



# Consumer Fraud, Misrepresentation and Reliance

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## ABSTRACT

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

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

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## 1. Introduction

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

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

information conveyed did not rely on the false statement. Hence, their action for damages will be denied.

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

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

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

liable for the entire harm it inflicts, including the harm incurred by non-relying consumers.<sup>2</sup>

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

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

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

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

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

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

ful representation. This decline in profit would exactly match the social loss emanating from the misrepresentation.

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

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

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

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

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

<sup>2</sup> For an analogous point made in the antitrust literature, see [Landes \(1983\)](#).

<sup>3</sup> If the firm were to charge a higher price, 120 at most, its net profits would be lower, equal to  $100 \cdot (120 - 80) = 4,000$ .

<sup>4</sup> 120 is indeed a profit-maximizing price for the firm given misrepresentation. See note 6 *infra*.

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

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

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

<sup>8</sup> We discuss this in Section 4.2.

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

ize losses would lead to an excessive level of deterrence.<sup>10</sup> Hence, the deterrence argument for removing the reliance requirement may not be directly applicable to misrepresentations affecting secondary markets. In what follows, we therefore restrict attention to primary market misrepresentations, where the misrepresenting party is also a party to the transaction.

The reliance requirement has sometimes been criticized in the literature, albeit on a different basis from that emphasized here. Existing critique primarily stresses the requirement's chilling effect on consumer class actions. In consumer markets, class actions serve as the prominent vehicle of enforcement, as individual actions are often not cost-effective. While subjective harm may be difficult to prove, average harm is often substantially easier to establish. The reliance requirement, however, places a severe strain on the viability of class actions. For a class to be certified under class action law, class members must establish that their claims raise "common issues of law and fact" and that the class action is a "superior" method of resolving the controversy, relative to individual suits.<sup>11</sup> But as commentators point out, the reliance requirement makes it exceedingly difficult to meet these burdens.<sup>12</sup> For the class to retain commonality, non-relying consumers must be identified and excluded from the class. This requires establishing the percentage of consumers who were exposed to the representation, and then within the exposed group, identifying those for whom the representation drove the decision to buy. The information required to reach that determination is often unknowable, let alone susceptible to proof. Thus, from a practical perspective, the requirement has the effect of undermining the efficacy of enforcement.

Yet, the notion that the requirement should be revoked on this basis is vulnerable to a significant counter-objection. While the argument rightly highlights the requirement's detrimental effect on enforcement, it does not deny its propriety as a matter of substantive law. If it is substantively justified that recovery be conditioned on reliance, then it follows that setting the requirement aside would cause liability to be wrongly imposed. Thus, although abandoning the requirement would render class actions easier to litigate, it would distort liability in a new, different way.

The argument advanced here for revoking the requirement therefore focuses not on its hindering effect on enforcement, but rather on its substantive merit. Our proposed justification itself builds on a substantive law argument: It addresses the requirement's effect on deterrence, entirely apart from its effect on the practicality of litigation. It establishes that removing the requirement does not in fact entail a sacrifice of substantive law principles; to the contrary, these very principles require its removal.

The remainder of the paper unfolds as follows: Section 2 places the reliance requirement in its doctrinal context. Section 3 discusses the relationship between reliance and causation. Section 4 then develops a model to examine the requirement's effect on welfare, and examines the welfare implications of alternative remedial regimes in a monopolistic market. Section 5 discusses extensions: It considers the robustness of the results in an imperfectly competitive market; it discusses further adverse implications of the reliance requirement; and it also explores the relevance of the reliance

requirement to cases of non-disclosure, and its implications for enforcement through class actions. The final section concludes.

## 2. Doctrinal review

In the U.S., a lawsuit alleging consumer misrepresentation, whether in an individual suit or in a class action, may be based on several alternative grounds. These include common law fraud or negligent misrepresentation; breach of warranty under the Uniform Commercial Code (UCC); state Unfair and Deceptive Acts and Practices (UDAP) laws; and the federal Racketeer Influenced and Corrupt Organizations (RICO) Act. As mentioned, the misrepresentation may also be grounds for a contractual claim for rescission and restitution.

This section reviews the alternative legal regimes that apply to market misrepresentation. Our aim is not to analyze each of these alternatives in detail; rather, it is to place the discussion of the reliance requirement in its doctrinal context, and to demonstrate the effect of this requirement on the scope of liability.

Under common law, a plaintiff may allege that a misrepresentation amounts to intentional fraud<sup>13</sup> or may alternatively claim liability for negligent misrepresentation.<sup>14</sup> The reliance requirement is deeply rooted in both of these common law actions.<sup>15</sup> To meet the requirement, the plaintiff must show that a false representation caused her to act (or refrain from acting) in a manner that ultimately produced harm,<sup>16</sup> and that the action taken was justifiable in view of the information presented.<sup>17</sup>

Other causes of action feature a less uniform approach to the requirement of reliance. For example, a plaintiff may rest his claim on a breach of warranty theory under the Uniform Commercial Code (UCC).<sup>18</sup> Unlike the common law actions, in a breach of warranty case the scope of the requirement is less settled. The UCC does not mention reliance explicitly, but it does require that the seller's affirmation of fact be "part of the basis of the bargain."<sup>19</sup> Under one possible interpretation, a representation can become 'part of the basis of the bargain' only if it is relied upon. Hence, some commentators and courts have interpreted this language to imply a reliance requirement.<sup>20</sup> Others have disagreed,<sup>21</sup> and so the question remains a matter of enduring debate.<sup>22</sup>

State statutory laws provide yet another avenue for suit for consumer misrepresentations. By the early 1970s, virtually all states had enacted statutes aimed at deterring consumer fraud,<sup>23</sup> often referred to as Unfair and Deceptive Acts and Practices laws, or "UDAP statutes".<sup>24</sup> State UDAP statutes differ across various dimen-

<sup>13</sup> See Restatement (Second) of Torts § 525 (1977).

<sup>14</sup> *Id.* § 552. See also Dobbs (2000).

<sup>15</sup> See, e.g., Restatement (Second) of Torts § 537(a) (fraudulent representation), 552(1) (negligent representation) (1977).

<sup>16</sup> See Dobbs (2000: 1358).

<sup>17</sup> *Id.* at 1359 ("Reliance is not ordinarily justifiable if the misrepresentation (a) is not material; (b) is mere puffing, states an opinion or judgment of one without specialized knowledge and who does not imply assertion of facts; (c) predicts some future course of events over which the defendant has little or no control; (d) states a legal conclusion by one without specialized knowledge and who does not imply assertion of facts"). See also Restatement (Second) of Torts, § 538–545 (1977).

<sup>18</sup> U.C.C. § 2–313 (2002).

<sup>19</sup> *Id.* § 2–313(1)(a).

<sup>20</sup> See, e.g., White and Summers (1995), Hodoszky (1991).

<sup>21</sup> See Heckman (1987), Murray (1982), Savage (1993), Kwestel (1992).

<sup>22</sup> See, e.g., Adler (1994), White (1998), McLaughlin (2009).

<sup>23</sup> For a review, see Lovett (1971). For a discussion of variations among UDAP statutes, see ABA Section of Antitrust Law, Consumer Protection Law Developments (2009); Brown and Hepler (2005), Schwartz and Silverman (2005).

