Cleveland State Law Review

Volume 13
Issue 2 *Fraud and Deceit (A Symposium)*

Article

1964

Damages in Fraud Actions

Howard M. Rossen

Howard H. Fairweather

Damages in Fraud Actions

Howard M. Rossen and Howard H. Fairweather ***

TWO DISTINCT LEGAL THEORIES have been developed in determining the amount of damages to be awarded in an action for fraud and deceit. The majority view is the "benefit-of-the-bargain" rule (also known as the "warranty rule"), and the minority view is known as the "tort rule" (or more commonly, the "out-of-pocket" rule).[1]

Both rules have limited use. In *Hines v. Brode*[2] the California court made it clear that the two rules should be applied only where a contract is fully executed or where the plaintiff stands on his contract and has not rescinded it. The rationale behind this holding is clear; a plaintiff who has rescinded his contract without tendering the consideration should not be placed in a more advantageous position than the plaintiff who has performed fully before bringing an action in fraud.[3] Ohio will deny the plaintiff's suit for damages where he refuses to surrender defendant's consideration.[4]

"Out-of-Pocket" Rule Examined

The theory behind the "tort rule" is based on the recovery of the actual loss. The injured party should be allowed damages in the amount of the difference between the actual value of the item and the price paid.[5] Proponents of this rule contend that the law should not offer a remedy for the loss of expected profits, but should only compensate for the actual loss incurred. The American Law Institute's position is that damages should be predicated not on what the plaintiff would have profited if the

---

* A.B., University of Pittsburgh; Personal Injury Claims Representative, New Amsterdam Casualty Company; Fourth-year student at Cleveland-Marshall Law School of Baldwin-Wallace College.

** A.B., Harvard College; M.B.A., Amos Tuck School of Business Administration; Commercial Banking Department of Central National Bank of Cleveland; Second-year student at Cleveland-Marshall Law School of Baldwin-Wallace College.

1 McCormick, Damages, Sec. 121 (1935); Oleck, Cases on Damages, c. 25 (1962).

2 Hines v. Brode, 168 Cal. 507, 143 P. 729 (1914).

3 *Ibid.;* In 1935 California, by statute, adopted the out-of-pocket rule. Stat. 1935, c. 536, p. 1612, Sec. 1.

4 Hirschl v. Richards, 28 Ohio App. 38, 162 N. E. 616 (1927).

5 McCormick, and Oleck, *op. cit. supra,* n. 1.

representations had been true, but on what he has lost by reason of their falsity,[6] *i.e.*, the difference between what was paid and value received.

From a study of various cases, one finds that this view has been supported by the Supreme Court of the United States,[7] the English courts,[8] a minority of state courts,[9] and the Restatement of Torts.[10]

In application, this rule has been used with some flexibility. In *Lowrey v. Dingmann*,[11] plaintiff was a horse dealer who purchased two ponies from defendant who fraudulently represented that they were registered, thoroughbred animals. After training them, plaintiff sold them to a third party at a substantial profit. When the fraud was discovered, the third party demanded and obtained rescission and damages. In plaintiff's subsequent suit against defendant, four elements of recovery were allowed by the court: (1) the difference between the value of the ponies and the price he paid for them; (2) the amount of the settlement; (3) damages for injury to the plaintiff's business reputation; and (4) the amount of lost profits. On appeal by defendant, the judgment for plaintiff was affirmed with the court holding that the lost profits were recoverable under the "out-of-pocket" rule since they were earned prior to the discovery of the fraud, and were lost as a direct and proximate result of the defendant's deceit. Despite the fact that Minnesota adheres to the "out-of-pocket" rule,[12] wherein lost profits are usually denied,[13] the court may have allowed the recovery because the profits were earned prior to the discovery of the fraud and consequently were certain and not speculative.[14]

---

[6] Sedgwick, Damages, Sec. 781 (9th ed., 1913).

[7] Sigafus v. Porter, 179 U. S. 116, 21 Sup. Ct. 34 (1900).

[8] Peek v. Derry, L. R. Ch. Div. 541 (1887), reversed on other grounds; McConnel v. Wright, 1 Ch. 546 (1903).

[9] *E.g.*, Ark., Minn., N. Y., Pa.; 57 A. L. R. 1147 (1938) names 12 states.

[10] Restatement, Torts, Secs. 525, 549 (1938).

