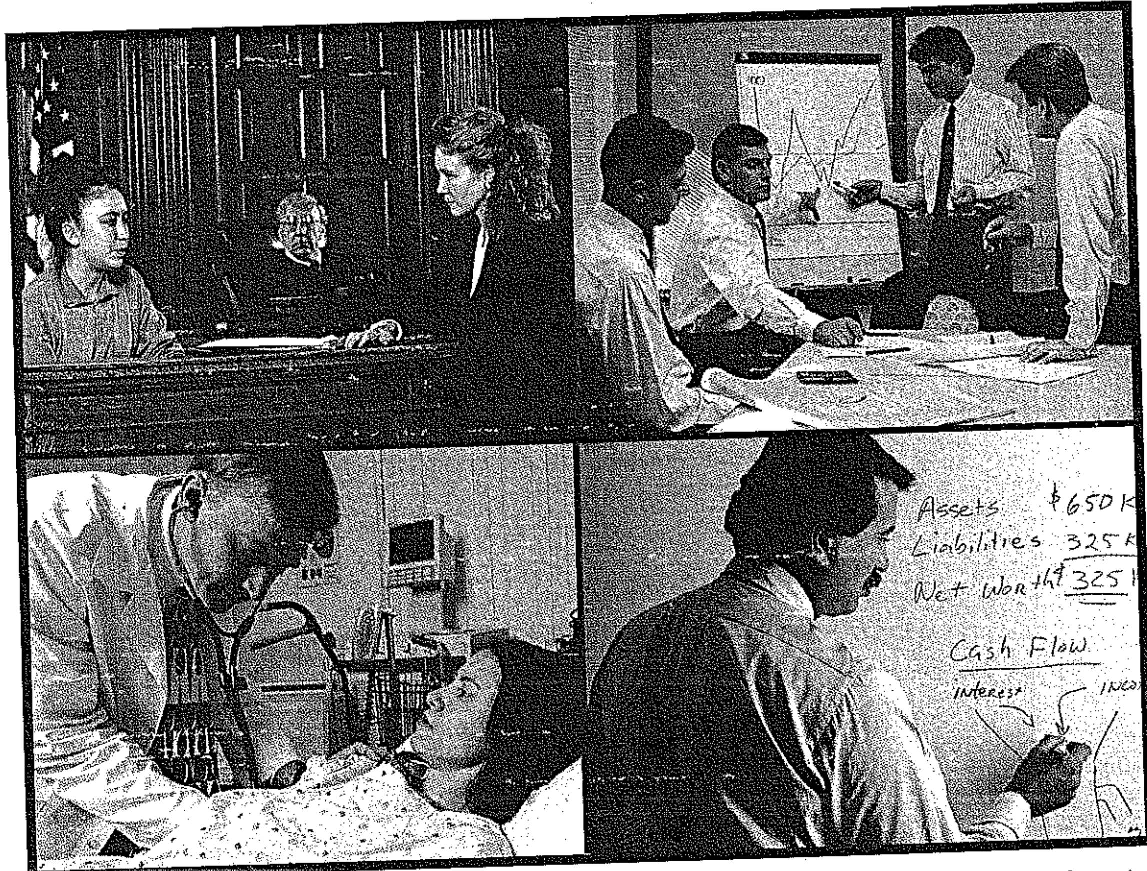
Legal Beat

By MICHAEL SEAN QUINN

Negligent Misrepresentation—Part I

A primer on how negligence differs from fraud, what constitutes negligence and how Texas law applies

For a century and half, or so, tort law was divided into business torts and personal injury. Business torts includes such things as tortuous interference, trade secret misappropriation, some forms of defamation, unfair competition, trespass (to business property), some other common law torts and various statutory tort-like actions. Personal injury included some of the same torts (such as trespass, false imprisonment, and malicious prosecution, for example), a number of intentional torts which were characteristic of personal interaction (battery, assault, and so forth), and—of course—negligence.



Business runs on information. What happens when false information is supplied? What happens when information that it supplies is so poor—so full of gaps—that it might as well be false?

