enron "with no duty to account therefor" to the participating banks, an acknowledgment of participating banks that they had not relied on the letter of credit bank in making the decision to enter into the agreement and that they would make their continuing decisions as to whether or not to take action under the agreement or letters of credit issued under the agreement "independently and without reliance upon . . . the [letter of credit bank]." *Id*. at 491–02.

86 169 A.D.2d 254, 572 N.Y.S.2d 672, 60 USLW 2070 (N.Y. App. 1991).

87 169 A.D.2d at 260.

88 "As broad as this language may be, a reasonable interpretation is that its effect is limited to tangible or physical matters and does not extend to paranormal phenomena. Finally, if the language of the contract is to be construed as broadly as defendant urges to encompass the presence of poltergeists in the house, it cannot be said that she has delivered the premises 'vacant' in accordance with her obligation under the provisions of the contract rider." *Id*.

89 "Where, as here, the seller not only takes unfair advantage of the buyer's ignorance but has created and perpetuated a condition about which he is unlikely to even inquire, enforcement of the contract (in whole or in part) is offensive to the court's sense of equity. Application of the remedy of rescission, within the bounds of the narrow exception to the doctrine of caveat emptor set forth herein, is entirely appropriate to relieve the unwitting purchaser from the consequences of a most unnatural bargain." *Id*.

90 *See* text accompanying notes 112–14.

91 "The parties further declare that they have not relied upon any representation of any party hereby released . . . [Party A] or of their attorneys, agents, or other representatives concerning the nature or extent of their respective injuries or damages." "[Party A represents and warrants] . . . (a) no promise or inducement for this Agreement has been made to him except as set forth herein; (b) this Agreement is executed by . . . [Party A] freely and voluntarily, and without reliance upon any statement or representation by Purchaser, the Company, any of the Affiliates or . . . [Party B] or any of their attorneys or agents except as set forth herein; (c) he has read and fully understands this Agreement and the meaning of its provisions; (d) he is legally competent to enter into this Agreement and to accept full responsibility therefor; and (e) he has been advised to consult with counsel before entering into this Agreement and has had the opportunity to do so." Rissman v. Rissman, 213 F.3d 381, 383 (5th Cir. 2000).

92 959 S.W.2d 171 (Tex. 1997).

93 When the sellers discovered the prospects of the venture were brighter than they supposed, they sued for misrepresentation. The jury award of compensatory and exemplary damages was reversed on appeal, the Texas Supreme Court holding, "Because the parties were attempting to put an end to their deal, and had become embroiled in a dispute over the feasibility and value of the project, we conclude that the disclaimer of reliance the [the sellers] Swansons gave conclusively negates the element of reliance." *Id*. at 180.

94 1 F.3d 1005 (10th Cir. 1993).

95 *Id*. at 1008, footnote 1.

96 The court dismissed the claim on summary judgment, finding the utility had effectively excluded itself from all responsibility for site conditions. By accepting the bid documents, the contractor assumed the risk that moisture content of the soil was higher than described in the bid documents.

97 BLACK'S LAW DICTIONARY, *supra* note 70, 929.

98 *E.g.*, Wilkinson v. Carpenter, 276 Or. 311, 554 P.2d 512 (Or. 1976), holding that a merger clause barred a claim for rescission of a contract for the sale of a business based on an alleged innocent misrepresentation by the seller.

99 Citibank, N.A. v. Plapinger, 66 N.Y.2d 90 (N.Y. 1985); Wells Fargo Bank Nw. v. TACA Int'l Airlines, 247 F. Supp. 2d 352, 360 (S.D.N.Y.2003).

100 426 F.3d 204 (3d Cir. 2005).

101 *Id*. at 210–11.

102 *Id*. at 212–13.

103 967 F. Supp. 81 (W.D.N.Y. 1997).

104 *See* text accompanying note 1.

105 "5.5 *Due Diligence*. Purchaser understands and agrees that it is solely responsible for conducting a due diligence investigation of the Mortgage Loans, Servicing Rights (including, without limitation, the Loan Documents) and the Certificates, and that Purchaser is buying the Certificates and the Servicing Rights 'as is' without any representation or warranty except as expressly provided in this Agreement and, except as provided in Section 2.3, without recourse against the Seller or the RTC." *Id*. at 85.

106 "5.7 *Access to Information*. Purchaser has been finished with, and has had an opportunity to review and has reviewed, all financial data, and other information relating to the Servicing Agreement, the Loan Documents, the Certificates, and the Servicing Rights requested by Purchaser. Purchaser has had any questions arising from or relating to such review answered to the satisfaction of Purchaser. Purchaser has not relied upon the Thrift, the Seller or the RTC or any of their respective employees, counsel, or agents with respect to any information regarding the Certificates or the Servicing Rights." *Id*. at 85–86.

107 "There are a number of issues of fact in this case that simply cannot be resolved on a motion to dismiss. In general, these issues relate to: what information was known to RTC, but not to OnBank, prior to the formation of the contract; whether that information was 'peculiarly within' RTC's knowledge, and whether it was available to OnBank; whether RTC made any material misrepresentations to OnBank; and OnBank's ability to have discovered the discrepancy between the Certificate Principal Amount and the actual loan balance prior to the date on which the servicing rights and obligations were transferred to OnBank." *Id*. at 87. The case was eventually settled before these factual issues were tried. United States District Court, W.D. New York, Docket 6:95cv06640.

108 [1951] Argus L.R. 771, 84 C.L.R. 377 (High Court of Australia 1951).

109 *Id*. at 382.

110 *Id*. at 398.

111 *Id*. at 410.

112 443 A.2d 1 (Del. 1982).

113 *Id*. at 7. *See also*, Slomin's, Inc. v. Wilson, C.A. No. 07-07-0217 (Del. Com. Pl. 2009), where a homeowner who was contemplating moving to Pennsylvania asked and was told by a home alarm company that it serviced all of Pennsylvania, and on that basis signed a 5-year service contract. When he moved to Pennsylvania, he learned service was not available in that state and cancelled the contract. The alarm company sued, and the home owner introduced evidence of the statements made by the company before the contract was signed; the company objected, citing the merger clause in the contract. The court held the evidence was admissible to show a mutual mistake of fact. The court said of the merger clause, "[B]ecause of the nature of the standardized contract and the oral statements of the sales representative, it is unlikely that this contract represents the real intentions of the parties." The case should have been decided on the ground the homeowner was induced by a misrepresentation, albeit innocent or negligent.

114 169 A.D.2d 254, 572 N.Y.S.2d 672, 60 USLW 2070 (N.Y. App. 1991).

115 *See* text accompanying notes 86–90.

116 "Where, as here, the seller not only takes unfair advantage of the buyer's ignorance but has created and perpetuated a condition about which he is unlikely to even inquire, enforcement of the contract (in whole or in part) is offensive to the court's sense of equity. Application of the remedy of rescission, within the bounds of the narrow exception to the doctrine of caveat emptor set forth herein, is entirely appropriate to relieve the unwitting purchaser from the consequences of a most unnatural bargain." *Id*.

117 26 F.3d 1057 (11th Cir. 1994).

118 *See* text accompanying ch. 3, notes 108 and 109.

119 273 F. Supp. 2d 436; 2003 U.S. Dist. LEXIS 11950 (S.D.N.Y. 2003).

120 "The section's use of the disjunctive conjunction, 'or,' which, along with the preceding comma, setting off a second conditional clause, indicates that two propositions are being delineated—one for circumstances involving changing rules and standards and another involving materially adverse effects of regulatory rules and [**20] standards irrespective of any change." *Id*. at 447.