<sup>24</sup> UDAP statutes are divided into two broad categories: "Little FTC Acts," which follow the enforcement model of the Federal Trade Commission (FTC), and "Uniform Deceptive Trade Practices Acts" (UDTPA), which follow various versions of the Uniform Act. See Scheurman (2006).

<sup>10</sup> Interestingly, however, in the realm of securities regulation, the "fraud on the market" doctrine provides that plaintiffs need not prove reliance to establish their secondary market claim. The reasoning stated above therefore suggests that the doctrine may well produce over-deterrence of security-related misrepresentations. For a comprehensive survey of the doctrine, see Langevoort (2008). See also Ayres (1991) and Macey et al. (1991).

<sup>11</sup> Fed. R. Civ. P. 23(a)(2); 23(b)(3).

<sup>12</sup> See, e.g., Issacharoff (2000), Goldberg and Zipursky (2013) ("The fraud on-the-market doctrine, put differently, is needed because a requirement of proof of individual reliance would largely defeat the possibility of class certification, a result that would significantly hamper this form of securities-fraud regulation.")

sions, including whether reliance is set as a prerequisite for liability. Some statutes explicitly require it<sup>25</sup>; other explicitly reject it<sup>26</sup>; and yet others remain silent on the matter, leaving it to the discretion of the courts.<sup>27</sup> Case law on the matter has often proved inconsistent, not only among states but also within them.<sup>28</sup>

Finally, federal statutes stipulate additional causes of action, but those too do not feature a clear or uniform approach to reliance. In a lawsuit premised on the Racketeer Influenced and Corrupt Organizations (RICO) Act, for example, a plaintiff's reliance need not be established if the plaintiff suffered loss as a consequence of a third party's reliance.<sup>29</sup> The stated purpose of this policy was to create a punitive component, which would reinforce the incentive to sue.<sup>30</sup> Whether similar reasoning will ultimately lead to full revocation of the requirement in RICO cases is still unclear.<sup>31</sup>

In summary, reliance is broadly required, but not uniformly so. Pressure to revoke it is not driven by the conceptual understanding that a misstatement can cause harm—and does produce harm, in large magnitude—without reliance; rather, it emerges primarily from the concern that reliance might undermine the feasibility of litigation, especially in class actions, and hence dilute deterrence.<sup>32</sup> But as we argue in following sections, revoking the reliance requirement does not sacrifice the principle that a defendant should be liable only for harm causally inflicted by its actions; on the contrary, its revocation furthers that very goal.

### 3. Reliance, causation and price impact

The intuitive appeal of the reliance requirement stems no doubt from its close kinship with the concept of causation—so much so that the distinction between the two concepts is often utterly blurred. A telling example is the Restatement (second) of Torts' perception of this relationship<sup>33</sup>:

If the misrepresentation has not in fact been relied upon by the recipient in entering into a transaction in which he suffers pecuniary loss, the misrepresentation is not in fact a cause of the loss under the rule stated in this section. If the misrepresentation has in fact induced the recipient to enter into the transaction, there is causation in fact of the loss suffered in the transaction; and the question becomes one of whether the loss is of a kind for which the maker is legally responsible.

The understanding reflected in this comment is that causation is impossible without reliance. This portrayal of the conceptual relationship between causation and reliance, however, is misguided.

<sup>25</sup> See, e.g., Ind. Code Ann. § 24-5-0.5-4(a); Tex. Bus. & Com. Code Ann. § 17.50(a)(1)(B); Wyo. Stat. Ann. § 40-12-108(a).

<sup>26</sup> See, e.g., Kan. Stat. Ann. § 50-626(b); Ariz. Rev. Stat. § 44-1522(A) (“whether or not any consumer has in fact been misled”). However, the Arizona Court of Appeals held that reliance is required. See *Peery v. Hansen*, 585 P.2d 574, 577 (Ariz. App. 1978).

<sup>27</sup> See, e.g., Ky. Rev. Stat. § 367.220 (1974); La. Stat. Ann. § 51:1409 (2011) (no reference to reliance).

<sup>28</sup> Compare *Ford Motor Credit Co. v. Majors*, 2005 Minn. App. LEXIS 448, at \*8–9 (May. 3, 2005) (no reliance required), with *Higgins v. Harold-Chevrolet-Geo, Inc.*, 2004 Minn. App. LEXIS 1303, at \*10 (Nov. 23, 2004) (reliance is required to recover damages). See also *Cullen v. Valley Forge Life Ins. Co.*, 589 S.E.2d 423, 431 (N.C. App. 2003) (no reliance required), in comparison to *Tucker v. Boulevard At Piper Glen LLC*, 564 S.E.2d 248, 251 (N.C. App. 2002); *Forbes v. Par Ten Group, Inc.*, 394 S.E.2d 643, 651 (N.C. App. 1990) (reliance is required).

<sup>29</sup> See *Bridge v. Phoenix Bond & Indemnity Co.*, 553 U.S. 639, 658–659 (2008).

<sup>30</sup> See *Ledingham* (2010).

<sup>31</sup> *Id.* at 311–315.

<sup>32</sup> See, e.g., *Hinchliffe v. American Motors Corporation*, 184 Conn. 607, 617–618 (1981) (Ct.) (“The CUTPA [Connecticut Unfair Trade Practices Act] plaintiff need not prove reliance. The legislative history demonstrates that CUTPA seeks to create a climate in which private litigants help to enforce the ban on unfair or deceptive trade practices or acts”).

<sup>33</sup> Restatement (Second) of Torts, § 546, cmt. A (1977).

Contrary to the Restatement's depiction, causation does not necessarily imply reliance—nor, for that matter, does reliance imply causation. Despite their affinity, the two concepts are analytically distinct, and neither one subsumes the other.

A party “relies” on a representation if it causes her to detrimentally change her position. For that to occur, she must be exposed to it; she must believe it; and that belief must drive her to make a decision she would not otherwise make.<sup>34</sup> In contrast, “causation in fact” is essentially a different requirement—namely, that harm be the result of a breached duty.<sup>35</sup> Hence, one can well contemplate injuries that are caused in fact without reliance<sup>36</sup> (as well as ones in which reliance ensues without a “caused” injury).<sup>37</sup>

In the case of market misrepresentation, harm is very often “caused” without reliance, and on a substantial scale. It is generated through the false statement's effect on price – its ‘price impact’: A product depicted as being more attractive than it truly is induces a rise in demand among consumers who are exposed to the misrepresentation; this rise in demand then raises the product's market price. Unexposed consumers do not contribute to this rise in demand, but because relying consumers were deceived, aggregate demand increases, and consequently the price set in equilibrium rises. Relying and non-relying consumers alike pay the new, higher price. Thus, the price increase is an injury “causally” borne by *all* consumers, irrespective of their reliance.

This ‘price externality’ is not unique to misrepresentations about quality, as in the example above, but also extends to false statements about any other detail of the transaction, such as quantity or price. Thus, for instance, the firm may advertise a discount yet actually charge an undiscounted price; or it may state that the product is of a particular size, whereas it is in fact smaller. In those situations as well, consumers exposed to the advertised information reach their purchase decisions believing that they are paying less per unit than they are actually charged.<sup>38</sup> That, in turn, implies an upward shift in aggregate demand, just as in the case of misrepresented quality. The ultimate effect is a higher price charged to all consumers, including those who did not rely. For deterrence to be optimal, that entire loss must be internalized.