[11] 251 Minn. 124, 86 N. W. 2d 499 (1957).

[12] Lehman v. Hansord Pontiac Co., 246 Minn. 1, 74 N. W. 2d 305 (1955); See also McCormick, Damages, Sec. 121 at 449-50 (1935).

[13] Magnuson v. Burgess, 124 Minn. 374, 145 N. W. 32 (1914); Foster v. Di Paolo, 236 N. Y. 132, 140 N. E. 220 (1923).

[14] In effect, plaintiff received the full benefit of the bargain. A sum of $1,400 was paid for the two Shetland ponies whereas their actual value was only $800. Plaintiff resold them for $2,925. The recovery gave the plaintiff the profit of $1,525, the "out-of-pocket" loss of $600, and the ponies worth $800.

In examining the relative advantages and disadvantages of the "out-of-pocket" rule, its strongest feature is that its application permits recovery in the amount actually lost by the plaintiff. This avoids the need of speculation on the amount of lost profits as a result of the fraud. The rule is simple and definite, making the plaintiff whole, rather than giving him a windfall or protecting his profit on the transaction.

However, certain objections exist. Generally, the damages recoverable for fraudulent misrepresentation of goods sold are different from, and usually less than, the damages recoverable for a simple breach of warranty based on the same misrepresentations.[15] Thus, one guilty of willful fraud may suffer less than one who merely breaches his contract. Such a rule does not discourage fraud in commercial enterprise since the fraudulent party takes little chance of losing anything, *e.g.*, if he should be called to account, he merely submits to what amounts to an honest contract, and if he is not called to account, he enjoys his plunder.[16]

Some of the force of this objection is dissipated when it is noted that the defrauded vendee may seek any of three alternative remedies: (1) rescission and recovery of consideration; (2) an action for deceit and recovery of actual loss, i.e., the difference between the value of what he parts with and what he receives; (3) an action for breach of warranty contained in the contract of purchase and recovery of the difference in value between the property as received and as warranted.[17] Note that this last alternative is similar to the measure under the "benefit-of-the-bargain" rule.

"Benefit-of-the-Bargain" Rule Examined

The majority view allows recovery of the difference between the actual value of the property and the value which it would have had if the representations had been true.[18] A leading case expounding this view is *Selman v. Shirley*.[19] It set forth the fol-

---

[15] See 124 A. L. R. 1 (1940).

[16] *Ibid.;* See also Hannigan, The Measure of Damages in Tort for Deceit, 18 B. U. L. Rev. 681 (1938).

[17] Sedgwick, Damages, Sec. 781 (9th ed., 1912); 1 Encyc. of Negligence, Sec. 299 (1962).

[18] McCormick, and Oleck, *op. cit. supra* n. 1.

[19] 161 Or. 582, 85 P. 2d 384, 124 A. L. R. 1 (1938), noted in 23 Minn. L. Rev. 836 (1939); 19 Oreg. L. Rev. 64 (1939); 13 So. Calif. L. Rev. 168 (1939).

lowing rules in the measurement of damages for fraud: (1) If the defrauded party is content with the recovery of only the amount he has actually lost, his damages will always be measured under that rule. (2) If the fraudulent transaction also amounted to a warranty, he may recover for loss of the bargain, because a fraud accompanied by a broken promise should cost the wrongdoer as much as the breach of promise alone. (3) Where the circumstances disclosed by the proof are so vague as to cast virtually no light upon the value of the property had it conformed to the representations, damages will be awarded equal to the loss sustained, and (4) Where the damages under the "benefit-of-the-bargain" rule are proved with reasonable certainty, that rule will be employed.[20]

The objections to "benefit-of-the-bargain" are somewhat obvious. It is possible, as noted by the dissent, for the injured plaintiff to obtain the property free, depending on the extent of the defendant's misrepresentations. Such a windfall should appear, even to the most ardent defender of the rule, as somewhat unjust. A further objection is that it is often difficult to establish the value of the property *if it had been as warranted.*

Those in favor of the rule correctly argue that the element of deceit should not deprive the injured party of the rights which would be his if this element were lacking, as might be the case under application of the "out-of-pocket" rule.[21] It is further stated that the rule protects the plaintiff against loss caused by defendant's deceit and also protects his interests in making an advantageous bargain.[22]

Measure of Damages in Ohio

In general, Ohio courts have followed the majority rule in cases involving transactions wherein the buyer has been defrauded. Although the rule is the same in either real or personal property transactions, the rationale in the latter is open to serious doubt.

