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Misrepresentation: the pitfalls of pre-contract statements

Inside

Introduction

Prior to the conclusion of a contract parties will often make statements to each other - during negotiations, in tender documents and in a variety of other ways. Most pre-contract statements are carefully considered. But sometimes statements are made which are false or misleading. When false statements induce an innocent party to enter into a contract the consequences can be serious.

The purpose of this guide is to consider the litigation risks generated by pre-contract statements, the remedies available in connection with false statements and the contractual protections available to affected parties.

What makes a misrepresentation actionable?

There are various conditions that must be satisfied to make a misrepresentation actionable:

1. There must be a statement by the representor or his agent. The statement can be oral, written or by conduct.
2. The statement must be a statement of fact (as opposed to a statement of opinion or future intention).
3. The representation must be made to the representee or to a class of which the representee is a member.
4. The representee must reasonably have been induced by the representation or reasonably acted in reliance upon it, believing it to be true. Usually the representee will have entered into a contract on the basis of the representation.
5. The representor must have either intended the representee to act upon the statement, or at least the facts must be such that he or she ought to have realised that the representee might have done so.
6. The representation must be false.

What is a statement of "fact"?

It is not always possible to draw a clear dividing line between statements of fact (which are actionable) and opinion (which are not actionable as misrepresentations).

Often the issue is whether the representor has stated an opinion which impliedly represents that there exists some state of facts which is different from the truth. In such cases the court must decide "*what a reasonable person would have inferred was being implicitly represented by the representor's words and conduct*" and whether those implied representations are false (*IFE Fund SA v Goldman Sachs International* [2006] EWHC 2887 (Comm)).

For example, if a supplier states that they will be able to deliver their product or service within a certain time frame that will not, on its face, amount to a statement of fact; it is a statement of opinion by the supplier about its ability to complete the work in the stated timescale. However, the statement of opinion carries with it an implied representation of fact, namely that the supplier in fact held such an opinion. In an appropriate context, it also carries with it an implied representation of fact that the supplier had reasonable grounds for holding that opinion and perhaps also the further implied representation that it had carried out a proper analysis of the amount of time needed to complete the work. Proving that those implied representations of fact were false would in principle lead to liability in misrepresentation.

The key point is that actionable misrepresentations may not be immediately obvious. Often litigation risk arises out of implied misrepresentations rather than clear factual statements which are deliberately misleading. Care should therefore be taken in connection with both express and implied statements. If a representor creates a false impression he might also create litigation risk.

Reliance and inducement

For a misrepresentation to be actionable, it must have induced the representee to enter into the contract. This is a question of fact. For example, in the case of *Hartelid v Sawyer & McClintock Real Estate Ltd* [1977] 5 WLR 481 an estate agent made a false statement about the size of a garage to a potential buyer, but prior to purchasing the relevant property the buyer visited the garage and saw for himself its true size. It was held that there was no actionable misrepresentation because the representor's false statement had no causal impact - the representee had carried out his own investigations and knew the true position prior to signing the contract.

Furthermore, misrepresentation need not be the only matter which induces the other party to enter into the contract. It is sufficient if it can be shown to have been one of the inducing causes. In the case of *Edgington v Fitzmaurice* (1885) 29 ChD 459 the claimant was induced to purchase a financial instrument partly because of a misrepresentation in the prospectus, but also because of a mistaken belief of his own that the instrument had certain rights of security attached to it. The court found that "*it is not necessary to show that the misstatement was the sole cause of*

his acting as he did". What is generally required is that the representee would not have entered the contract *but for* the misrepresentation.

In cases of fraudulent misrepresentation the standard of causation is lower. It is sufficient if there is evidence to show that the representee was materially influenced by the misrepresentation merely in the sense that it had some impact on his thinking, or "was actively present to his mind" (*Hayward v Zurich Insurance Co plc* [2016] 4 All ER 441). Once someone has made a fraudulent statement the court will not look too closely at whether it caused the claimant to enter the contract.

How "false" does the representation have to be?

