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COMPUTER LITIGATION AND THE MANUFACTURER'S DEFENSES AGAINST FRAUD

by CRAIG M. WALKER*

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I. INTRODUCTION

This Article is intended to provide guidelines to the practicing attorney or litigator in resolving allegations of fraud in disputes involving computers or other high technology products or processes. Although such products or systems are complex and often involve unique factual circumstances, general principles of law are still applicable. While the illustrative context of this Article is that of computer sales, the analysis and legal principles discussed would apply to any circumstance in which a fraud claim is advanced.1

Computer manufacturers and purchasers are generally knowledgeable about the legal consequences of their commercial transactions, and the terms and conditions of such transactions usually are embodied in a written agreement. The definitive nature of written contracts has increased the use of alternative legal theories such as fraud in an attempt by the purchaser to circumvent those contracts that contain obstacles to recovery. One important such obstacle is a contract provision limiting the liability of the manufacturer or seller. Often these limitations on the manufacturer's liability have been reluctantly agreed to by the buyer in order to conclude the transaction or in order to obtain certain guarantees regarding performance of specific features or applications. Fraud in the inducement of the contract is a prominent legal theory used in an attempt to avoid these contract provisions in subsequent legal action.2

In addition to agreeing to the liability limitation provisions, often the purchasing party either has had the opportunity to conduct, or has actually conducted, an investigation of the computer system, technology or process it is purchasing. The purchaser's investigation or failure to investigate also has legal ramifications for its fraud claim.

This Article examines two elements of the defense against the theory of fraud in the inducement of the contract.3 First, in the situ-

1. The use of illustrations involving computer sales is timely. Citing numerous examples, the court in Earman Oil Co. v. Burroughs Corp., 625 F.2d 1291, 1293 (5th Cir. 1980) stated: "There have been an enormous number of suits in which disgruntled computer users have attempted to sort out their rights where both computer vendors and so-called lessors have been involved." Id. The claim of fraud is increasingly asserted in these cases.

2. See, e.g., APLications Inc. v. Hewlett-Packard Co., 501 F. Supp. 129 (S.D.N.Y. 1980); Badger Bearing Co. v. Burroughs Corp., 444 F. Supp. 919 (E.D. Wis. 1977), aff'd mem., 588 F.2d 838 (7th Cir. 1978). As stated by the APLications court, "fraud is a magic word, and it is elementary that any contract can be set aside for fraud." 501 F. Supp. at 134. It is a correct statement that rescission is appropriate, but as discussed infra, there are supplementary legal principles which apply in certain factual circumstances.

3. Other defensive measures such as attacks upon other basic elements of a
COMPUTER LITIGATION

ation where the party alleging fraud wishes to retain the benefits of a contract which includes a limitation of liability provision, this Article will discuss the defense that claimant's affirmance of the contract in suit prohibits any recovery under the fraud claims beyond the limitations of liability provided in the contract. Second, this Article will discuss the claimant's duty to investigate the facts which may preclude recovery on a fraud claim.

A. TYPES OF LIMITATIONS OF LIABILITY PROVISIONS INVOLVED

In the computer and other high technology fields, there is a great potential for claims for damage. While the hardware is a tangible element, the expected software and performance characteristics are not always precisely established by the parties. The situation is further complicated by the purchaser's desire to have specific adaptations or special features, the continuing development of software programs and hardware updates and the purchaser's efforts to increase its demands regarding performance of the computer system subsequent to installation.

At the outset of their relationship, the manufacturer ordinarily seeks to satisfy and accommodate the needs of the purchaser. As a result, most agreements contain provisions for repair or replacement. At times, however, this spirit of cooperation breaks down, and the purchaser either refuses to pay the contract price or commences a legal action against the seller. To reduce the risk of judgments in such situations, limitation of liability clauses are drafted into the sales agreements.

The following are examples of such limitation of liability provisions which might be encountered:

Seller . . . shall not be held responsible . . . in any event under this agreement for more than a refund of the purchase price, less reasonable rental for past use, upon return of the equipment to Seller.

claimant's fraud allegations (misrepresentation, materiality, or scienter) are not addressed in this Article. Additionally, because computer sales involving litigation usually are between sophisticated merchants, this Article does not deal with the difficulties posed by problems of unconscionable contracts or gross disparity of bargaining power. Where a purchaser is sophisticated at all, clauses limiting liability or warranties are not normally unconscionable. Earman Oil Co. v. Burroughs Corp., 623 F.2d 1291, 1299 (5th Cir. 1980).

4. In the commercial context, contract provisions either limiting damages or providing for liquidated damages are both legal and well recognized. See, e.g., U.C.C. § 2-719(1)(a) (1982).

The importance of limitation of liability clauses in the computer field is underlined by the fact that malfunctions may be attributed to an "elusive bug" which neither party can identify or locate. See Convoy Co. v. Sperry Rand Corp., 7 Computer L. Serv. Rep. (Callaghan) 1021 (D. Ore. 1977).
with Seller's prior written consent. (Purchaser hereby expressly waives all incidental and consequential damages.)

* * * * *

In no event shall UNIVAC be liable for any indirect, special or consequential damages such as loss of anticipated profits or other economic loss in connection with or arising out of the existence, furnishing, functioning or the Customer's use of any item of equipment or services provided for in this Agreement.

Alternatively, the limitation clause might combine a number of restrictions as follows:

6. LIMITS OF LIABILITY: If Customer rightfully rejects the Equipment or justifiably revokes acceptance of the Equipment, Seller shall be liable only to repay any part of the purchase price theretofore paid, upon the return of the Equipment to it. After acceptance of the Equipment, if any part thereof is found to be defective, under specified service conditions within 90 days after installation, and while the warranty hereunder is in effect, Seller at its option will repair or replace such part. The foregoing constitutes Customer's sole and exclusive remedy for breach of the terms of the sale of the Equipment. Seller shall in no event be liable for damages whether direct or indirect, including without limitation incidental or consequential damages, to the customer, to any property or to any person, for loss of profits, for downtime, for any other reason or cause by reason of Seller's negligence or otherwise, in connection with the sale, delivery, installation or use of the Equipment, and Customer shall indemnify and hold harmless Seller against all such liability.

In short, the contractual limitation should be clear and contain an exclusive or limited remedy.

5. Badger Bearing Co. v. Burroughs Corp., 444 F. Supp. 919, 921 (E.D. Wis. 1977). The Badger court held that a computer contract provision limiting the liability of the supplier of hardware, software, or data processing services to the amount paid by the customer is valid and enforceable. Id. at 921. See also Farris Eng'g Corp. v. Service Bureau Corp., 406 F.2d 519 (3rd Cir. 1969). On judicial enforcement of clauses limiting liability generally, and in computer sales contexts specifically, see Moorhead, Limiting Liability in Electronic Data Processing Service Contracts, 4 Rutgers J. Computers & L. 141 (1974). The limitation clause could be drafted to specify a specific dollar amount if that figure was reasonable.


7. U.C.C. § 2-719 also provides that the exclusive or limited remedy must not "fail of its essential purpose." This criteria is most often applicable in situations where the sole remedy is repair, and there are substantial deficiencies and substantial delay is encountered. In such circumstances, the contractual limitation of repair might be inapplicable and therefore might not preclude recovery of damages for fraud or breach of warranty. See Chatlos Sys., Inc. v. National Cash Register Corp., 635 F.2d 1081 (3rd Cir. 1980). Although there is divided authority, Chatlos held that a
In order to avoid these limitation of liability provisions, purchasers often assert that they were defrauded and claim substantial damage. Succinctly stated, the elements of a claim for fraud are (1) a false or misleading misrepresentation or omission made by defendant which is (2) material and as to which (3) the defendant had the requisite “scienter” (knowledge of falsity or its equivalent), and that (4) plaintiff relied on the representation and (5) suffered damage.  