### 4. Model

Consider a firm offering a product of type *B*, but falsely representing it as being of type *A*. The misrepresentation may be intentional, negligent or innocent. Denote the cost of accurate representation of the product's quality by  $k_B \geq 0$  and of misrepresentation by  $k_A \geq 0$ .

Demand for good *B* is non-increasing in quantity from left to right. For simplicity, we assume that consumers may buy either one unit of the good or no unit at all.<sup>39</sup> The cost of producing good

<sup>34</sup> See *Dobbs* (2000).

<sup>35</sup> *Id.*, at 405; *Keeton et al.* (1984: 263–264).

<sup>36</sup> On the distinction between reliance and causation, see *Pegram v. Herbling*, 667 So. 2d 696 (Ala., 1995); *Goldberg et al.* (2006), *Goren* (2002). In the context of securities fraud see *Fisch* (2013), *Langevoort* (2009).

<sup>37</sup> For an example in which reliance does not imply causation, suppose that Mary contemplates whether to invest in security *A* or in security *B*. Influenced by a false representation, suggesting that the value of *B* is likely to rise, she decides to acquire *B*. It then transpires that *B* actually declines in value but that *A* declines simultaneously at an identical magnitude. Mary “relied” on the representation, as she was exposed to it, believed it, and acted upon that belief. However, her harm was not “caused” by the representation as she would have suffered the same loss had she acquired security *A* instead.

<sup>38</sup> We assume here that consumers derive greater utility from a bigger product, although this is not always the cases. Note, however, that if consumers do not prefer a bigger product, then the firm carries no incentive to misrepresent quantity.

<sup>39</sup> We could alternatively think of a consumer buying *k* units as *k* different consumers buying one unit each. This, however, would require the court to be able to verify the value the consumer attaches to *each* of the units.

$B$  is given by  $c(q)$ . The price charged following misrepresentation is denoted  $p_A$ , whereas the price that would have been charged absent the misrepresentation is denoted  $p_B$ .

We define a “relying consumer” as one whose decision to buy was driven by the misrepresentation. Thus, for a relying consumer,  $v_A \geq p_A > v_B$ , where  $v_A$  and  $v_B$  are her valuations of products  $A$  and  $B$ , respectively. Accordingly, a non-relying consumer is one who was either not exposed to the misrepresentation, or for whom the misrepresentation did not drive the decision to buy (i.e., for whom  $v_B \geq p_A$ ).

We assume that there are no consumers who chose not to buy the product given the misrepresentation, but would have purchased it without it. We discuss this assumption in Section 5.3 below.

For simplicity, we analyze only cases in which  $p_A \geq p_B$ , where the firm’s liability is positive. All of our results also hold if  $p_A < p_B$  but such cases may imply negative damage payments, that is, payments made by consumers to the firm. Such payments are not legally actionable, and therefore we do not discuss them.

#### 4.1. Remedies

We consider both a rule of damages, and a rule allowing relying consumers to choose between damages and rescission and restitution. Under the former option, the consumer keeps the good and claims damages for her injury. Under the latter option, the consumer returns the product for a refund of  $p_A$ . Upon returning the good, we assume that its value might depreciate, so that its resale price diminishes to  $p_R \leq p_B$ .

We consider first the simpler case in which the consumer’s remedy is restricted to damages. Within this category, we compare two possible regimes—one allowing recovery to all consumers, and one restricting it only to relying consumers.

**Remedy 1: Damages Unrestricted by Reliance.** The firm is liable towards *all* consumers (relying and non-relying) by an amount given by:

$$\max \{p_A - p_B, p_A - v_B\} \quad (R1)$$

Under Remedy 1 all consumers recover damages, placing them in the position they would be in absent the misrepresentation.<sup>40</sup> Namely, consumers for whom  $v_B > p_B$  would buy the product absent the misrepresentation and capture a net gain of  $v_B - p_B$ . Accordingly, under Remedy 1 they are awarded  $p_A - p_B$ , and are placed in the same position. Similarly, consumers for whom  $v_B \leq p_B$  would not buy the product absent the misrepresentation, and hence would capture a net gain of 0. Hence, they may recover  $p_A - v_B$ , which again places them in the same position.

**Remedy 2: Damages Restricted by Reliance.** Remedy 2 is similar to Remedy 1, except that recovery is restricted to relying consumers, namely, to consumers for whom  $p_A > v_B$ .

Remedy 2 is the regime currently applied. Remedy 1 is our proposed modification.

Next consider the case in which consumers can choose between damages and rescission and restitution. In this case, the definitions of the two remedies are modified as follows:

**Remedy 3: Damages or Restitution Restricted by Reliance.** All consumers can choose between an option of damages, given by—

$$\max \{p_A - p_B, p_A - v_B\}$$

and an option of rescission and restitution, in which case they return the good for a refund of  $p_A$ , and the good’s value upon return is  $p_R$ .

**Remedy 4: Damages or Restitution Unrestricted by Reliance.** Remedy 4 is similar to Remedy 3, except that, as before, it is restricted to relying consumers only.

Remedy 4 is the existing rule when physical restitution is possible. Remedy 3 is our proposed modification.

Observe that under both remedies 3 and 4, consumers whose valuation of the good is  $v_B > p_B$  strictly prefer to keep the good and claim damages, as it allows them to retain a net benefit of  $v_B - p_B$  rather than 0. Relying consumers for whom  $v_B \leq p_B$  are indifferent between keeping the good and returning it, as both options leave them with a payoff of 0. Further observe that their decisions in that case may or may not be efficient: Namely, if  $v_B < p_R < p_B$ , the good confers greater social value when returned, whereas when  $p_R < v_B \leq p_B$ , its value is higher when kept. As consumers are indifferent between keeping the good and returning it in both cases, their decision need not necessarily be optimal. In what follows, we therefore assume that consumers for whom  $v_B \leq p_B$  may take either course of action, and examine the welfare consequences of removing the reliance requirement, given their decisions. We also assume that the proportion of consumers who will choose to return the product is correctly anticipated by the firm.

We begin by examining the case in which the firm is a monopoly. We show that if the reliance requirement is removed, the firm will engage in misrepresentation only if it is efficient. This property is not retained when liability is restricted by reliance.

In the Extensions section, we examine the case of imperfect competition. While the analysis reveals similar results to those obtained in the monopoly case, the imperfectly competitive setting also calls attention to the misrepresentation’s effect on competitors. We show, in particular, that for the firm to carry optimal incentives, liability must extend to injured competitors, in addition to injured consumers.

We do not analyze the case of perfect competition, since in that setting, the reliance requirement is redundant. In a perfectly competitive market, every consumer who buys from the misrepresenting firm is a relying consumer: because the product is always available at its competitive price from an alternative seller, no consumer is ever willing to pay more for the product than the competitive price. Since the category of non-relying consumers is therefore absent, the question concerning the desirability of the reliance requirement becomes moot.