Negligence

Three important points need to be made. First, in terms of shifting losses, negligence is by far the most important tort in the personal arena. Second, for most of its history, the tort of negligence required physical injury or property damage. The Texas Supreme Court has even held that there is no such thing as a cause of action for negligent infliction of emotional distress. Third, the tort of negligence was not widely used in business torts, except for professional malpractice against lawyers, accountants, engineers and the like. Of course, there has always existed a tort of malpractice against insurance agents, brokers and other intermediaries, and it turns upon the law of negligence, but it is restricted in various ways, as we shall see.

Business runs on information. What happens when false information is supplied? What happens when information that it supplies is so poor—so full of gaps—that it might as well be false? How does the law handle this? How is it handled in the insurance industry where poor information can lead to the avoidance of an insurance policy?

Fraud and negligence

The traditional way of handling it was through the tort of fraud. "Fraud" is an ugly word for an ugly event. Fraud is lying. One commits the tort of fraud when one lies; someone else relies on the lie; and they lose money as a result. In some states, if that reliance is negligent, damages may be reduced. Such is not the case in Texas. Texas has it right. If you lie to me, I should be able to rely on your intentional statements, so I don't have to be constantly on the lookout.

But surely, most misinformation is transmitted not as the result of lies but as the result of screw-ups and inattention. Surely, negligent misrepresentations are, as a statistical matter, more significant than deliberate misrepresentations. Sloppiness, stumbling, fouling-up and inattention are surely more common than out-and-out material lying. What does the law do about negligent misrepresentations? After all, they usually cause financial injury, not physical injury or property damage. If the law conditions all recoveries for negligence upon either bodily injury or property damage, there can not be a cause of action for negligent misrepresentation.

This was a problem a hundred years, or so, ago. The minds of jurists creak, alas. The law changes, but usually at a slow, slow pace. By well into the 20th century, however, the law of negligent misrepresentation was reasonably well established, and several

cases in Texas over the last few years have brought it of age.

Negligent misrepresentation

Although there were cases around the country—as it were, hither, thither, and yon—the tort of negligent misrepresentation became firmly established on a nationwide level in approximately 1965, when it was included in the epochal (but quite private) *Restatement (Second) of Torts*, one of the most influential legal documents ever written. It reformulated the tort in roughly the following terms.

When someone, while acting in the course of his business profession, or employment, or who is involved in the transaction in which he has a pecuniary interest, provides false information for the guidance of others in a business transaction of theirs, that person is subject to liability for the pecuniary loss caused by the justifiable reliance of anyone who was intended to rely upon that information, if the person who provides the information has failed to exercise reasonable care in obtaining or communicating the information.

There are several important features to notice about the tort of negligent misrepresentation. First, it is restricted to business and business-like transactions. Second, the group of those who may sue the provider of the false information is not the class of all those who rely upon it. Rather, it is those who the provider intended should rely on it or who he knew would rely on it.

Third, such reliance must be justifiable. In other words, if the person who receives the information and relies upon it is negligent—if his reliance is unreasonable—then his right to damages is either defeated or reduced. Presumably, courts would use principles of comparative negligence. Fourth, damages are restricted to pecuniary losses. One cannot recover for mental anguish. One can only recover for amounts of money one lost or spent.

Fraud and negligence, again

Quite clearly, the purpose of the law of negligent misrepresentation differs from the purpose of the law of fraud. Fraud is designed to secure honesty. The law of negligent misrepresentation secures a standard of care in dealing with information. To be sure, both torts are designed to protect the economy and keep truthful information flowing while keeping false information out of the flow. False information can creep into economic transactions in all sorts of ways, of course. There can be failures to investigate. People can draw the wrong inferences before they

CHAMBERS OF COMMERCE
CLUBS-CIVIC/SOCIAL
DEVELOPMENTALLY DISABLED
DRUG & ALCOHOL CENTERS
GROUP HOMES
HEAD START
MUSEUMS
OUTPATIENT CLINICS
SCHOOLS
SOCIAL SERVICE AGENCIES
THRIFT STORES
YOUTH PROGRAMS
YWCAS

100% dedicated to your nonprofit

No Departments.
No Divisions.
An Entire Company.
That's the Difference.

CHARITY FIRST
Insurance Dedicated to Nonprofit Groups

Underwriting Managers Offering
Complete Package Policies
Workers Compensation
Directors and Officers

Contact Mike Komar at
1.800.352.2761
www.charityfirst.com

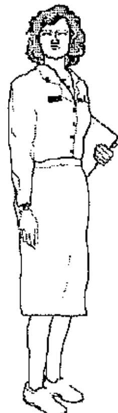
A+ Rated Carriers

provide information. Communicating can be done badly. Fraud sometimes is used to punish. Negligent misrepresentation is used only to compensate.