8. See W. PROSSER, LAW OF TORTS § 105 (4th ed. 1977); Stone v. Farnell, 239 F.2d 750, 754 (9th Cir. 1956); Hobart v. Hobart Estate Co., 26 Cal. 2d 412, 415, 159 P.2d 958, 961 (1945); Roberts v. Ball, 57 Cal. App. 3d 104, 108, 128 Cal. Rptr. 901, 905 (1976); CAL. CIV. CODE § 1572 (West 1954). Using California law as an illustration, the criteria for the common law are as follows:


(2) **Falsity:** To be actionable, a fraudulent representation must either state a false fact or be the opinion of an expert or of anyone who holds himself out as specially qualified. Teamsters Sec. Fund v. Sperry Rand Corp., 6 Computer L. Serv. Rep. (Callaghan) 951 (N.D. Cal. 1977); Gagne v. Bertran, 43 Cal. 2d 481, 483, 275 P.2d 15, 17 (1954); Bagdasarian v. Gragnon, 31 Cal. 2d 744, 748, 192 P.2d 935, 939 (1948); Harizim v. Lyman, 267 Cal. App. 2d 127, 130, 72 Cal. Rptr. 670, 673 (1968).

(3) **Scienter:** Scienter and intent to defraud are shown in two ways: (1) by proving the defendant had actual knowledge of the falsity of his representations or (2) by establishing that the defendant “lacked an honest belief in their truth, or that the statements were carelessly and recklessly made, in a manner not warranted by the information available to the defendant.” Wishnick v. Frye, 111 Cal. App. 2d 926, 930, 245 P.2d 532, 536 (1952). See also Dunn Appraisal Co. v. Honeywell Information Sys., Inc., No. 81-3110, slip op. (6th Cir. Sept. 10, 1982); Glovatorium, Inc. v. NCR Corp., No. 81-4453, slip op. (9th Cir. Aug. 20, 1982); Yellow Creek Logging Corp. v. Dare, 216 Cal. App. 2d 50, 57, 30 Cal. Rptr. 629, 632-33 (1963). Where a false representation is knowingly made, intent to deceive may be inferred directly. Boss v. Bank of Am. Trust & Sav. Ass'n, 51 Cal. App. 2d 592, 596, 125 P.2d 620, 623-24 (1942). Boss is representative of the general rule that intent may be inferred from circumstantial evidence. See also State Street Trust Co. v. Ernst, 278 N.Y. 104, 15 N.E.2d 416 (1938); Ultramares Corp. v. Touche, 225 N.Y. 170, 174 N.E. 441 (1931).

(4) **Reliance:** California applies a “substantial factor” test in determining whether the plaintiff relied on the representation. If the defendant's representation is a “substantial factor in inducing plaintiff to act, even though he also relies in part upon the advice of others, reliance is sufficiently shown.” Wennerholm v. Stanford Univ. School of Medicine, 20 Cal. 2d 713, 717, 128 P.2d 522, 524 (1942).

(5) **Damages:** In California, a defrauded purchaser is entitled to recover all
Some jurisdictions, such as California, have another form of fraud, deceit or negligent misrepresentation. Under this formulation, unlike the usual fraud claim, with deceit/negligent misrepresentation, neither scienter nor an intent to defraud is required. The intent requisite for negligent misrepresentation is merely an "intent to induce action," which exists whenever defendant knows plaintiff is likely to rely on its representations. Otherwise, the elements of an action for deceit/negligent misrepresentation are the same as those for actual fraud.

In California, the claimant's burden of proof for its common law fraud claims is proof by a fair preponderance of the evidence. Some states, such as New York and Wisconsin, require proof by "clear and convincing" evidence. Because state law varies and because a request for application of another state's law must be timely, counsel must make an early analysis and comparison of the applicable state law.


10. Stone v. Farnell, 239 F.2d 750, 753 (9th Cir. 1966); Hale v. George A. Hormel & Co., 48 Cal. App. 3d 73, 82, 121 Cal. Rptr. 144, 150 (1975).


Typically, these liability elements of a fraud claim are difficult for a computer purchaser to assert. Even in those instances where these elements are established, however, the discussion below relative to recoverable damages is pertinent.

II. AFFIRMANCE OF CONTRACT LIMITATIONS OF LIABILITY

A. CLAIMANT'S DECISION TO COMMENCE AN ACTION OR ASSERT A COUNTERCLAIM

At the outset of the action, once a plaintiff purchaser or counterclaimant purchaser decides to claim that it has been misled or "fraudulently induced" to enter into a contract, it faces a difficult choice. If, indeed, a fraud has been practiced, the purchaser has the right to tender back to the seller all benefits conferred by the defrauding seller and sue the manufacturer and seller for such damages allegedly flowing from the fraud as would restore the purchase to status quo ante. In the alternative, it could affirm the contract, continue to accept the benefits (and obligations) of that contract and, subject to those obligations, sue the manufacturer to compel performance of that contract and/or recover damages, if any, traceable to the fraud allegedly committed. The United States Supreme Court stated this essential principle in Shappiro v. Goldberg.

It is well settled by repeated decisions of this court that where a

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15. The use of a fraud theory is becoming increasingly popular due to the factual and legal difficulties of a negligence action and the failure of remedies theories. Moreover, in many instances a prima facie case of fraud may be made because there is a narrow distinction between sales "puffing" and fraud. Allegations of fraud, however, must be pleaded with particularity. Fed. R. Civ. P. 9(b). A fraud claim must be supported by substantial evidence; it cannot be a breach of contract claim couched in the legal theory of fraud. Earman Oil Co. v. Burroughs Corp., 625 F.2d 1291, 1294 (5th Cir. 1980); Investors Premium Corp. v. Burroughs Corp., 389 F. Supp. 39, 45-46 (D.S.C. 1974).


17. This Article deals only with limitation of liability clauses and not clauses involving a total immunity or a total disclaimer of liability. In situations involving total immunity or disclaimers, there is authority against the principle of affirmance usually due to the unequal bargaining power that such clauses often evidence. See, e.g., Cal. Civ. Code § 1668 (West 1973); Agricultural Servs. Ass'n, Inc. v. Ferry-Morse Seed Co., 551 F.2d 1057 (6th Cir. 1977).


party desires to rescind upon the ground of misrepresentation or fraud, he must upon the discovery of the fraud announce his purpose and adhere to it. If he continues to treat the property as his own the right of rescission is gone, and the party will be held bound by the contract.\textsuperscript{20}

In many cases, claimant-purchasers do not take any steps whatever to rescind any of the contract in question or to tender back any of the benefits received thereunder.\textsuperscript{21} Instead, claimants elect to affirm the contract and continue to use the object of the contract. Acts of affirmance are demonstrated in many instances by (i) the filing of the complaint or counter-claim itself which demands specific performance as well as damages, (ii) the claimant working with the manufacturer to bring the system to a level of acceptability at the same time the suit is progressing, (iii) the claimant's acknowledgement of obligations under the contract, such as payment of the purchase price, rental or license fees or the like (or even if not paying such amounts recognizing and reserving such amounts on the company's books), (iv) the claimant's rejection of defendant's offer to repossess or repurchase all the interests of the claimant at cost, and (v) the purchaser's failure to reject, revoke its acceptance or return the computer system to the manufacturer with the purchaser continuing to use the system.