---

[20] Selman v. Shirley, *supra* n. 19 at 394; See also Salter v. Heiser, 39 Wash. 2d 826, 239 P. 2d 327 (1952); Zeliff v. Sabatino, 15 N. J. 70, 104 A. 2d 54 (1954) where it is stated (at page 55) that New Jersey is not so inexorably wedded to the "out-of-pocket" rule as to the measure of damages that the "benefit-of-the-bargain" rule cannot be applied where justice requires.

[21] Williston, Contracts, Sec. 1391 et seq. (Rev. ed., Williston and Thompson, 1937).

[22] See Johnson v. Meyers, 91 Or. 179, 177 P. 631 (1919); Chapman v. Bible, 171 Mich. 663, 137 N. W. 533 (1912).

As to the measure of damages for fraud in commercial dealings in real property, the Ohio courts time and again have made it clear that the measure of damages in a suit on the contract is the difference between the property as it was represented to be and its actual value at the time of the purchase or exchange. In *Linerode v. Rasmussen,*[23] where defendant was sued on notes given for purchase of farm land, he sought to recoup damages on the ground that plaintiff had represented that underlying the premises was a vein of coal, the court in its decision for defendant stated clearly:

> Assuming that plaintiff made the representation as asserted by the defendant and that it was not a mere puff or an expression of opinion, the true measure of the damages would be the difference between the value of the land as it was represented to be and what it was actually worth at the time of purchase.[24]

This clear statement of the rule has been consistently followed in a string of decisions.[25] That the application of the "out-of-pocket" measure of damages may not fully compensate the defrauded party in cases involving the exchange of real property, has been recognized. In *J. A. C. Goldner v. George Luttner,*[26] where the plaintiff in error urged that the measure of damages be the difference between the actual value of the thing parted with and the actual value of the thing received (*i.e.,* "out-of-pocket" damages), the court dismissed this argument by stating that while there is respectable authority for this rule, it would, in essence, make a new contract. The court continued:

> One may trade his property for another's because he expects to make a good bargain and a profit, and would make a decided profit if the thing traded for were as represented; by reason of the false representations, however, he receives something worth less, instead of more than what he parted with. The rule urged cuts out profit which he had a right

---

[23] 63 Ohio St. 545, 59 N. E. 220 (1900).

[24] *Id.* at 546.

[25] The cases are: Molnar v. Beriswell, 122 Ohio St. 348, 171 N. E. 593 (1930) where defendant fraudulently misrepresented occupancy in an apartment building sold to plaintiff; Kwartler v. Humphreys, 33 Ohio App. 353, 169 N. E. 591 (1929), again a case involving fraudulent misrepresentation as to rental price of suites in an apartment building; Dieterle v. Bourne, 40 Ohio Law Abs. 550, 57 N. E. 2d 405 (1943).

[26] 20 Ohio C. C. R. (n. s.) 137 (1912), 31 Ohio C. C. R. (n. s.) 137, 31 Ohio C. C. Dec. 236 (1912).

to expect and remits him to the actual value of what he parted with.[27]

The extent to which Ohio has adhered to the "benefit-of-the-bargain" rule can be seen from the decision in *Kwartler v. Humphreys,*[28] wherein the court refused to allow defendant's testimony in which he wished to prove that the real value of the property was much more than the consideration paid by the plaintiff and that in spite of the fact that defendant had knowingly overstated the rental income, the plaintiff should have no damages as he did not lose, but rather profited, by the transaction. The court countered this contention by stating: ". . . if the plaintiff purchased a bargain, he was entitled to a bargain." [29] This is the sum and substance of Ohio law in this area.

While it appears that the law is similarly settled as to the measure of damages in fraudulent transactions involving personal property, an examination of the decisions raises speculation as to its soundness. The principal Ohio case applying the majority rule to the exchange of personal property was *Shoffstal v. Elder,*[30] subsequently affirmed by *Elder v. Shoffstall (sic).*[31] An examination of both of these cases shows that the question of the measure of damages was given only secondary attention. The case involved a fraudulent representation as to the quality and quantity of dry goods made by defendant who wished to trade the goods in exchange for real property owned by plaintiff. It was brought to the Court of Appeals for Sandusky County primarily on a question of interpretation of the then newly amended "Three-fourths Jury Law" (General Code §11455). Of the eleven page opinion given by the court, sixteen lines were devoted to the issue of the correct measure of damages. Upholding the trial court's charge to the jury as to measurement of damages, the appellate court stated:

> The correct rule of damage is laid down by our supreme court in *Linerode v. Rasmussen,* 63 Ohio St., 545. It is the difference between the stock of goods as it was at the time of exchange and its value if it had been as represented by the defendants.[32]

---

[27] *Id.* at 138.