#### 4.2. Analysis of the case in which the firm is a monopolist in both markets

Suppose that the firm is a monopolist in the markets for both products of types  $A$  and  $B$  if it chooses to be active in them. The firm makes an announcement  $a$  about the type of good it produces, and sets a price  $p_a$ . For simplicity, suppose that  $a \in \{A, B\}$ . Namely, the firm either announces truthfully that it produces the product  $B$  ( $a=B$ ), or it misrepresents the quality of the product and claims it is of type  $A$  although it is in fact of type  $B$  ( $a=A$ ). We assume that there is only one possible type of misrepresentation, but the analysis can be easily extended to cover any number of possible misrepresentations.

Denote the inverse demand (marginal benefit) functions for goods  $A$  and  $B$  by  $f_A$  and  $f_B$ , respectively. A third relevant inverse demand function is the one that describes the marginal benefit for good  $B$  of those consumers who bought good  $B$  following the firm’s misrepresentation, under the illusion they were buying good  $A$ . We denote this inverse demand function by  $f_{B|A}$ . If the firm misrepresents and sets the price  $p_A$  then it sells the quantity  $q_A$ , such

<sup>40</sup> Notice that in order to apply Remedy 1, the court needs to be able to ascertain the price  $p_B$  that would be available for consumers if the firm did not misrepresent.

that  $f_A(q_A) = p_A$ . This implies that consumers believe the firm's announcement.

Let

$$SW_A(p_A) = \int_0^{q_A} f_{B/A}(\theta) d\theta - c(q_A) - k_A$$

denote the social welfare that is generated by announcement  $A$  and price  $p_A$ , where the quantity  $q_A$  is such that  $f_A(q_A) = p_A$  and  $k_A$  denotes the cost of announcing  $A$ . The social welfare that is generated by announcement  $B$  and price  $p_B$  is given by

$$SW_B(p_B) = \int_0^{q_B} f_B(\theta) d\theta - c(q_B) - k_B$$

where the quantity  $q_B$  is such that  $f_B(q_B) = p_B$  and  $k_B$  denotes the cost of announcing  $B$ .

Let

$$CS_A(p_A) = \int_0^{q_A} [f_{B/A}(\theta) - p_A] d\theta$$

denote the (true) consumers' surplus that is generated by announcement  $A$  and price  $p_A$ , and let

$$CS_B(p_B) = \int_0^{q_B} [f_B(\theta) - p_B] d\theta$$

denote the consumers' surplus that is generated by announcement  $B$  and price  $p_B$ , where the quantities  $q_A$  and  $q_B$  are defined as before. Notice that both social welfare and consumers' surplus depend on the firm's announcement because it affects the consumers' perceived demand for the product and the quantity sold, and that social welfare is independent of the price for which the good is sold,  $p_a$ .

Social surplus equals the sum of the profit to the firm and consumer surplus, so that for any announcement  $a$  and price  $p_a$ ,

$$SW_a(p_a) = \pi_a(p_a) + CS_a(p_a) - k_a$$

where  $\pi_a(p_a)$  denotes the profit to the firm given announcement  $a$  and price  $p_a$  (again, the quantity sold is  $f_a(q_a) = p_a$ ).

As explained in Section 4.1, the damages stipulated by Remedy 1 ensure that all consumers who buy from the firm are placed in the same position as they would be in absent the misrepresentation. This is because following announcement  $a=A$  the compensation that is paid to a consumer whose valuation is  $v_B$  is  $\max\{p_A - p_B, p_A - v_B\}$ .

Denote the total sum of damages paid by the firm to all eligible consumers under Remedy 1 by  $D_{R1}(A, p_A)$ . A firm that represents truthfully pays no damages, so  $D_{R1}(B, p_B) = 0$ . The fact that each consumer's utility following misrepresentation and compensation is equal to her utility without misrepresentation (and no compensation) implies that the value of consumer surplus under misrepresentation plus total damage payments is equal to consumer surplus given truthful representation, or

$$CS_A(p_A) + D_{R1}(A, p_A) = CS_B(p_B).$$

It therefore follows that the net profit of a firm that misrepresents, chooses the price  $p_A$ , and is subject to damages is

$$\begin{aligned} \pi_A(p_A) - k_A - D_{R1}(A, p_A) &= \pi_A(p_A) - k_A + CS_A(p_A) - CS_B(p_B) \\ &= SW_A(p_A) - CS_B(p_B). \end{aligned}$$

Namely, the damage payments stipulated by Remedy 1 ensure that the firm's net profits following damage payments are equal to

social surplus up to a constant  $CS_B(p_B)$ . Because a firm that does not misrepresent pays no damages, the profits to a firm that does not misrepresent is

$$\pi_B(p_B) - k_B = SW_B(p_B) - CS_B(p_B),$$

which is again equal to social surplus up to the same constant.

It therefore follows that if the firm, which maximizes its own profits, is induced by Remedy 1 to make the announcement  $a=A$ , then it sets the price  $p_A$  which maximizes social welfare given that announcement. Furthermore, it chooses to make the announcement  $a=A$  if and only if this generates greater social welfare than announcing  $a=B$  and setting the monopolistic price  $p_B$ .

Remedy 3 also ensures that each consumer's utility under misrepresentation and compensation is equal to her utility under no misrepresentation. Therefore, consumer surplus is also equal under these two scenarios. Hence, the same argument presented above applies to the case of Remedy 3 and produces the same result.

Recall that consumers do not always exercise their option to return the good in a socially optimal manner. With that notwithstanding, the implication of the observation above is that welfare is maximized given their choice. The reason is that, while the reliance requirement does not alter their decision whether to keep the good or return it, it drives the firm to internalize the full social loss emanating from the misrepresentation, including their potentially inefficient decision whether to return. We further address how consumers may be incentivized to take the optimal return decision, below.<sup>41</sup>

The next proposition summarizes our findings so far.

**Proposition 1.** *Under both Remedy 1 and Remedy 3, the firm's decision whether to misrepresent, and the associated price following misrepresentation, are socially optimal.*

It is important to note that a truthful monopolistic firm usually charges a price that is higher than the perfectly competitive or efficient price, and sells a quantity that is lower than the competitive or efficient quantity. Such behavior generates an inefficiency that is referred to as the deadweight loss that is generated by the monopolist. When the firm misrepresents, Remedy 1 induces it to choose the socially optimal quantity, given the induced inverse demand function  $f_{B/A}$ . This is because the fact that a truthful firm is a monopolist implies that it does not sell to some consumers for whom it is efficient to sell. These consumers may be induced to buy from the firm under misrepresentation.<sup>42</sup> Because these consumers are relying (would not buy without misrepresentation), as explained above, these consumers are guaranteed by Remedy 1 a payoff of zero. This in turn implies that the monopolist captures the entire rent associated with these consumers, and therefore acts as a "perfectly discriminating monopolist" with respect to them. Hence, the monopolist would efficiently choose to misrepresent the quality of the product, when the elimination of monopolistic distortion under Remedy 1 outweighs the social costs of misrepresentation.

Under Remedy 2, the compensation  $\max\{p_A - p_B, p_A - v_B\}$  is only paid to relying consumers, that is, consumers with valuations  $v_B < p_A$ . Hence, overall compensation under Remedy 2,  $D_{R2}(A, p_A)$ , is lower than under Remedy 1. It follows that, under Remedy 2, the firm's incentives to avoid misrepresentation are not aligned with social welfare. The same argument applies to Remedy 4.