The relevant representation must be false. But what does that mean? Does the defendant need to show that its statement was entirely correct or can they defeat a misrepresentation claim by showing some lesser standard of truth? The answer is that representors do not need to show that their statements were entirely correct. If a representor can show that their representation was "substantially correct" then that may be sufficient to defeat a claim for misrepresentation.

What are the available causes of action?

Depending on the facts of the case and the representor's degree of fault, different causes of action are available with regard to misrepresentation. The key causes of action are:

- fraudulent misrepresentation;
- negligent misrepresentation;
- innocent misrepresentation;
- breach of contract;
- breach of collateral contract; and
- negligent misstatement.

Fraudulent misrepresentation

This is the most serious kind of misrepresentation. An action for fraudulent misrepresentation is founded in the tort of deceit. It occurs where a false representation has been made knowingly, or without belief in its truth, or recklessly as to its truth. In *Eco 3 Capital Ltd and others v Ludsin Overseas Ltd* [2013] EWCA CIV 413, the Court of Appeal confirmed that the tort of deceit contains four ingredients:

- the defendant makes a false representation to the claimant;
- the defendant knows that the representation is false or, alternatively, he is reckless as to whether it is true or false;
- the defendant intends that the claimant should act in reliance on it; and
- the claimant does act in reliance on the representation and, in consequence, suffers loss.

If proven, fraud unravels everything - the contract can be rescinded, damages will be payable and caps on liability will fall away.

Negligent misrepresentation

Claims for contractual misrepresentation are based on section 2(1) of the Misrepresentation Act 1967 ("the Act").

A claim will be made out under the Act if the claimant can show that:

- a misrepresentation has been made to them;
- they have entered into a contract in reliance on the statement; and
- they have thereby suffered loss.

The burden of proof then shifts to the defendant to prove that they had reasonable grounds to believe (and did believe up to the time of the contract) that the facts represented were true. Given that the burden of proof can switch to the defendant in these types of claim, it can be very important for them to retain contemporaneous documents evidencing the basis upon which they believed their representations to be true.

Once the requirements of the Act are met, a right to damages is conferred as if the misrepresentation had been fraudulent. The Act, in effect, transforms a negligent misrepresentation into a fraudulent one for the purposes of calculating damages (see below under Remedies).

Innocent misrepresentation

An innocent misrepresentation is best defined negatively in the sense that it is a cause of action based on a false statement which is neither fraudulent nor negligent.

Implied representations

In BSkyB Ltd v HP Enterprise Services UK Ltd [2010] EWHC 86 (TCC) the defendant successfully bid for a project to supply a customer relationship management (CRM) system at the claimant's customer contact centres in Scotland. Prior to signing the CRM contract the defendant gave a response to tender which indicated that it, the supplier, would be in a position to go live with the new CRM system "on time" and "within the required timescales". The defendant was not able to complete the contract in time, within 9 months, and the claimant ultimately went on to complete the project itself. The claimant brought a claim against the defendant and the question was whether a statement that the project would be delivered on time was a statement of opinion or future intention (which was not actionable) or whether such statements carried within them implied and actionable statements of fact.

At trial was that there was a detailed investigation into what evidence the defendant had to support its time estimates – had it actually conducted a proper analysis of the time needed to complete the project? Were there actually any reasonable grounds for believing that the project could be completed within 9 months?

The judge found that the statement that the CRM system would be delivered on time contained two implied statements of fact:

- *that the defendant had carried out a proper analysis of the amount of time needed to complete the project; and*
- *that the defendant had reasonable grounds for holding the opinion that they could and would deliver the project within the timescales referred to in the tender response.*

The judge found that these implied statements were false because there had been no proper analysis of the time needed to go live and there were no reasonable grounds for holding the opinion that the project could be delivered within 9 months. The defendants were found liable.

Breach of contract

This is available where the representation has become a term of the contract. Whether it has done so is a question of fact. Breach of contract is proved by showing that the representation is false.

Breach of collateral contract

A collateral contract arises where the courts are prepared to treat a pre-contract statement as a separate contract or warranty, collateral to the main transaction. Collateral contracts may arise where one party refuses to enter into the main contract unless the other gives him an assurance on a certain point.