It is characteristic of the common law that wherever there can be negligence, there can also be gross negligence. Gross negligence occurs when someone acts in conscious disregard of the rights of others. Gross negligence occurs when an actor flagrantly disregards the rights of others, while he knows they are in potential danger. Gross negligence is not simply egregious error. It is not simply stunning negligence. Legal negligence is not a spectrum-type concept. The conduct is either negligent or it's not.

Gross negligence arises when someone knows about the danger of another, knows he very well may be injured, and simply announces to himself that he does not care. If there is such a thing as negligent misrepresentation, there is such a thing as grossly negligent misrepresentation, although the line between grossly negligent misrepresentation and out-and-out fraud is not very clear. Often plaintiffs can recover punitive damages in gross negligence cases. This is not true in misrepresentation cases.

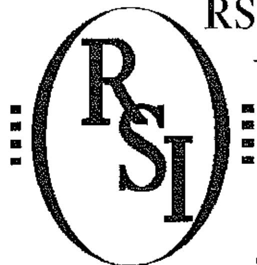
A New WORKERS COMPENSATION MARKET



✔ All "A" Rated Insurers
✔ Standard Underwriting Criteria Apply
✔ NO Minimum Premium

Now means to take care of the "other" coverage area for your clients as well as the property, casualty and auto.

We continue to look for markets to help you in writing accounts.



RSI INTERNATIONAL, INC.
MANAGING GENERAL AGENCY
(817) 861-6999 • Metro (817) 461-2099
(800) 275-2084 • Fax (817) 861-8955
1301 S. Bowen Road • Suite 460
P.O. Box 13479 • Arlington, Texas 76094-0479
www.rsimga.com
Houston Office
(713) 917-6849 • (888) 917-6849 • Fax (713) 917-6789
9801 Westheimer • Suite 302 • Houston, Texas 77042

Texas law

One of the most important cases ever decided in the area of negligent misrepresentation was *Federal Land Bank Association of Tyler v. Sloane*, decided by the Supreme Court of Texas in 1991. It pretty well adopted the rule set forth in the *Restatement* (Second). In that case, prospective borrowers sued a lender because an employee of the lender had promised to make a loan; the prospective borrowers spent money in reliance upon the bank's affirmation; but the bank backed out.

The court not only adopted the rule of the Restatement, it said that an oral promise, which is also a predictive statement, would support an action for negligent misrepresentation. This is an extremely important technicality. Often, oral promises do not constitute enforceable contracts, and cannot be litigated as such. For some strange reason, the rule mandating this result is called the "Statute of Frauds," although it is not about fraud but about when contracts have to be in writing.

> *Fraud is designed to secure honesty. The law of negligent misrepresentation secures a standard of care in dealing with information.*

Lawyers as defendants

Another significant development in the tort of negligent misrepresentation has surrounded lawyers. It is characteristic of professional malpractice cases that only clients can bring them. Thus, only patients can sue their doctors; only clients have been able to sue their lawyers; only customers can sue insurance brokers. In certain very narrow circumstances, some states have created exceptions to this rule. For example, if a lawyer has drafted a will for someone and screws it up, in several states, disappointed beneficiaries under what should have been a correctly drawn will can sue the lawyer.

This question came up in Texas in 1996. By a vote of 6-3, the Texas Supreme Court

clung to the old rule. To this day, in Texas, only a client can sue a lawyer for malpractice. The court was concerned that if non-clients could sue lawyers for malpractice, too many conflicts of interest would be created for the lawyer, who owes his principal duties to his client and his client alone.

The question then arose whether a non-client could sue a lawyer successfully for negligent misrepresentation. Suppose, on behalf of his client, a lawyer provides information to a bank the basis of which the bank issues a loan to the client. Perhaps the information is in an opinion letter or something of that sort. If the lawyer's factual statements are false, and the bank had no reason to think they were false, doesn't it make sense that lawyer should be liable? Isn't this particularly true since large commercial lending and securities transactions often hinge upon the honesty and competence of legal opinions.