<sup>41</sup> Section 4.4.

<sup>42</sup> Note that Remedy 1 ensures that the monopolist cannot gain from misrepresentation if it does not sell to such consumers, because non-relying consumers are compensated for the difference in price under misrepresentation.

### 4.3. A right to return without damages

Under all four remedies examined above, consumers are granted the right to recover damages—either as an exclusive right (as in remedies 1 and 2), or as an alternative to returning the product for a refund (as in remedies 3 and 4). We now examine the effect of a third type of rule, under which return is offered as an *exclusive* remedy. Although such a rule is not usually applied as a formal matter, it nevertheless reflects a reality on the ground, in cases where prohibitive litigation costs exclude the possibility of damage suits. We therefore examine the effect of such a rule on the firm's incentives.

**Remedy 5: Return Only.** Consumers can return the good for a full refund, but cannot recover damages.

Under this rule, relying consumers choose to exercise the remedy and return the good, because by definition they value it by less than the refund ( $v_B < p_A$ ). Non-relying consumers, who value the good by more than refund ( $v_B > p_A$ ), will choose to keep the good.<sup>43</sup>

Given the choice of relying consumers, it can be easily verified that the rule deters misrepresentations that require no investment in their prevention ( $k_B - k_A \leq 0$ ). As transactions with relying consumers are rescinded, the misrepresentation can benefit the firm, at most by allowing it to charge an inflated price to non-relying consumers.<sup>44</sup> This benefit, however, is too small to render the misrepresentation profitable for the firm: The firm could extract the same profit from non-relying consumers simply by representing the good truthfully, and pricing it at  $p_A$ . The fact that, given truthful representation, the firm would charge  $p_B$ , implies that the firm would do better by charging  $p_B$  and representing truthfully, than by charging  $p_A$  and engaging in misrepresentation. Thus, under a rule that allows return as an exclusive remedy, misrepresentations are fully deterred if they are costless to prevent.<sup>45</sup>

The rule, however, fails to create optimal incentives to prevent misrepresentations if their prevention is costly ( $k_B - k_A > 0$ ). This is so because it falls short of compensating consumers for their entire loss. When relying consumers return the good, they are placed in their pre-contractual positions, although absent the misrepresentation some of them would have captured a positive gain. Namely, given truthful representation, consumers valuing the good by  $p_A > v_B > p_B$  would have gained  $v_B - p_B > 0$ . The misrepresentation denies them that benefit, even after the remedy is applied. That loss of value is a social loss, which the remedy does not lead the firm to internalize. Moreover, the firm's incentives to prevent the misrepresentation are further weakened by the fact that non-relying consumers do not return the good at all, thereby allowing it to capture the extra profit it extracted from charging them the inflated price.

Thus, a Return Only remedy produces deterrence if avoiding the misrepresentation is not costly. However, if the firm must expend

<sup>43</sup> Notice that some non-relying consumers, namely those who were never exposed to the misrepresentation, may also choose to return the product (if allowed to do so). Non-exposed consumers have based their decision to purchase on their beliefs regarding product type. If they attached a sufficiently high probability that the product was of type A, and  $p_A < v_A$ , then they could rationally purchase it, even though  $p_A > v_B$ . Such consumers would therefore seek to return the product once the misrepresentation is revealed. Our results do not depend on the existence or magnitude of this group.

<sup>44</sup> The firm's benefit will generally be lower, as the resale value of returned products will generally be lower than its original value ( $p_R < p_B$ ), and because some non-relying consumers may choose to return the good.

<sup>45</sup> Note that the same argument would not follow under Remedy 2 with Return, in which consumers can choose between damages and rescission. Under Remedy 2 with Return, relying consumers whose value is  $p_B < v_B < p_A$  would choose not to return the product, and the firm would therefore gain  $p_B > c(q)$  from its transactions with them. This is akin to allowing the firm to engage in price discrimination between relying and non-relying consumers, in which case it would not be deterred from defrauding them.

a precautionary cost to avoid it, then the level of deterrence may be inadequate.

### 4.4. Inducing optimal incentives to return

As noted above, Remedies 1 and 3 both create optimal incentives for the firm to avoid the misrepresentation. However, Remedy 3—which allows consumers to choose between damages and restitution—does not necessarily induce them to make the efficient choice between the two remedies, i.e., to choose restitution if and only if  $v_B < p_R$ . The following modification of Remedy 3, although somewhat removed from actual doctrine, would eliminate this inefficiency:

**Modified Remedy 3.** All consumers recover damages, given by:  $\max\{p_A - p_B, p_A - v_B\}$ , but no more than  $p_A - p_R$ .

Above and beyond the recovery of damages, all consumers may return the good, for a refund of  $p_R \leq p_B$ .<sup>46</sup>

As the refund granted upon returning the good is given by  $p_R$ , consumers return it if and only if it is efficient. Notice that consumers for whom  $v_B > p_B$  keep the good and recover  $p_A - p_B$ . Those for whom  $p_R < v_B < p_B$  keep the good and recover  $p_A - v_B$ . Finally, those for whom  $v_B > p_R$  return the good for a refund of  $p_R$ , and recover additional damages of  $p_A - p_R$ . Since all consumers are placed in the same positions they would be in absent the misrepresentation, the firm's incentives are optimal pursuant to the same argument as that in Section 4.2.

## 5. Extensions

### 5.1. Imperfect competition

Whereas the model in Section 4 considered the case of a monopolistic market, we now turn to examine whether results continue to hold in an imperfectly competitive setting. The conclusion is that they do: For the firm to carry optimal incentives, it must internalize all the costs and benefits that the misrepresentation produces. This implies that the firm must compensate consumers for their losses, irrespective of reliance.

Yet, the imperfectly competitive case brings a further point to the fore, namely that it is not only consumers who are harmed by a misrepresentation, but also competitors, whose profits decline.

To the extent that competitors' losses emanate from reduced prices, their loss is not a social loss—as lower prices are merely a transfer from sellers to buyers. Yet, the misrepresentation does affect social welfare by shifting demand from competitors to the misrepresenting firm: The firm attracts consumers who would otherwise transact with competing sellers. The shift prevents the creation of a surplus in an alternative transaction, while creating a new surplus in the transaction that is formed. The firm internalizes the difference in consumer surplus through its liability to consumers; it also internalizes the producer surplus created in the new transaction; but in order to have it internalize the loss of the producer surplus in the alternative transaction, it must also bear liability towards competitors.

Hence, in what follows we indeed show that for the firm's incentives to be efficient, it must compensate competitors for their losses. The argument for compensating competitors is akin to that underlying liability towards non-relying consumers. However, in contrast to the case of non-relying consumers, existing law does recognize competitors' cause of action. In particular, The Lanham Act establishes the standing of competitors, allowing them to claim damages

<sup>46</sup> Notice that if  $p_R = p_B$  then this remedy is identical to Remedy 3.

for lost profits.<sup>47</sup> Hence, contrary to the status of non-relying consumers, the law concerning competitors is in fact efficient.