This affirmation of the contract by purchasers unquestionably results from a determination by the purchasers that it is more in their economic interest to retain the contract in an effort to earn profits rather than to rescind the arrangement and forego use of the contract object. In many cases the purchaser clearly profits from continued use of the computer systems but the weight of authority holds that having affirmed the contract, claimants must accept the burdens, as well as the benefits, of the contract. Specifically, claimants are then bound by all of the contract provisions including the limitation on liability.

\textsuperscript{20} 192 U.S. at 242.

\textsuperscript{21} Rescission claims and tender offers are often omitted from the complaint for fear that the alleged defrauding party may accept the tender offer. Additionally, rescission may be complicated in those situations where the object of a contract is sold to a third party and leased back to the contracting party. In such a case the owner may not wish to disgorge his interest and the concommitant investment credit tax advantage.


B. **Contract Affirmance Precludes Partial Rescission**

In *Merry Realty Co. v. Shamokin & Hollis Real Estate Co.*, the New York Court of Appeals held that "[if] rescission is the remedy selected it must be in whole and not in part. *If there be an affirmance it must be of all the terms and conditions of the transaction.*" The law mirrors common sense and does not permit claimant purchasers to affirm only as much of the contract as pleases them and disaffirm that which is not to their liking.

This principle was applied in *Leav v. Weitzner*. In *Leav*, the plaintiffs sued for damages arising out of fraudulent misrepresentations allegedly made to induce the plaintiffs to enter into a lease with the defendant. The lease contained a clause under which both parties waived trial by jury in any action "arising out of or in any way connected with this lease." The court held that in suing for damages, the plaintiffs had affirmed the lease and, therefore, could not rescind a part of the transaction and enforce that part which is of value to them. See also *Throckmorton v. Johnson*, where the court stated: "It is equally definitely established that when a rescission is asserted it must be in whole and not in part. The plaintiffs may not rescind a part of the transaction and enforce that part which is of value to them." See also *Thompson v. Thompson*, where the court held the plaintiffs cannot hold on to such part of the contract as may be desirable on their part, and avoid the residue, but must rescind in toto, if at all. There is authority, however, that "affirmance of the contract is not necessarily affirmation and ratification of the fraud inducing it." *422 West 15th St., Inc. v. Estate of Johnson*, where the court stated:

One entitled to relief can affirm or avoid the contract, but he cannot do both; if he adopts a part, he adopts it all. He must reject it entirely if he desires to obtain relief. Defendant cannot accept the benefits of the contract and then assert he is entitled to be relieved of its obligations. His action was a confirmation of the contract and a waiver of any alleged misrepresentation, mistake, fraud or other wrong. The time for him to demand relief is upon the discovery of the alleged misrepresentations.

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22. 230 N.Y. 316, 323, 130 N.E. 306, 313 (1921). See also *Throckmorton v. Johnson*, 232 A.D. 495, 497, 250 N.Y.S. 426, 428 (1931), where the court stated: "It is equally definitely established that when a rescission is asserted it must be in whole and not in part... the plaintiffs may not rescind a part of the transaction and enforce that part which is of value to them." See also *Thompson v. Thompson*, 232 A.D. 498, 497, 250 N.Y.S. 433, 439 (1931), aff'd, 258 N.Y. 626, 180 N.E. 362 (1932). The same rule was announced long ago in *Masson v. Bovet*, 1 Denio 69, 74 (N.Y. 1845), where the court held the plaintiff "cannot hold on to such part of the contract as may be desirable on his part, and avoid the residue, but must rescind in toto, if at all." *Id.* There is authority, however, that "affirmance of the contract is not necessarily affirmation and ratification of the fraud inducing it." *422 West 15th St., Inc. v. Estate of Johnson*, 258 A.D. 227, 228, 16 N.Y.S.2d 283 (1939).


24. See *Angerosa v. White Co.*, 248 A.D. 425, 428, 290 N.Y.S. 204, 209 (1936), aff'd, 275 N.Y. 524, 11 N.E.2d 652 (1937), where the court stated that "by electing to affirm the contract and seeking to enforce it, appellant adopted that which is detrimental as well as that which is beneficial." *Id.* See also *Security Underground Storage, Inc. v. Anderson*, 347 F.2d 964 (10th Cir. 1965); *Big Chief Sales Co. v. Lowe*, 178 Kan. 33, 283 P.2d 480 (1955); *Bell v. Keepers*, 39 Kan. 105, 17 P. 785 (1888); *United States v. Idlewild Pharmacy, Inc.*, 303 F. Supp. 19, 23 (E.D. Va. 1969), where the court stated:

One entitled to relief can affirm or avoid the contract, but he cannot do both; if he adopts a part, he adopts it all. He must reject it entirely if he desires to obtain relief. Defendant cannot accept the benefits of the contract and then assert he is entitled to be relieved of its obligations. His action was a confirmation of the contract and a waiver of any alleged misrepresentation, mistake, fraud or other wrong. The time for him to demand relief is upon the discovery of the alleged misrepresentations.

not at the same time deny the lease provision waiving a jury trial.\(^{26}\)

Similarly, in *Lummus Co. v. Commonwealth Oil Refining Co.*,\(^ {27}\) under contracts guaranteeing product yields and performance characteristics, Commonwealth, the plaintiff-appellee, acquired a large oil refinery that had been designed, built and placed in operation by the defendant-appellant. Once erected, the refinery encountered severe difficulties with power consumption and its steam and water cooling systems. Dissatisfied with the plant, the plaintiff claimed fraudulent inducement, and sued for approximately twice the amount invested in plant construction. The court was then faced with the issue of whether the plaintiff, which had not rescinded the contract, was entitled to avoid the contract clause requiring arbitration of "any controversy or claim arising out of or related to this Agreement" via a "just and equitable" partial rescission.

Applying New York law, the Court of Appeals for the First Circuit held that the arbitration clause was binding absent any showing that the individual clause had itself been induced by fraud.\(^ {28}\)

Since *Lummus* was decided, the principal New York case relied upon in *Lummus* for the conclusion that New York would not apply a separability analysis to the arbitration issue, has been overruled.\(^ {29}\)

With the exception of the separability of an arbitration clause, how-

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26. The court stated:

In asserting a claim for damages resulting from the execution of the lease, the plaintiffs necessarily affirm its existence and maintain the action on the theory that the defendants' fraud resulted in a subsisting contract which, on account of the falsity of the representations, is detrimental to them. Under these circumstances, the plaintiffs are not in a position to contend, as they might perhaps contend in an action for rescission, that the stipulation waiving a jury trial perished with all the other rights and obligations under the lease. . . . In pursuing their remedy for damages, they necessarily affirm the existence of the lease from which the damages ensue. . . . They may not at the same time rely upon the lease as the foundation of their claim for damages and repudiate the provisions by which they waived their constitutional right to a jury trial.


27. 280 F.2d 915 (1st Cir.), *cert. denied*, 364 U.S. 911 (1960).


ever, the general principles addressed in the *Lummus* case continue to be applicable.

C. APPLICABILITY OF CONTRACT TERMS

The terms and conditions sought to be avoided by the purchaser are often those limiting the financial liability of the manufacturer. Generally, a purchaser’s damage claims arise out of alleged defects or malfunctions in the object of the contract.

The sales contract will often provide for such possibilities and establish limitations on the manufacturer's liabilities in the event that one of these possibilities occurs. The purchaser's assertions of "fraud" are an attempt to avoid those contractual limitations while preserving to the purchaser all of the benefits of the contract.