Or suppose that two parties are trying to settle a lawsuit arising out of a deal, that settling the lawsuit makes sense only if a particular proposition is true, and that one side agrees to settle the lawsuit upon the condition that an opposing lawyer certifies that the crucial proposition is true. Could that lawyer be guilty of negligent misrepresentation because she negligently made a false statement to her client's opponent?

Both of these case have come up in recent years. The Fifth Circuit found that the lawyer who gave false information to the bank could be liable to the bank for negligent misrepresentation, and the Texas Supreme Court found that the lawyer who makes the mistake in the context of settlement may also be held liable on the same theory.

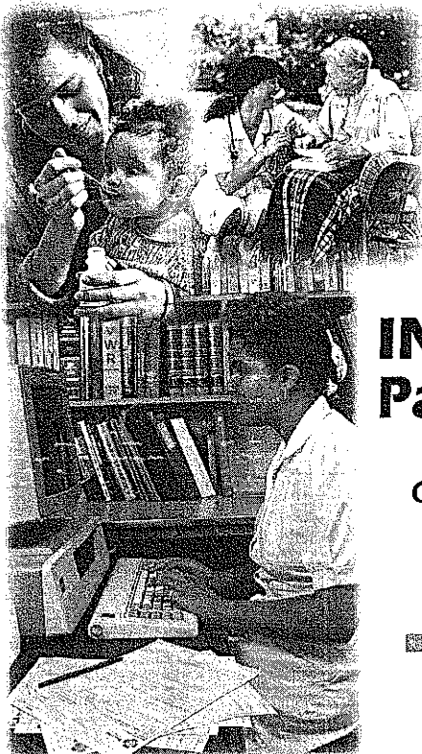
Interestingly, both of these cases are very close to being fraud cases. In the lawyer-bank case the lawyer said that he checked something when he didn't—hence, the lawyer lied. In the settlement-case, the certifying lawyer's senior partner knew that what the junior lawyer certified was false. If the knowledge of the senior lawyer is automatically attributed, as a matter of law, to the junior lawyer, then the junior lawyer lied (in legal contemplation), even if he (really) didn't.

Nevertheless, the black letter law of Texas is clear. Lawyers can be liable for negligent misrepresentations to transactional and litigation opponents. In the year 2000, however, the Dallas Court of Appeals held that lawyers could not be held liable for negligent misrepresentation when they negligently insert false propositions into court pleadings. One wonders why not. Of course, it's not okay to assert false propositions in pleadings. There are procedural and ethical rules forbidding this conduct and providing remedies. Still, the law wants each lawsuit over and done with. All good things must come to an end sometime. It does not encourage doubling back and starting a dispute over again, once it has been declared over.

Where do agents stand?

The position of insurance agents and brokers is, to some degree, similar to that of lawyers. Insurance intermediaries advise their clients on how to handle risk. They advise them on insurance dimensions of all sorts of transactions and all sorts of business arrangements. Thus, insurance agents and brokers provide information and advice that is crucial to the smooth functioning of the economy. What kind of liability may insurance brokers have for negligent misrepresentation? This is the topic for Part II. ◼

Quinn is an Austin shareholder in the law firm of Sheinfeld, Maley & Kay. He is mostly involved in litigation problems involving insurance coverage. Many of the problems upon which he works involve conduct of lawyers. He testifies from time to tome on insurance related issues and on issues pertaining to the conduct of lawyers.



A Professional Insurance Program Designed Exclusively For Non-Profit Institutions Providing Comprehensive Social Services

INSTITUTIONAL Package Program

Comprehensive Coverages Available Include:

- Professional Liability
- Commercial General Liability
- Property Coverage
- Crime
- Inland Marine
- Automobile
- Umbrella
- Directors and Officers Liability

- Counseling Offices
- Special Schools
- Group Homes
- Residential Facilities
- Day Care
- Shelters
- Halfway Houses
- Developmental Disabilities
- Vocational Training
- Mental Health Operations
- Physical Therapy
- Recreation Programs
- Drug and Alcohol Rehabilitation
- Facilities for the Handicapped
- Fund Raising Activities
- YWCAs
- Crisis Centers
- Community Centers

Through

NORTH ISLAND FACILITIES, LTD.
30 Park Avenue
Manhasset, New York 11030
516-365-7440

Underwriting Managers for Licensed "A" Rated Carriers

– Outside of New York –

1-800-892-8892