Consider a model of horizontal product differentiation as in Hotelling (1929) with two firms, 1 and 2. The firms are located at the two ends of a unit interval, with firm 1 located at the point  $L_1 = 0$  and firm 2 located at the point  $L_2 = 1$ . Suppose that firm 2 produces a product of normal quality which consumers value at  $v > 0$ . Firm 1 engages in costless product innovation which, if successful, results in higher product quality, valued by consumers at  $v + 1$ . If it fails, then the product is of normal quality and is valued by consumers at  $v$ . Whether firm 1 is indeed capable of producing the higher quality product is privately known by firm 1, and cannot be observed by consumers or by firm 2, but may be verified in court. For both firms and both quality levels, costs of production are normalized to zero. The costs of representation are also assumed to be zero.

A mass one of consumers is spread uniformly on the unit interval. Each consumer buys one unit either from firm 1 or from firm 2.<sup>48</sup> Consumers know that firm 2 offers a product of normal quality. A consumer located at  $x \in [0, 1]$  who buys from firm  $i \in \{1, 2\}$  pays the price  $p_i$  and bears linear transportation costs of  $|L_i - x|$ . As before, we assume that the consumers and firm 2 believe firm 1's announcement regarding the quality of its product.

Suppose that firm 1 truthfully announces that it has produced a product of normal quality. The quantity sold by firm  $i$  if prices are  $p_i$  and  $p_j$  is  $\frac{1}{2} + \frac{p_i - p_j}{2}$  and so in the Nash equilibrium of the game in which the two firms choose their prices simultaneously, they both choose prices  $p_1 = p_2 = 1$  and sell a quantity of  $\frac{1}{2}$  each. The profits to both firms are  $\frac{1}{2}$ .

Similar analysis reveals that if firm 1 truthfully reports and is believed to have produced a product of high quality, then the Nash equilibrium prices and quantities are given by  $p_1 = \frac{4}{3}, p_2 = \frac{2}{3}, q_1 = \frac{2}{3}$  and  $q_2 = \frac{1}{3}$ , and profits are given by  $\pi_1 = \frac{8}{9}$  and  $\pi_2 = \frac{2}{9}$ , respectively.

Suppose that firm 1 produces a product of normal quality but claims falsely that it is of high quality and is believed by consumers and firm 2. We assume that firm 2 believes this announcement and therefore chooses the same price  $p_2 = \frac{2}{3}$  as in the Nash equilibrium in which the product produced by firm 1 is indeed of high quality. We now examine firm 1's best response to this price, subject to the alternative remedy regimes.<sup>49</sup>

As explained in Section 4.1 above, Remedy 1 ensures that, following a misrepresentation, consumers are placed in the same position they would be in if the representation was truthful. Damages to consumer  $x \in [0, 1]$  are  $\max \{p_1 - p_1^T, p_1 - v_1(x)\}$  where  $p_1$  is the price set by firm 1;  $p_1^T = 1$  is the price that would be set by firm 1 if it represented truthfully; and  $v_1(x) = [v - x] - \max \{v - (1 - x) - p_2^T, 0\}$  equals the *marginal contribution* that firm 1's product provides to consumer  $x$ , given that absent the misrepresentation she could buy the product sold by firm 2 for  $p_2^T = 1$ .

If  $v$  is sufficiently large, then  $\max \{p_1 - p_1^T, p_1 - v_1(x)\} = \max \{p_1 - 1, p_1 - (2 - 2x)\}$ . For consumers  $x \in [0, \frac{1}{2}]$ , who would have bought from firm 1 absent the misrepresentation,  $\max \{p_1 - 1, p_1 - (2 - 2x)\} = p_1 - 1$ . Hence, their utility is the same as under truthful representation. For consumers

$x \in [\frac{1}{2}, 1]$  who buy from firm 1 (but would have bought from firm 2, given truthful representation) the maximum is attained at  $p_1 - v_1(x) = p_1 - (2 - 2x)$ , which equals the price difference  $p_1 - 1$  plus the additional, inefficient transportation cost borne by the consumer,  $x - (1 - x) = 2x - 1$ . Hence, these consumers also enjoy the same utility as they would under truthful representation.

As explained above, for Remedy 1 to induce efficient behavior, firm 1 must also compensate firm 2 for the profit it lost as a result of the shift in demand to firm 1.

We now identify those consumers: If firm 1 misrepresents, then the consumer who is indifferent between buying from the two firms is given by  $x = x(p_1, p_2)$  that solves the following equation:

$$(v + 1) - x - p_1 = v - (1 - x) - p_2$$

or  $x(p_1, p_2) = 1 + \frac{p_2 - p_1}{2}$  where  $p_2 = \frac{2}{3}$  denotes firm 2's price following firm 1's misrepresentation. Consumers with an  $x$  smaller than  $x(p_1, p_2)$  buy from firm 1, while consumers with a larger  $x$  buy from firm 2. Hence, consumers whose  $x$  satisfies  $\frac{1}{2} < x \leq x(p_1, p_2)$ , are those who bought from firm 1 following the misrepresentation, but would have bought from firm 2, if firm 1 represented truthfully.

If firm 1 compensates firm 2 for profits lost in sales to those consumers, and in addition Remedy 1 is applied toward consumers who bought from firm 1, then firm 1's profit is given by:

$$p_1 x(p_1, p_2) - \int_0^{x(p_1, p_2)} \max \{p_1 - p_1^T, p_1 - v_1(x)\} dx - \int_{\frac{1}{2}}^{\max\{x(p_1, p_2), \frac{1}{2}\}} 1 \cdot dx$$

where the first integral refers to damage payments to consumers, and the second, to damage payments to firm 2 for its lost profits. Firm 1 must solve for the price  $p_1$  that maximizes this expression.

Plotting this function as a function of  $p_1$  reveals that it is maximized at  $p_1 = \frac{5}{3}$ , which induces the efficient outcome: consumers with  $x < \frac{1}{2}$  purchase from firm 1 and those with  $x > \frac{1}{2}$  purchase from firm 2. Moreover, it can be shown that the profit to firm 1 if it misrepresents and prices at  $p_1 = \frac{5}{3}$  is equal to  $\frac{1}{2}$ , which means that firm 1 has no incentive to misrepresent.

Similar analysis reveals that if Remedy 2 is applied instead of Remedy 1, that is, firm 1 compensates only relying consumers (in addition to compensating firm 2 for its lost profits due to the shift in demand), the outcome would be inefficient. Firm 1 would oversell relative to the efficient level, and would be induced to misrepresent.

Under Remedy 2, damages,  $\max \{p_1 - p_1^T, p_1 - v_1(x)\}$ , are only paid to relying consumers—those who bought from firm 1, but under truthful representation, would prefer buying from firm 2, given firm 2's price following misrepresentation,  $p_2 = \frac{2}{3}$ . Namely, damages are only paid to consumers who bought from firm 1 whose  $x$  is larger than the value solving:

$$v - x - p_1 = v - (1 - x) - p_2$$

or  $x = \frac{5}{6} - \frac{p_1}{2}$ . It follows that firm 1 is induced to solve for the price  $p_1$  that maximizes its profit:

$$p_1 x(p_1, p_2) - \int_{\frac{5}{6} - \frac{p_1}{2}}^{x(p_1, p_2)} \max \{p_1 - p_1^T, p_1 - v_1(x)\} dx - \int_{\frac{1}{2}}^{\max\{x(p_1, p_2), \frac{1}{2}\}} 1 \cdot dx$$

Plotting this function as a function of  $p_1$  reveals that the optimal price is  $p_1 = \frac{13}{9}$ . At this price, firm 1 sells more than the efficient quantity ( $\frac{11}{18} > \frac{1}{2}$ ) and captures more profit than it would obtain under truthful representation (.537 > 0.5).