In arriving at their contractual arrangements, the parties often have foreseen and anticipated the possible occurrence of these events, that is, the failure of the system to meet all of the purchaser's asserted needs or the failure of the system to achieve the performance guarantees set forth in the agreement, as well as faults in development, design or construction. Accordingly, the parties have determined, in view of those possibilities, that the responsibility of the manufacturer should be defined and written into the contract to be executed by the parties and that one of the contractual provisions should be a limitation of the manufacturer's liability.

The resulting limitation provisions are the outcome of bargaining negotiations, or the recognition of recurring problems, and are drafted and designed to deal with the fact that problems might hamper the achievement of the desired goals.

If the computer system or other project is a failure, purchasers will rescind. In most instances, however, the computer system is at least moderately or potentially successful. It is clearly the prospect of profit and other economic benefit that leads claimant to proceed with the contract rather than rescind. Having made that determination, even with knowledge of the alleged fraud practiced, the purchaser must accept the contract limitations that are designed to deal with the problems encountered.

D. CONTRACT AFFIRMANCE BINDS PARTIES TO LIABILITY LIMITATION CLAUSES

The soundness of the above position is established by *Soviero Bros. Contracting Corp. v. City of New York.* In *Soviero*, a con-

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struction contractor, aware that the City of New York had misrepresented site conditions, affirmed its contract, proceeded with construction, and then sued for damages arising out of the alleged misrepresentations. The contract contained a provision requiring the commencement of an action upon "any claim arising out of or based upon this contract or by reason of any act or omission or requirement of the City" within one year after a specified date. The contractor commenced his action after expiration of the one year period. Noting that the contractor had made no effort to rescind, the court observed: "Presumably, the contractor wished to retain the profits of these contracts, and to look only to damages for the misrepresentations, rather than to rescind, risk his profits, and be limited to damages measured by benefits conferred." Thus, since the plaintiff "did not rescind, but proceeded with the contracts under protest," the court held the contractor bound by the contractual limitation of one year for bringing any suit for damages resulting from fraudulent inducement. It rejected the contractor's reliance on other cases dealing with total immunity clauses and distinguished them from those providing for a reasonable limitation.

31. Contractual limitations upon the time period in which to commence an action are specifically sanctioned in U.C.C. § 2-725(1), provided that the period is not less than one year.

32. 286 A.D. at 439-40, 142 N.Y.S.2d at 512.

33. Id. at 439, 142 N.Y.S.2d at 511.

34. Id. at 441-42, 142 N.Y.S.2d at 513. But see Bankers Trust Co. v. Pacific Employers Ins. Co., 282 F.2d 106 (9th Cir. 1960), cert. denied, 368 U.S. 822 (1961). In Bankers, the Ninth Circuit, without considering the affirmation point, held that the contractual limitation on the time for bringing suit did not control in a fraud action.

35. The court stated:

The contractor relies upon a well-settled line of cases which told that one who is guilty of fraud in the making of a written agreement may not invoke a provision of that agreement which purports, directly or indirectly for his own fraud. Each of these cases was an action for damages brought at law based upon the misrepresentations made in the inducement of the contract. . . . These cases apply a rule well recognized in law that avoids the effect of an immunity clause, the very existence of which arises only because the contract containing it was induced by fraud and which provision is designed [emphasis in original] to shield the fraud. A total immunity clause is bad; a limitation provision, if reasonable, is not. [emphasis added].

As noted earlier, other reasonable limitations on the assertion of fraud claims also have been upheld. A party charging fraudulent inducement, for example, cannot, after affirmance, avoid a contract provision that provides that disputes be determined by arbitration, nor that the dispute be determined without a jury. Indeed, the New York courts have held that a party affirming a contract may be entirely barred from asserting a claim for fraudulent inducement when, by the terms of the contract, he has expressly contracted away his right to claim reliance on the specific representations later said to have been false.

Only a few cases, however, have considered a limitation of liability/damage clause in an affirmed contract later claimed to have been fraudulently induced. In Gates Rubber Co. v. USM Corp.,

In truth, the rule rests not so much on the basis that the immunity provision may be avoided for fraud in the inducement of the contract, but on the principle that the provision is illegal, and therefore null, because it violates public policy. Consequently, the provision never had any life. It requires neither the existence of fraud nor rescission to destroy it. It is void in the beginning.

286 A.D. at 441, 142 N.Y.S.2d at 513.

36. See supra notes 27-29 and accompanying text.

37. Id.

38. See supra notes 25-26 and accompanying text.


40. To the extent that support for the enforceability of liquidated damages clauses and clauses limiting liability as to consequential damages is derived from general principles of law not involving a claim of fraudulent inducement, see N.Y.U.C.C. § 2-718 (McKinney 1982) (liquidation or limitation of damages); N.Y.U.C.C. § 2-719(3) (McKinney 1982) (limitation or exclusion of consequential damages); Farris Eng'g Corp. v. Service Bureau Corp., 406 F.2d 519 (3rd Cir. 1969) (principles governing enforcement of provisions absolving a contract party from his own negligent acts); U.S. Fibres, Inc. v. Proctor & Schwartz, Inc., 358 F. Supp. 449, 460 (E.D. Mich. 1972), aff'd, 509 F.2d 1043 (6th Cir. 1975) ("Both parties realized that its purpose was to allocate the risks associated with this type of transaction."); County Asphalt, Inc. v. Lewis Welding & Eng'g Corp., 323 F. Supp. 1300, 1308-09 (S.D.N.Y.), aff'd, 444 F.2d 372 (2d Cir. 1970), cert. denied, 404 U.S. 939 (1971) (discussion of circumstances when exclusion of consequential damages may be regarded as unconscionable under Ohio law and where the court stated that "plaintiff's experience and expertise, and the parties' care in negotiating these large contracts, preclude any argument of unfair surprise"); Rogers v. Dorchester Assoc., 32 N.Y.2d 553, 300 N.E.2d 403, 347 N.Y.S.2d 22 (1973) (holding that limitations upon that consequential damages must be narrowly construed); Melodee Lane Lingerie Co. v. American Dist. Tel. Co., 18 N.Y.2d 57, 281 N.E.2d 661, 271 N.Y.S.2d 937 (1966); Van Dyke Prod., Inc. v. Eastman Kodak Co., 12 N.Y.2d 301, 189 N.E.2d 693, 239 N.Y.S.2d 337 (1963); Ciofalo v. Vic Tanney Gyms, 10 N.Y.2d 294, 177 N.E.2d 925, 220 N.Y.S.2d 962 (1961); Mosler Safe Co. v. Maiden Lane Safe Deposit Co., 199 N.Y. 479, 93 N.E. 81 (1910); H.G. Metals, Inc. v. Wells Fargo
the Seventh Circuit held a contract clause excluding consequential damages valid even though the plaintiff claimed fraudulent inducement. In dictum and applying Maryland law, the District Court in Potomac Electric Power Co. v. Westinghouse Electric Corp. interpreted a broadly drafted limitation of liability clause which applied to claims “under this contract, whether in tort, under any warranty, or otherwise” to preclude recovery of damages for misrepresentation. The court had earlier found that no cause of action for fraud or deceit was supported by the evidence.

In Waterman-Bic Pen Corp. v. L.E. Waterman Pen Co., both the New York Supreme Court and the Appellate Division held that plaintiff's affirmation of the contract made the limitation clause “binding,” but the Appellate Division stated that construction of that particular clause was a triable issue and it should not be construed at an early stage of the proceeding to limit defendants' liability for the alleged fraud.