The policy behind the enforcement of collateral contracts was set out as follows in the case of *J. Evans & Son (Portsmouth) Ltd v Andrea Merzario Ltd [1976]* 1 W.L.R. 1078:

"When a person gives a promise or an assurance to another, intending that he should act on it by entering into a contract, and he does act on it by entering into the contract, we hold that it is binding."

Therefore even if a pre-contract representation does not make its way into the main contract it could nevertheless form the basis of a collateral contract. If the pre-contract representation is then broken there is the potential for a claim that the collateral contract has been breached.

Collateral contract

In the case of De Lassalle v Guildford [1901] 2 K.B. 215 the claimant and the defendant negotiated for the lease of a house. The terms of the lease were agreed but prior to execution of the contract the claimant told the defendant that he would not complete the deal unless the defendant assured him that the drains were in good order. The contract contained no terms concerning the drains but the defendant gave this assurance, and the contract was then signed.

It later became apparent that the drains were not in good order and the claimant sued the defendant on his assurance. The claimant could not sue on the main contract because it said nothing about the drains.

The Court of Appeal held that the pre-contract assurance constituted a separate actionable contract that was collateral to the main property sale.

Negligent misstatement

A claim for negligent misstatement is brought at common law in negligence under the principles of *Hedley Byrne & Co Ltd v Heller and Partners* (1964) AC 465. The claimant must prove that the representor owed them a duty of care, breach of the duty (i.e. negligence) and loss.

Although the terms "negligent misrepresentation" and "negligent misstatement" are sometimes used interchangeably, the key difference is that an action for "misrepresentation" is between contracting parties, whereas an action for "negligent misstatement" may be invoked even where a contractual relationship does not exist.

Remedies

The remedies available for misrepresentation depend on whether the misrepresentation was fraudulent, negligent or innocent. Broadly speaking, however, the two types of available remedy are rescission and damages.

Rescission

The effect of rescission is that the contract is reversed, as if there had been no contract. The parties must return any property that they received under the contract and be returned to the position that they were in before the contract was entered into. Rescission is available in principle for fraudulent, negligent or innocent misrepresentation. Rescission is often an attractive remedy where a claimant has struck a "bad bargain" and wishes to reverse the deal.

Rescission is within the discretion of the court. The court's discretion to award rescission will not be exercised where certain "bars to rescission" have arisen:

- The parties cannot be put back into their pre-contractual positions.

  It is not necessary that the parties should be returned to their precise pre-contract position. It will be sufficient if restitution can be achieved fairly and substantially (see *Salt v Stratstone* case study).

- A bona fide third party has acquired rights for value under the contract and would be prejudiced.

- The contract has been affirmed by the counter party.

  If the claimant knows of their right to rescission and nevertheless affirms the contract, the right to rescind is lost.

- There has been undue delay by the party asserting an entitlement to rescind.

  Delay between the date of the contract and seeking rescission may be a bar in itself. Undue delay between discovery of the truth and seeking to rescind may also evidence affirmation.

Rescission (subject to the above bars) is a right of the claimant in cases of fraud. However, in cases of negligent or innocent misrepresentation the court has a discretion to award damages in lieu of rescission under section 2(2) of the Act.

Bars to rescission

In Salt v Stratstone Specialist Ltd [2015] EWCA Civ 745 the defendant represented that a car was brand new when, in fact, it was two years old and had been damaged in a previous collision.

The defendant sought to avoid rescission by arguing that the car had depreciated since its sale and therefore it was no longer possible to put the parties back in their original position (i.e. the car could not be restored to the defendant in its original condition).

The Court of Appeal ruled that the depreciation of the vehicle did not render it impossible to restore the parties to their original position and that rescission would be available if "practical justice" could be done. Such practical justice might involve the claimant returning the vehicle and receiving a refund, but then compensating the defendant for relevant depreciation costs.

Damages

The table below sets out in summary form the applicable measure of damages for each cause of action.