[28] Kwartler v. Humphreys, *supra,* n. 25.

[29] *Id.* at 357.

[30] 1 Ohio App. 390, 24 Ohio C. C. Dec. 279 (1913).

[31] 90 Ohio St. 265, 107 N. E. 539 (1914).

[32] *Supra* n. 30 at 401.

As noted previously, *Linerode v. Rasmussen* dealt with the measure of damages for fraud in the conveyance of *real* property.[33] Was the appellate court justified in citing the *Linerode* case as clear authority? It is questionable at best, for in so doing they have pulled the rule beyond legal reason.

At the Supreme Court level, no additional light was shed on the problem. Emphasizing the interpretation of General Code §11455, the court gave only passing attention to the question of damages by simply echoing the appellate decision.

It is possible that in its cursory treatment of the question of damages, the court too hastily applied a measure applicable only to fraud in real property transactions while not applicable in all cases dealing with sale of ordinary chattels. It should be clear that the "benefit-of-the-bargain" rule is most effective in the area of commercial transactions where a businessman would unjustly suffer if his compensation was limited to his "out-of-pocket" loss. However, the syllabus in the *Elder* case would appear to allow the application of the "benefit-of-the-bargain" rule in all sales of chattels:

> In an action to recover damages for false and fraudulent representation as to the value of personal property, made by the seller in order to induce the purchaser to buy, the measure of damages is the difference between the value of the property as it was represented to be and its actual value at the time of the sale.[34]

In the non-commercial sale of chattels, it is questionable whether such a rule should apply, since the purchaser generally does not think of the sale as a *bargain from which he will profit* except perhaps in terms of personal satisfaction.

In the commercial areas of fraud in the sale of securities, and misrepresentation of profit levels in the sale of a business, Ohio applies the majority rule. For securities, the damages are the difference between the property as it was represented and its actual value at the time of the purchase, and not simply the difference between the purchase price and the market value at maturity.[35] It should be noted that again the authority cited by the court in the decision was, in part, *Linerode v. Rassmussen*[36]

---

[33] *Supra* n. 23.

[34] *Supra* n. 31 at 265.

[35] Citizens Banking and Savings Co. v. Spitzer, Rorick & Co., 65 Ohio App. 309, 29 N. E. 2d 892 (1938).

[36] *Supra* n. 23.

and *Molnar v. Beriswell.*[37] In misrepresentation of profits, plaintiff is entitled to the difference between the actual value of that which he bought and the value which it was represented to have for the uses and purposes for which it was bought.[38]

Comment

Regardless of nominal adherence to either rule, many courts will measure damages by regarding the status of the parties, the character of the misrepresentation and other factors. For example, in a Minnesota case, *Shane v. Jacobson,*[39] the court did not use the "out-of-pocket" rule as is normal in that jurisdiction, but rather limited recovery to the cost of actually putting the fraudulently represented improvements on the land. In Ohio, the courts will occasionally disregard the "benefit-of-the-bargain" rule and measure the damages under the more general rules of damages in cases of fraud: *i.e.,* compensatory damages.[40] Indeed, this same reasoning is followed in the leading case, *Selman v. Shirley,*[41] where the court noted that a strict adherence to either the "out-of-pocket" rule or the "benefit-of-the-bargain" rule would be at the expense of justice in some cases. And as both rules are merely aspects of the basic proximate result rule, they should be employed in a flexible manner, with due regard to the equities involved.

---

[37] *Supra* n. 25.

[38] Norton v. Parker, 17 Ohio C. C. R. 715, 8 Ohio C. C. Dec. 572 (1899). Also see Gray v. Gordon, 96 Ohio St. 490, 117 N. E. 891 (1917).

[39] 136 Minn. 386, 162 N. W. 472 (1917).

[40] See especially Grau v. Kramer, 48 Ohio Op. 136, 108 N. E. 2d 368 (1952).

[41] *Supra* n. 19.