The Waterman-Bic rulings resulted from an application to vacate a warrant of attachment which, under the then applicable law, was authorized in an action “for money only” when fraud was claimed. The plaintiff had purchased a business from defendants giving in payment shares in a corporation formed to take over the business. The contract provided that “any decrease in value of the inventory and of the accounts receivable not in excess of $150,000 will not be deemed to constitute a breach of warrant[y].” It further provided that, if the deficiency in inventory or receivables exceeded $150,000, the sellers should either pay the amount of such deficiency in cash or surrender to plaintiff shares in the corporation in prescribed amounts. Finding the accounts receivable materially

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44. 19 Misc. 2d at 422, 190 N.Y.S.2d at 50.
deficient after closing the transaction, plaintiff affirmed the contract, sued for fraudulent inducement, sought money damages and obtained an attachment. Special Term vacated the attachment holding that the contract provided a self-executing remedy and that the action was not one for "money only."\textsuperscript{45}

The Appellate Division reversed and reinstated the attachment holding that plaintiff had made a sufficient \textit{prima facie} showing of fraud and that defendants had "failed to demonstrate that plaintiff cannot ultimately succeed" and that the action was indeed one for money only. That court noted that the plaintiff was claiming that "many of the accounts receivable did not represent actual sales, and were overstated by more than $300,000, and that other assets and liabilities were also misstated."\textsuperscript{46}

The Appellate Division explicitly held that affirmance of the contract had made the limitation clause "binding." However, characterizing the clause as one applicable to a decrease in accounts receivable that might occur "in the regular course of business," the court expressed doubt whether the clause would give immunity where such accounts "were completely nonexistent, fraudulent or fictitious," stating that the clause should not be read that broadly "at this stage." The court clearly was leaving open the possibility of a determination at trial, based upon all the relevant evidence, that the clause was applicable to plaintiff's claims.\textsuperscript{47}

In a computer case, \textit{National Cash Register Co. v. Modern Transfer Co.},\textsuperscript{48} a manufacturer sued a buyer that refused to take delivery or pay for a computer system and the buyer asserted counterclaims alleging fraud. The court held, without extensive analysis, that a
limitation of liability clause of the contract (excluding consequential damages) was applicable and thereby dismissed the buyer's counterclaims based upon fraud.

Several cases, however, have held limitation of liability provisions inapplicable. In one early computer case, *Clements Auto Co. v. Service Bureau Corp.*,49 the plaintiff purchaser entered into a series of contracts with a subsidiary of IBM for computer goods and services that were to be used in inventory control. Each of the contracts was terminable by either party on 30 days notice. The contracts also contained a limitation of liability provision.50

The contractual relationship began in 1963 and was terminated in January 1967 by the plaintiff purchaser. In this period there were three generations of inventory reports based upon input material from the accounting and billing procedures which also had been automated by the defendant. The plaintiff purchaser brought the action in September 1967 proceeding on the theories of rescission, breach of implied warranty, breach of contract, reformation and fraudulent misrepresentation. The trial court found that the defendant had made fraudulent misrepresentations and granted damages for the period from 1963 to October 1966, but denied recovery on all other grounds. In doing so the trial court found that the limitation of liability provisions did not limit recovery for fraud or misrepresentation under the governing law of the contracts.51

On appeal, the defendant argued, *inter alia*, first that the actionable representations were in the nature of innocent misrepresentations. The court cited *Channel Master Corp. v. Aluminum Ltd. Sales, Inc.*, 4 N.Y.2d 403, 151 N.E.2d 833, 176 N.Y.S.2d 259 (1958) and *Lyman v. Romboli*, 293 Mass. 373, 199 N.E. 910 (1936). *Channel Master* states that a cause of action for fraud is entirely independent of the contractual relations between the parties. In *Lyman*, the plaintiff was fraudulently induced to enter a lease by representations that he could use what was represented as defendants' land for a driveway. Actually, the land was owned by the state. The lease provided if the lessee was hampered or prevented from having such a driveway he could terminate the lease. The trial court held that this term precluded recovery. The Supreme Judicial Court of Massachusetts reversed holding:

This provision does not show that the plaintiff did not rely on the representations. The judge apparently thought that it constituted a contractual substitute for any right of action for deceit. But it was settled by *Granlund v. Saraf* that an attempt by a contract to restrict the remedy of a party for fraud of the other party which induced the making of the contract, is ineffectual.

*Id.* at 374-75.


50. The contract stated that the purchaser's "liability with respect to this agreement is limited to the total charge for the services provided herein and no special or consequential damages may be recovered." 444 F.2d at 188.

51. The court cited *Channel Master Corp. v. Aluminum Ltd. Sales, Inc.*, 4 N.Y.2d 403, 151 N.E.2d 833, 176 N.Y.S.2d 259 (1958) and *Lyman v. Romboli*, 293 Mass. 373, 199 N.E. 910 (1936). *Channel Master* states that a cause of action for fraud is entirely independent of the contractual relations between the parties. In *Lyman*, the plaintiff was fraudulently induced to enter a lease by representations that he could use what was represented as defendants' land for a driveway. Actually, the land was owned by the state. The lease provided if the lessee was hampered or prevented from having such a driveway he could terminate the lease. The trial court held that this term precluded recovery. The Supreme Judicial Court of Massachusetts reversed holding:

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*Id.* at 374-75.
and second that the representations were not included in the contracts, were not express warranties, and contractual disclaimers negated all implied warranties. The defendant further argued that innocent misrepresentations were equivalent to warranties, either express or implied, and that in a commercial context they should be governed by the same contract principles, that is, the Uniform Commercial Code. The defendant also interposed the limitation of liability provisions. The Eighth Circuit rejected these contentions finding that the adoption of the Uniform Commercial Code did not alter the law of fraud and that a general contract disclaimer was ineffective to negate reliance on innocent misrepresentations. It further found that under Minnesota law, a limitation of liability clause was ineffective in an action for fraud. The court stated:

Minnesota's strong policy of providing an effective remedy in fraud would be substantially undermined were we to give effect to this severe restriction on the amount of liability. Having previously held that Minnesota would not give effect to a contract provision which would negate the fact of liability, we believe it inconsistent to hold that the court would then give effect to a provision limiting the amount of liability.

The reasoning of the Eight Circuit, therefore, while not directly contrary, is somewhat inconsistent with the law of New York as expressed in Soviero. In Clements, however, the plaintiff had terminated the relationship and thereafter used another data processing service. Therefore, it did not continue to accrue benefits under any contract or otherwise affirm the contract. This is a substantial and key distinguishing factor. In effect, because of the factual circumstances, the court did not analyze the indicia of affirmance of the contract or the applicable legal principles. Similarly, other computer cases which have stated that contractual limi-

52. Actionable fraud in Minnesota requires traditional scienter. The trial court found misrepresentations which the defendant "either knew to be false or, which is more likely, asserted as of its own knowledge without knowing whether they were true or false." 298 F. Supp. at 131.

53. The court did cut back the period used for computation of damages, finding that after April, 1965, the plaintiff was fully aware of the problem and could no longer rely on the misrepresentations. It noted that "we do not believe and [defendant] does not argue, that [plaintiff's] actions constitute a waiver of fraud for damages incurred to this point." 444 F.2d at 186 n.11. In short, while the Clements court permitted the plaintiff to collect damages accrued after learning of the fraud while it sought a buyer for the unprofitable business, the court refused to allow an increase in damages for additional expenditures on the property retained after the discovery of the fraud. See also Lane v. Midwest Bankshares Corp., 337 F. Supp. 1200 (D. Ark. 1972) (failure to disavow contract soon enough defeated securities fraud claim).