Cause of action	Remedy
Fraudulent misrepresentation	(i) Damages (tort measure) with no remoteness limit (i.e. all direct loss); and (ii) Rescission NB – no contributory negligence
Negligent misrepresentation	As above. The court also has discretion to awards damages in lieu of rescission under section 2(2) of the Act.
Innocent misrepresentation	Rescission (unless the court awards damages in lieu of rescission under section 2(2) of the Act)
Breach of (collateral) contract	Contract damages
Negligent misstatement	Tort damages

Fraudulent misrepresentation

Damages for fraudulent misrepresentation are awarded on the tortious basis. The aim of a damages award is to restore a claimant to the position it would have been in had the misrepresentation not been made. Generally, this will be the difference between the price paid for the property and its actual value at the date of the acquisition. In addition, claimants can claim wasted expenditure and consequential losses, such as the loss of passing up other profitable opportunities.

No deductions will be made for remoteness or contributory negligence, so a full measure of damages will be available even if the loss was unforeseeable and even if the claimant failed to protect their own interests with reasonable care. Claimants will, however, be expected to mitigate their losses in the usual way.

Negligent misrepresentation

Damages for negligent misrepresentation are calculated in the same way as fraudulent misrepresentation. Section 2(1) of the Act in effect transforms a negligent misrepresentation into a fraudulent one for the purposes of calculating damages. Therefore the same generous rules for recovery are available in negligent misrepresentation claims, with no limits for remoteness or contributory negligence.

Innocent misrepresentation

The Act does not define the measure of damages in cases of innocent misrepresentation (i.e. where damages awarded in lieu of rescission). Leading texts suggest that the tort measure of damages applies. Damages will reflect what is sufficient to return the claimant to their pre-contractual position. However, there is no authority on this issue.

Breach of contract

Damages for breach of contract or collateral contract will be assessed according to contractual principles. Damages are intended to put the claimant in the position he would have been in if the representation had been true. A claimant might want to claim this measure of damages where the contract would have been profitable if the representation had been true. The normal rules of remoteness and mitigation will apply.

Negligent misstatement

Damages for negligent misstatement will be assessed according to tortious principles and will be limited by the scope of the defendant's duty. Damages may also be reduced according to the principles of remoteness and contributory negligence.

Contractual protections

To manage the litigation risk associated with pre-contract statements, it is common for parties to insert one or more of the following clauses into their contract:

- entire agreement clause;
- non-reliance clause; and/or
- limitation of liability clause.

Entire agreement clause

An entire agreement clause provides that, when the agreement is signed, it constitutes the entire agreement between the parties and supersedes any prior agreements or negotiations. It is a binding agreement between the parties that the full contractual terms are to be found in the document containing the clause and not elsewhere, and that any promises or assurances made in the course of the negotiations shall have no contractual force.

This kind of clause will ordinarily be effective to prevent pre-contract statements becoming terms of the contract. Such clauses also protect against claims for breach of collateral contract. Parties who have signed an entire agreement clause will be contractually estopped from asserting that something outside the four corners of the contract is a term of the contract, or a contract collateral to it.

Crucially, bare entire agreement clauses will not protect against a claim for misrepresentation. In *BSkyB* (detailed above) the relevant contract contained a relatively standard entire agreement clause. It was found, however, that such clauses on their own do not amount to an agreement that representations are withdrawn, overridden or of no legal effect so far as any liability for misrepresentation may be concerned. It was said that this kind of entire agreement clause is concerned with the terms of the contract alone, and will not prevent representations having *non-contractual* force for the purposes of a misrepresentation claim. That reasoning was recently upheld in *Al-Hasawi v Nottingham Forest Football Club Ltd* [2018] EWHC 2884.

Non-reliance clause

Given the potentially limited effectiveness of an entire agreement clause in connection with misrepresentation it is common for parties to supplement their agreed terms with a non-reliance clause. A non-reliance clause aims to prevent parties from alleging that they were induced to enter a contract by the other's pre-contract representation.