It should be noted, however, that if firm 1 fails to compensate firm 2, then similar analysis reveals that the firm will engage in inefficient misrepresentation whether or not reliance is required. Under Remedy 1, firm 1 would set the price  $p_1 = 1$ , sell quantity of

<sup>47</sup> 15 U.S.C. § 1051, 1125(a) (1982) (section 43(a)).

<sup>48</sup> We assume that  $v$  is sufficiently large to ensure that the market is indeed fully "covered" in this sense. If  $v$  is lower, then some consumers might decide not to buy from either firm. Our results would continue to hold under this more complicated setting.

<sup>49</sup> Since firm 2 is assumed to believe firm 1's announcement, the price it sets is not necessarily the best response to firm 1's strategy. Yet, as we show below, in the case where the optimal remedies are applied, firm 1 never misrepresents, and therefore in this case, firm 2's beliefs are confirmed and the firms' actions do form a Nash Equilibrium.



$\frac{5}{6} > \frac{1}{2}$ , and earn profits of  $0.72 > 0.5$ . Under Remedy 2, it would set price at  $p_1 = \frac{10}{9}$ , sell quantity of  $\frac{7}{9} > \frac{1}{2}$ , and earn profits  $0.73 > 0.5$ .

Interestingly, the inefficiency induced by Remedy 1 in this case would exceed that induced by Remedy 2 (as  $\frac{5}{6} > \frac{7}{9}$ ). This is because, under Remedy 1, firm 1 gains nothing from its transactions with non-relying consumers. Its main effort is therefore directed at 'stealing' as many consumers as possible from firm 2, towards which it does not bear liability. Under Remedy 2, in contrast, since the firm does not compensate non-relying consumers, it must balance the benefit of 'stealing' consumers from firm 2, against the benefit of charging non-relying consumers a higher price. This, in turn, results in a more substantial distortion under Remedy 1.

## 5.2. Other effects of the reliance requirement

The inefficiency of the reliance requirement discussed thus far stems from a misallocation of resources, created as consumers purchase products whose cost of production exceeds their value to them. This, however, is but one type of social harm engendered by the requirement. Revoking the requirement carries the additional advantage of preventing other types of harm as well.

The requirement generates additional harm by lowering the value of the good after its purchase. Thus, for example, if a misrepresentation conceals a risk, consumers are prevented from taking precautions to counter it. If a seller of a car fraudulently represents that the brakes are in sound condition, the buyer will not immediately rush the car to the garage. More generally, incomplete information about the features of a good reduces its value by preventing consumers from making optimal use of it.<sup>50</sup> These costs extend to all exposed consumers, regardless of reliance. Hence, by denying non-relying consumers the right to recover, the reliance requirement prevents these losses from being internalized.

The reliance requirement additionally incentivizes rent-seeking investments by firms. If allowed to retain a profit from the fraud, firms are induced to invest in its successful execution. As an imposter may successfully defraud his victim only if his assertions are ultimately believed, he is motivated to devote resources to rendering his assertions believable. Barring non-relying consumers from recovery allows the deceiver to profit from the fraud, and thereby incentivizes investment in the fraud's successful commission.<sup>51</sup>

Finally, as the existing literature emphasizes, the reliance requirement also undermines deterrence through its chilling effect on consumer class actions.<sup>52</sup> In mass consumer markets, where the value of individual suits is often low, class actions remain the primary—if not exclusive—vehicle of enforcement. Furthermore, while the magnitude of harm for each individual consumer may be extremely difficult to establish, average harm to all consumers may be more readily ascertained—which makes the class action all the more essential mechanism for creating deterrence. Yet, the

reliance requirement burdens the class action with a substantial impediment, which greatly undermines its viability.

Under generally accepted principles of class action law, the certification of a class action requires a showing of two major elements (among others): First, that the claims of class members share common issues of law and fact<sup>53</sup>; and second, that the class action is the "superior" method of adjudicating the controversy fairly and efficiently.<sup>54</sup> The reliance requirement renders both of these elements extremely difficult to establish. If only the relying members of the class hold a valid cause of action, then the class representative must be able to identify and prove what segment of consumers actually relied, and then exclude non-relying consumers from the class. In mass consumer markets, obtaining such information is often prohibitively costly or outright impossible.<sup>55</sup> Moreover, even if this barrier is overcome, individual reliance would still have to be eventually proven for class members to establish their right of recovery. These difficulties undermine the manageability and efficiency of the entire procedure. In view of these complications, individual suits may prove a more suitable means for adjudicating the dispute, contrary to the requirement of superiority.<sup>56</sup>

Removing the reliance requirement may revive the class action, restoring its function as a prominent and effective means of enforcement. If reliance is not required, then all consumers share the right to recover for the price impact. At least for that component of harm, the class would comply with both the "commonality" and "superiority" requirements, needed for its certification. Furthermore, it follows from the foregoing analysis that allowing recovery for that harm will not result in the over-deterrence of the firm, as the price impact is merely a lower bound of the harm actually caused. Hence, by revoking the requirement, deterrence will be unequivocally improved.

## 5.3. A cause of action for nonconsumers?

The discussion so far has focused on the right of consumers—all consumers—to recover for harm caused by a misrepresentation, even if they have not relied. It should be observed, however, that a misrepresentation might harm not only those who have ultimately become consumers but also individuals who have eventually decided not to purchase the product, because of the misrepresentation—consumers who decided not to buy the product following the misrepresentation but would have bought it otherwise. Our analysis assumed that there are no such consumers. We now consider the implications of relaxing this assumption.

Consider again the firm representing its product as being of type *A* although in truth it is of type *B*. Consequently, its price rises from 80 to 100. A representee values type *A* products by 95 and type *B* products by 85. Given the misrepresentation, he will refrain from the purchase as he is not willing to pay 100 for a product he values merely by 95. However, absent the misrepresentation, he would have purchased the product for 80 and captured a benefit of 5. It is therefore a benefit that the representee has lost as a consequence of the false representation. It is a social harm caused in fact to a party who has ultimately *not* become a consumer.

In more general terms, then, we can identify an additional group of victims consisting of nonconsumers: Those are representees for whom  $v_A < p_A$  (and thus, they were unwilling to buy the product for

<sup>50</sup> Note that these costs are analytically distinct from those emanating from allocatively inefficient transactions: They may be incurred regardless of whether the consumer is the efficient owner of the product.