54. 444 F.2d at 188.
tations of liability would be ineffective against a finding of fraud do not involve the elements of affirmance or consideration of that issue.\(^\text{55}\)

An analysis similar to that in *Clements* is found in *Lamb v. Bangart*.\(^\text{56}\) *Lamb* involved the sale by defendants of, *inter alia*, a one-quarter interest in a contractually warranted bull for breeding purposes, which had been purchased for $50,000, and ten heifers, contractually warranted to be offspring of that bull, which were purchased for $25,000. Plaintiff alleged that the bull was in poor physical shape, was not a breeder, and had to be destroyed. The jury found fraud by the defendants, and at trial plaintiffs recovered damages for breach of contract and fraud. (The complaint count for rescission was abandoned.) The Supreme Court of Utah rejected the defendant's contention that a contract clause, defining liquidated damages and limitations, provided the exclusive remedy.\(^\text{57}\) The court held that such a remedy was merely optional unless it was stated to be exclusive. More importantly, however, the court held that application of a contract clause limiting liability would be against public policy.\(^\text{58}\) Although *Clements* and *Lamb* are factually distinguishable, these cases stand for the proposition that because a

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55. See, e.g., APLications Inc. v. Hewlett Packard Co., 501 F. Supp. 129 (S.D.N.Y. 1980) (the factual indicia of affirmance were not present). The trial court in *APLications* found that the defendant had made no false representations. See APLications Inc. v. Hewlett Packard Co., 672 F.2d 1076 (2d Cir. 1982).

Additionally, the issue of affirmance was not considered directly by the First Circuit in IBM Corp. v. Catamore Enter., 548 F.2d 1065 (1st Cir. 1976), because the court's attention was focused on the application of a subsequent written agreement to prior oral agreements. Citing *Soviero* the court did hold that a contractual period of limitations was applicable in the face of allegations of fraud. In a footnote comment, however, the court suggested that the trial court, through special interrogatories to the jury, could have determined whether the agreement was "voidable," either in whole or in part, by reason of fraud. *Id.* at 1068.

56. 525 P.2d 602 (Utah 1974).

57. The court summarized the contract provision as follows:

This paragraph contained a representation that the sellers had 1500 ampules of Fuyard 1st semen on hand on the date of the agreement. The paragraph provided that if the animal died prior to the buyers acquiring 750 ampules, the sellers and buyers would adjust the quantity so that each would have an equal amount. It further provided that if the animal died prior to the buyers receiving 1500 ampules of semen and the payment of $30,000 on January 5, 1969, was not due, the buyers would be exonerated from such payment. *Id.* at 608.

58. The court explained:

In the instant action, in addition to there being no provision that paragraph 4 provided the exclusive remedy, a contract clause limiting liability will not be applied in a fraud action. The law does not permit a covenant of immunity which will protect a person against his own fraud on the ground of public policy. A contract limitation on damages or remedies is valid only in the absence of allegations or proof of fraud.
total immunity provision will not be applied, a partial limitation also will not be applied. As such, these cases are contrary to the New York cases dealing with partial immunity which have been held not void as against any public policy. Both the exclusion of "consequential or indirect damage" and specific limitations of liability are reasonable in the light of the usual liabilities assumed and the acknowledged risks involved in any venture.

There is nothing in the nature of limitation of liability clauses to distinguish them from clauses compelling arbitration such as those in Lummus and Housekeeper, or from a clause waiving jury trial such as that in Leav, or from a clause imposing a short statute of limitations as in Soviero which would dictate that the result should be any different.

E. Waiver

A related concept is waiver of the fraud by a party's conduct subsequent to the discovery of the alleged fraud. This argument

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59. The exclusion of "indirect" damages such as lost profits or lost production is nothing more than a contractual statement of the liability limitations imposed by the New York law of damages for fraud. The New York Court of Appeals has repeatedly made clear that the New York measure of damages for fraudulent inducement is indemnification for the actual pecuniary loss suffered by the claimant as the direct result of the wrong, and that such direct damages are measured by the difference between consideration given and the value of the benefits, assets or services received from the fraudulently induced transaction and from which all elements of profit are excluded. The definitive and leading authority on this point is Reno v. Bull, 226 N.Y. 546, 124 N.E. 144 (1919).

This rule has been cited over the years and has been applied in a variety of cases. Foster v. DiPaolo, 236 N.Y. 132, 140 N.E. 220 (1923); Hotaling v. A.B. Leach & Co., 247 N.Y. 84, 159 N.E. 870 (1928); Sager v. Friedman, 270 N.Y. 472, 1 N.E.2d 971 (1936); Ross v. Preston, 292 N.Y. 433, 55 N.E.2d 490 (1944); Hanlon v. MacFadden Publications, Inc., 302 N.Y. 502, 99 N.E.2d 546 (1951). See also Toho Bussan Kaisha, Ltd. v. American President Lines, Ltd., 265 F.2d 418 (2nd Cir. 1959).


64. See generally Annot., 13 A.L.R.2d 588 (1949); Annot., 106 A.L.R. 172 (1937); Elwood v. Tiemair, 91 Kan. 842, 139 P. 362 (1914); St. John v. Hendrickson, 81 Ind. 350 (1882). In St. John, a waiver of the right to maintain an action for damages for fraudulent inducement was found on the basis of plaintiff's failure to have repudiated a transaction known to be fraudulent. The court recognized the general rule that a party may stand by his bargain and sue for damages resulting from fraud and held:
would have to be predicated on conduct by the plaintiffs which showed that the cause of action for damages was intended to be waived.65

In its broadest form, the rule is that in order to avoid a waiver of the right to damages, the defrauded party must remain at arm's length; he must on his part comply with the terms of the contract; he must not ask favors of the other party or offer to perform the contract only on conditions which he had no right to exact.66

The factual hurdles of establishing a waiver, however, are substantial and it is difficult to convince a fact-finder of the merits of such a position. More importantly, however, the commencement of an action at the time of discovery of the fraud would defeat such a claim whereas commencement of an action does not defeat the affirmance theory. In fact, the post-complaint activity of the complainant is central to the affirmance theory.

F. SUMMARY OF FACTUAL DEFENSE POSTURE

The factual defense posture of affirmance of the contractual limitations of liability may be summarized as follows: While claimant-purchasers may complain that it is, in their view, unfair that they should be bound by the liability limiting clauses of the contracts, they are bound as a result of their own plan and design. Claimants cannot deny their own knowledge and belief of the alleged fraud

"[w]e do decide that where a party with full knowledge declines to repudiate a transaction known to him to be fraudulent, and fully and expressly ratifies it, he can neither rescind nor maintain an action for damages." Id. at 354. The basis of the decision was that plaintiff, after learning of the true financial condition of the partnership in which he had invested, declined an offer to be released from the partnership by other partners who had allegedly induced it. Id.

Some courts find waiver of the right to sue for damages on the basis of an election to proceed while the contract is still substantially executory. Phillips Petroleum Co. v. Rau Constr. Co., 130 F.2d 499 (8th Cir. 1942); Simon v. Good Year Metallic Rubber Shoe Co., 105 F. 473 (6th Cir. 1900). On the failure to voice objections as to claimed invalidity for a long period of time, see United States v. Idlewild Pharmacy, Inc., 308 F. Supp. 19 (E.D. Va. 1969). In many courts the question is treated as an issue of law. See, e.g., Phillips Petroleum Co. v. Rau Constr. Co., 130 F.2d 499 (6th Cir. 1942); Simon v. Good Year Metallic Rubber Shoe Co., 105 F. 473 (6th Cir. 1900). In other cases, however, it is an issue of fact to be established at trial. Towers Realty Corp. v. Fox, 278 A.D. 74, 103 N.Y.S.2d 437 (1951); 422 W. 15th St., Inc. v. Estate of Johnson, 258 A.D. 227, 16 N.Y.S.2d 283 (1939); Mercogliano Lumber Corp. v. Sea Cliff Homes, Inc., 31 Misc. 2d 1078, 221 N.Y.S.2d 920 (1961); duPont v. Perot, 59 F.R.D. 404 (S.D.N.Y. 1973).

prior to filing a lawsuit or counterclaim and their election to stand by the contract. They cannot deny their continuing intent thereafter to retain and reap the benefits of the computer systems the purchase of which they claim to have been fraudulently induced. Furthermore, they cannot deny that they declined an opportunity to rescind the alleged fraudulent transaction and thereby to be made whole. They cannot deny that, but for the alleged fraudulent inducement, they never would have come to possess the very computer systems which generates their current and potential profits.