Reliance on the defendant's representation forms part of a misrepresentation claim. A non-reliance clause therefore aims to "knock out" a key element of such claims. Parties to a non-reliance clause agree that the basis upon which they have entered the relevant contract is that no reliance has been placed on pre-contract statements – they have agreed to assume that this state of affairs is true. If a claimant later tries to argue that they *did* rely on a pre-contract statement the defendant can raise a defence based on "contractual estoppel". The claimant is estopped from asserting that the agreed state of affairs is untrue.

Exclusion of liability

A further type of contractual risk management involves an exclusion of liability clause.

This type of clause expressly excludes liability that would otherwise arise in respect of pre-contract

representations and/or limits the remedies available in connection with such representations.

Statutory controls on risk management clauses

Exclusion clauses are subject to section 3(1) of the Act. The effect of section 3(1) is that clauses which exclude or restrict liability, or the remedies available, for misrepresentation will only be effective to the extent they satisfy the test of reasonableness under section 11(1) of the Unfair Contract Terms Act 1977 ("UCTA").

To satisfy the test of UCTA reasonableness the relevant clause has to have been a "*fair and reasonable one to be included having regard to the circumstances which were, or ought reasonably to have been, known to or in the contemplation of the parties when the contract was made.*"

There had been some uncertainty about whether non-reliance clauses exclude liability for misrepresentation (in which case the UCTA reasonableness test applied) or whether non-reliance clauses merely structured the parties' affairs in such a way liability does not arise. In the case of *First Tower Trustees Ltd v CDS (Superstores International) Ltd* [2018] EWCA Civ 1396 it was found that s.3(1) of the Act does apply to non-reliance clauses because (a) s.3(1) is intended to prevent parties escaping liability for misrepresentation unless it is reasonable for them to do so (b) if a non-reliance clause prevents a misrepresentation from being actionable then it should properly be regarded as an exclusion of liability and therefore subject to the test of UCTA reasonableness.

Misrepresentation Act 1967, s. 3(1):

"If a contract contains a term which would exclude or restrict—

(a) any liability to which a party to a contract may be subject by reason of any misrepresentation made by him before the contract was made; or

(b) any remedy available to another party to the contract by reason of such a misrepresentation, that term shall be of no effect except in so far as it satisfies the requirement of reasonableness as stated in section 11(1) of the Unfair Contract Terms Act 1977; and it is for those claiming that the term satisfies that requirement to show that it does."

Non-reliance and reasonableness

In FoodCo UK LLP v Henry Boot Developments Ltd [2010] EWHC 358 (Ch) the defendant issued pre-contract marketing material to the claimant and also provided written responses to the claimant's pre-contract queries. The defendant and claimant then entered into a contract for the lease of premises. The lease contained an entire agreement clause which stated that the claimant was not relying on any representation or warranty by the defendant, save for the defendant's written replies to the enquiries raised by the claimant. After the contract was concluded the claimant brought a claim of misrepresentation against the defendant. The issue was whether the non-reliance clause was "reasonable". The court found that that the non-reliance clause was reasonable because there was no substantial imbalance of bargaining power between the parties, each party had its own legal advisers, the clause had been open to negotiation and, importantly, the claimant was allowed to rely on a defined category of written pre-contract representations. This represented a fair allocation of risk and promoted certainty between the parties.

Practical hints and tips

Given the above matters, it will be appreciated that pre-contract statements have the potential to generate significant litigation risk. Some practical tips to help manage that risk are as follows:

- Do take care of what is said during contract negotiations.
- Do ensure that those negotiating contracts are aware of the risks.
- Do ensure that contemporaneous records are kept to verify and support statements of fact or opinion submitted during pre-contract negotiations.
- Do correct statements, prior to the conclusion of a contract, if you realise they are misleading.
- Do use appropriate risk management clauses and consider what can be done to ensure that the clause is "fair and reasonable" pursuant to UCTA.
- Do not rely solely on an entire agreement clause to protect against a misrepresentation claim.
- Do not assume that contractual protections will always be effective to avoid liability.
- Do not assume that liability only arises in connection with misleading express statements – implied statements can also generate litigation risk.
- Do not assume that there can be no liability for statements of opinion or intention.

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20210226 - DR - Misrepresentation - the pitfalls of pre-contract statements

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