<sup>51</sup> In a regime of no liability, a mirror image problem would arise, in which consumers would invest in self-protecting measures against fraud. Consumers who are aware that firms are inadequately deterred would invest resources in an effort to protect themselves from losses. For example, a car buyer suspecting that the car's condition is not as represented, would invest resources in ascertaining its actual condition. Such self-protecting investments would then add to the social waste incurred by misrepresentations. This problem is resolved, however, in a regime in which liability is imposed for misrepresentation, even if it is restricted to relying consumers. Under such a regime, relying consumers do not invest in self-protecting measures because liability insures them against losses. Likewise, non-relying consumers have no incentive to invest, because, by definition, having the correct information would not alter their decision to buy.

<sup>52</sup> See *supra* note 12.

<sup>53</sup> See Fed. R. Civ. P. 23(a)(2).

<sup>54</sup> See Fed. R. Civ. P. 23(b)(3). For a more detailed discussion, see [Newberg and Conte \(2011\)](#).

<sup>55</sup> See *supra* note 12. See also [Erbesen \(2005\)](#).

<sup>56</sup> See, e.g., [Newberg and Conte \(2011\)](#) 49, §4.58. See also Fed. R. Civ. P. 23(b)(3) advisory committee's note ("[A] fraud case may be unsuited for treatment as a class action if there was material variation in the representation made or in the kinds or degrees of reliance by the persons to whom they were addressed").

$p_A$ ), but  $v_B > p_B$  (and thus they would have purchased the product if it were truthfully represented). For members of this group, the representation obstructs a welfare-enhancing transaction. The firm internalizes the firm surplus that is thereby lost, but externalizes the consumer surplus. Thus, for optimal deterrence to be realized, members of this group should be able to recover for their consumer surplus.<sup>57</sup>

Under existing law, however, non-consumer victims do not recover damages. This policy may perhaps be justified on a practical basis. Recognizing the claims of non-consumers is likely to produce serious evidentiary barriers, which may be very difficult to surmount. Recall that their essential claim is that they would have purchased the product had it been truthfully represented, and so they were deprived of the benefit emanating from the unsummed transaction. Substantiating such a claim, however, will often be a formidable task. Any nonconsumer—whether or not a true member of the group—might claim that she would have purchased a product had it been truthfully represented. Little can be done by way of making such a claim verifiable. Furthermore, such a nonconsumer could generally reduce the extent of harm by acquiring a substitute, but the subjective value of such a substitute is again unverifiable. Hence, although liability towards nonconsumers is required for optimal deterrence to obtain, real-world evidentiary difficulties may militate against it.

#### 5.4. A cause of action in cases of non-Disclosure?

The analysis has thus far made no distinction between an *active misrepresentation*—an affirmative statement that is incorrect—and a *passive misrepresentation*—a failure to disclose material information despite an applicable duty to do so. Legally, the term “misrepresentation” encompasses both types of conduct.<sup>58</sup> The question we address next is whether the two ought to be distinguished from the standpoint of legal policy.

We believe that the answer to this question is no. The reliance requirement ought to be revoked in both cases and for similar reasons. To elaborate, consider a firm failing to list all of a product’s ingredients upon its label, in violation of a duty to do so. Accordingly, one can distinguish between relying and non-relying consumers: Relying consumers are those who read the label and whose decision to purchase was driven by the belief that the product did not include a particular ingredient. Non-relying consumers are those who were exposed to the inaccurate label, but did not change their position as a consequence; or those who never read the label.

One may wonder whether it is possible for a consumer to be “unexposed” to non-disclosure. Indeed, in the context of securities litigation, the United States Supreme Court has long adopted a rule that reliance should not be required in cases of failure to disclose,<sup>59</sup>

<sup>57</sup> Note that members of this group, unwilling to pay  $p_A$  for product A, might be motivated to buy a substitute product elsewhere in the market. That alternative transaction would then create a gain for both the buyer and the seller and, accordingly, would generate both a producer and a consumer surplus. At first glance it might seem that the benefit a consumer would obtain from that transaction ought to be deducted from his claim against the firm. Such a conclusion would be incorrect, however. The consumer’s willingness to pay for the product already takes account of all available alternatives. Thus, if the consumer were willing to pay, say, 85 for the product, whereby absent the misrepresentation the product would cost 80, it follows that he would gain 5 from the purchase, over and above the value of his next best alternative. Hence, by setting compensation at 5, one already accounts for the value of the alternative and precisely measures the extent of harm.

<sup>58</sup> Restatement (Second) of Torts, § 551, cmt. A (1977).

<sup>59</sup> See *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 153–154 (1972) (when a case involves “primarily a failure to disclose, positive proof of reliance is not a prerequisite to recovery”). See also *Stoneridge Inv. Partners, LLC v. ScientificAtlanta, Inc.*, 552 U.S. 148, 158 (2008) (“[I]f there is an omission of a material fact

possibly based on a theory that non-exposure is impossible in such cases.<sup>60</sup> More careful examination reveals, however, that whether a consumer may be unexposed to non-disclosure depends on the context within which disclosure should have been made. In the above example, disclosure was required to appear on the product’s label. Therefore, any consumer who did not bother to read the label was unexposed to the non-disclosure.<sup>61</sup>

As in the case of active misrepresentations, non-relying consumers nevertheless sustained an injury engendered by the inflated price. Accordingly, if the firm is allowed to retain the profits it captures from its failure to disclose, without internalizing the attendant cost to consumers, it would be under-deterred from violating the duty to disclose. Other inefficiencies—stemming from deficient reliance investments and wasteful efforts in perpetrating fraud—would also arise. Hence, the reliance requirement is as inefficient in the case of passive misrepresentations as it is in the case of active ones.

## 6. Conclusion

The reliance requirement has drawn considerable attention among academics, courts, and legislators. Nevertheless, to date, its effect on deterrence has not been systematically analyzed.

The question of reliance probes into the very essence of the concept of misrepresentation. Intuitively, a person cannot suffer an injury from misrepresentation unless she is actually deceived. Yet, in a market context, a false statement may well cause harm without reliance, and at a substantial scale. Thus, if the aim of legal policy is to optimally deter against the harm emanating from misrepresentation, then the legal meaning of ‘misrepresentation’ must encompass all injuries caused by the false statement, including those that are not a byproduct of reliance. Where the misrepresenting firm fully internalizes the benefit arising from the statement’s impact on price, it should fully internalize the associated social cost. The reliance requirement effectively precludes liability for a portion of that cost, and thereby fosters an inefficient incentive by firms to disseminate false information.

The argument against the reliance requirement applies irrespective of the procedural route by which the claim is litigated. Its implications, however, are most acute in the context of class actions, where the requirement undermines the prospect of class certification. Revocation of the requirement would remove an impediment that unduly weakens the capacity of the class action to serve as an effective instrument of private enforcement. This has been the focus of the literature on market fraud so far. Our deterrence analysis confirms that setting the requirement aside is also correct from a social welfare perspective, regardless of the procedural mechanism that is employed. It is desirable not only as a means to embolden class action litigation, but more importantly as a means to ensure that litigation concludes with a correct outcome, in which the firm’s liability exactly equals the harm engendered by its actions.

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by one with a duty to disclose, the investor to whom the duty was owed need not provide specific proof of reliance”).

<sup>60</sup> See *Goldberg et al.* (2006).

<sup>61</sup> If, however, disclosure should have been made orally to each consumer, then any failure to make it would automatically imply exposure. See *Hazen* (1996), *Hazen* (2011).

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