By such conduct, claimant-purchasers have implicitly chosen to accept all of the benefits of the contracts in suit and, thereby, to accept the reasonable limitations on the liability of manufacturers for the failures and deficiencies of which claimants would complain.

III. PLAINTIFF'S DUTY TO INVESTIGATE

The application of limitation of liability clauses affects the purchaser's right to damages. In the litigation setting, a defensive attack on the damages claimed is bolstered by a complimentary attack on the liability elements. Accordingly, a qualified defensive measure which might be appropriate in any fraud case concerns the extent of the claimant's knowledge from its own investigation or lack of knowledge of the facts arising out of a failure to investigate and its reliance on the alleged misrepresentations or concealments. To prove fraud, the claimant must prove its reliance on the misrepresentations and that its reliance was reasonable.

As such this defense is an attack on the reliance element of fraud and is based upon the claimant's qualified duty and failure to investigate the facts. In the computer context the defense may be particularly appropriate in many cases because of the degree of sophistication of the customer and the customer's capabilities and re-

67. For a time, the defense attack based on a claimant's failure to investigate was sidetracked in the conceptual pigeonhole of contributory negligence, particularly in securities fraud actions. See Clement A. Evans & Co. v. McAlpine, 434 F.2d 100, 104 (5th Cir. 1970), cert. denied, 402 U.S. 988 (1971). In federal securities law the defense was referred to as plaintiff's duty of due diligence or due care. See Wheeler, Plaintiff's Duty of Due Care Under Rule 10b-5: An Implied Defense To An Implied Remedy, 70 NW. U.L. REV. 561 (1975); Note, The Due Diligence Requirement for Plaintiff Under Rule 10b-5; 1975 DUKE L.J. 753 (1975); Note, Reliance Under Rule 10b-5: Is the "Reasonable Investor" Reasonable?, 72 COLUM. L. REV. 562 (1972). This development occurred because plaintiffs were asserting that negligence constituted scienter. The United States Supreme Court in Ernst & Ernst v. Hochfelder, 425 U.S. 185, however, prescribed that under the federal securities fraud case, scienter was required and was not satisfied by negligent conduct. The Hochfelder decision refocused the defense contention and returned it to the proper classification of an attack on the reliance element of fraud.
sources to investigate thoroughly. For example, in *APLicitations Inc. v. Hewlett-Packard Co.*, the trial court found that the plaintiff company's president possessed a sophisticated knowledge of computer technology, had seen repeated demonstrations of the computer hardware, and had received training on the computer hardware. Consequently, the court held that the plaintiff had not relied upon advertising literature or other statements and "did not exercise due care" in investigating the system for defects. The court concluded that the "case should never have been brought" for trial. General common law principles support this defense in appropriate situations.

**A. MISREPRESENTATION**

In order to recover for fraudulent misrepresentation, claimant's reliance on the representation must have been justifiable under the circumstances. Historically, the doctrine of *caveat emptor* mandated the claimant's duty of inquiry. The retrenchment from that doctrine, which was occasioned by the desire to promote commercial dealing, led to the general rule that the recipient of an intentional misrepresentation had no duty to investigate. The principle is phrased by section 540 of the *Restatement (Second) of Torts* as

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> In actions for fraud it is not required that a defendant's representations be the sole cause of damage. If they are a substantial factor in inducing the plaintiff to act, even though he also relies in part upon the advice of others, reliance is sufficiently shown.

*Id.*


71. The Council of the American Law Institute, however, supported modification of the predecessor section which was virtually identical to read as follows:

> The recipient of a fraudulent misrepresentation is justified in relying upon its
Duty to Investigate

The recipient of a fraudulent misrepresentation of fact is justified in relying upon its truth, although he might have ascertained the falsity of the representation had he made an investigation. In effect, claimant’s negligence ordinarily is not a defense to intentional fraud. The representation, however, will not be held to be misleading if it is obviously false or specifically disclaimed. If the facts represented are not matters peculiarly within the party’s knowledge, and the other party has the means available to him of knowing, by the exercise of ordinarily intelligence, the truth or the real quality of the subject of the representation, he must make use of those means, or he will not be heard to complain he truth without investigation, unless he knows or has reason to know of facts which make his reliance unreasonable.

RESTATEMENT (SECOND) OF TORTS § 540 (Tent. Draft No. 11, 1965). It reasoned as follows:

The argument has revolved around the question of a plaintiff who has ‘notice’ of something wrong. In other words, he knows enough to know that he cannot safely rely without investigating, although he does not definitely know that the statement is false. ‘Notice’ runs all through the law, wherever the question of justifiable reliance is involved. Even the purchaser of a negotiable instrument cannot take as a holder in due course if he has notice that there is something wrong with it. The Reporter believes that the taker of a misrepresentation of fact stands on no better footing, and that there should be something about it in this Section.

Id. at 10.

72. Comment (a) to section 540 reads as follows:

The rule stated in this Section applies not only when an investigation would involve an expenditure of effort and money out of proportion to the magnitude of the transaction, but also when it could be made without any considerable trouble or expense. Thus it is no defense to one who has made a fraudulent statement about his financial position that his offer to submit his books to examination is rejected. On the other hand, if a mere cursory glance would have disclosed the falsity of the representation, its falsity is regarded as obvious under the rule stated in § 541.


74. RESTATEMENT (SECOND) OF TORTS § 541 (1977).

was induced to enter into the transaction by misrepresentations.\textsuperscript{76} The recipient of fraudulent information is "required to use his senses and cannot recover if he blindly relies upon the misrepresentation."\textsuperscript{77} As the United States Supreme Court stated in 1903 in \textit{Shappiro v. Goldberg}:

When the means of knowledge are open and at hand or furnished to the purchaser or his agent and no effort is made to prevent the party from using them, and especially where the purchaser undertakes examination for himself, he will not be heard to say that he has been deceived to his injury by the misrepresentations of the vendor.\textsuperscript{78}

Additionally, a plaintiff cannot recover if he knew that the information was false.\textsuperscript{79} In \textit{200 East End Avenue Corp. v. General Electric Co.},\textsuperscript{80} an owner-contractor brought an action for fraud and breach of warranty relating to the purchase of a heating and cooling system. Plaintiff claimed that defendant's circulars falsely represented that by using defendant's units, tenants could have individual temperature control, year-round air conditioning and fresh air in the apartments without opening windows. An engineer retained by plaintiff, however, testified that he was fully aware of the precise manner in which defendant's units would and did perform. Accordingly, the court held that:

However limited may be the duty to probe the truthfulness of a representation, . . . there can be no liability in fraud where the complaining party is, in advance, fully knowledgeable and apprised of those matters as to which the representations are alleged to have deceived.\textsuperscript{81}

Under the common law, it is unclear the extent to which something more than negligence but less than actual knowledge by the plaintiff will preclude recovery in an action based upon fraud. A standard of recklessness would seem to prevail. In \textit{Feak v. Marion Steam Shovel Co.},\textsuperscript{82} a buyer of a steam shovel was advised and put on notice that a third person owned the shovel. The buyer, however,

\textsuperscript{76} Schumaker v. Mather, 133 N.Y. 590, 596 (1892); Danann Realty Corp. v. Harris, 5 N.Y.2d 317, 157 N.E.2d 597, 184 N.Y.S.2d 599 (1959).

\textsuperscript{77} See \textsc{Restatement (Second) of Torts} § 541 comment a (1977).

\textsuperscript{78} 192 U.S. 232, 241-42 (1904). The Supreme Court considered the general rule but concluded that there are many instances which were distinguishable. See also Costello v. Larsen, 182 Va. 567, 29 S.E.2d 856 (1944).

\textsuperscript{79} \textsc{Restatement (Second) of Torts} § 541 (1977).


\textsuperscript{81} 5 A.D.2d at 418, 172 N.Y.S.2d at 412.

\textsuperscript{82} 84 F.2d 670 (9th Cir.), \textit{cert. denied}, 299 U.S. 604 (1936). See also Lawrence Warehouse Co. v. Dove Creek State Bank, 172 Colo. 90, 470 P.2d 838 (1970).
went back to the defrauding party to allay his fears. The court found that

where a party is once put upon notice of fraud he cannot avoid the consequences of his constructive knowledge of the fraud nor fulfill his duty to investigate by going to the party he suspects of the fraud. He cannot desist from further investigation because he is reassured of the truth of the original representation. 83

The case of City of Del Rio v. Ulen Contracting Corp. 84 involved a representation in a construction contract as to the state of incorporation and the domicile of the contractor. The city later ignored the contract and performed the work itself and the contractor sued for the consequent lost profits. Disallowing the city's defensive assertion of fraud, the court found that documents submitted as part of the contractor's bid disclosed the actual facts and that "one cannot close his eyes to the obvious and then claim to be deceived." 85

Similarly, Security Trust Co. v. O'Hair 86 involved the sale of corporate stock with representations as to its value where plaintiff previously had loaned the corporation money and knew of its poor financial condition. The Indiana Appellate Court held that there was no justifiable reliance stating:

[W]e hold that when both parties are dealing at arm’s length and one party, in spite of the facts well known to him, deliberately ignores such facts and chooses to believe statements to the contrary, he closes his eyes to the truth and deliberately takes a chance. It then cannot be said that he was injured in law. All that can be said is that he gambled and lost. 87

In essence, Feak, City of Del Rio and Security Trust are cases where the allegedly defrauded parties made a reckless and deliberate decision to disregard signals that the representations were false.

The effect of an investigation of some sort is treated as follows in the Restatement (Second) of Torts: 88


84. 94 F.2d 701 (5th Cir. 1938).

85. Id. at 703. See also Kaiser v. Nummeroff, 120 Wis. 234, 97 N.W. 932 (1935) (sale of inventory the value of which could have been checked by simple addition and where court held that plaintiff was not justified in relying on it without investigation).

86. 103 Ind. App. 56, 197 N.E. 694 (1935).

87. Id. at 59, 197 N.E. at 696-97.

Recipient Relying on His Own Investigation

(1) Except as stated in Subsection (2), the maker of a fraudulent misrepresentation is not liable to another whose decision to engage in the transaction that the representation was intended to induce is not caused by his belief in the truth of the representation but is the result of an independent investigation made by him.

(2) The fact that the recipient of a fraudulent misrepresentation is relying upon his own investigation does not relieve the maker from liability if he by false statements or otherwise intentionally prevents the investigation from being effective.

The Restatement rule is a workable concept with adequate qualifications for each interested party.

B. Concealment

When considering the duty to investigate, the cases do not distinguish between misrepresentation and concealment. Consequently, the above principles are also applicable to concealment claims. In Hartford Accident & Indemnity Co. v. Kranz,90 the plaintiff surety brought an action to rescind a bond on a subcontractor’s performance. The plaintiff contended that defendant contractors had failed to disclose another contract for which there was no bond. The action was dismissed for lack of evidence of an intent on the part of defendant to perpetrate a fraud on the plaintiff. The court found that the plaintiff had not made any inquiries and that when it first was informed of the second contract, it had not promptly objected or rescinded. In its decision the court stated: “With the opportunity to obtain knowledge of the facts, one cannot sit idly by to reap the harvest, if plentiful, but in the event of scarcity, charge fraud.”90

Similarly, Dambmann v. Schulting,91 involved an action for rescission of a release alleged to have been procured by fraudulent concealment. In that case, plaintiff loaned defendant $10,000 to enable defendant to continue in business and thereafter pay off prior sums owed to plaintiff. When the original debt was repaid, the plaintiff executed a release of the debt with a moral obligation to repay the sum if he was able. This release was invalid for lack of consideration. Defendant later sold his business. The proceeds of the sale were used to satisfy other debts, but the defendant retained rights to one-third of whatever the goods should sell for above the purchase price. Plaintiff asked the defendant the value of this share

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89. 7 A.D.2d 604, 184 N.Y.S.2d 918 (1959).
90. Id. at 607, 184 N.Y.S.2d at 921. In Hartford, the court cited Magee v. Manhattan Life Ins. Co., 92 U.S. 93 (1875).
91. 75 N.Y. 55 (1878).
and was told it was worth about $20,000. The goods were later sold, and his interest came to about $100,000. When the defendant knew his share was going to be larger than expected, he explained to plaintiff that the prior release was inoperative and asked the plaintiff if he would execute a legal release upon payment of $5,000. This the plaintiff did. The court held that defendant's declarations were made in good faith, that they were not made in any business transaction with plaintiff, and that there was no relationship of trust or confidence compelling disclosure. The court further stated:

A party buying or selling property, or executing instruments, must by inquiry or examination gain all the knowledge he desires. He cannot proceed blindly, omitting all inquiry and examination, and then complain that the other party did not volunteer all the information he had.92

The principle would seem to be different, however, where there was a half truth, a relationship of trust or the concealing party with superior knowledge was put on notice that the other party was acting under a misconception as to material facts.

C. NEGLIGENT MISREPRESENTATION

In an action for negligent misrepresentation, the standard of care expected of plaintiff shifts from the recklessness standard to an ordinary negligence standard.93 Consequently, a plaintiff is barred from recovering for negligent misrepresentation if the plaintiff himself was careless in accepting the misrepresentation as true when held to the standard of care, knowledge, intelligence and judgment of a reasonable man. As stated in section 552A of the Restatement (Second) of Torts:

Contributory Negligence

The recipient of a negligent misrepresentation is barred from recovery for pecuniary loss suffered in reliance upon it if he is negligent in so relying.94

The duty to investigate is inherent in this rule.95

92. Id. at 61-62.
93. Restatement (Second) of Torts § 552A comment a (1977).
94. Id.
95. As noted above, in certain factual settings, the duty to investigate may be inapplicable. This is particularly true with respect to certified experts, such as accountants and auditors, who issue fraudulent reports. A party is justified in its reliance on representations made by experts concerning existing facts which the relying party has not itself investigated or to which it does not have equal access. Gagne v. Bertran, 43 Cal. 2d 481, 275 P.2d 15 (1954); Hobart v. Hobart Estate Co., 26 Cal. 2d 412, 159 P.2d 958 (1945); Harazim v. Lyman, 267 Cal. App. 2d 127, 72 Cal. Rptr. 670 (1968).

The element of reliance is satisfied even where a defrauded party relies on more than one report or expert opinion. As stated in MacDonald v. De Fremery, 168 Cal.
D. APPLICATION OF THE DUTY TO INVESTIGATE IN
THE COMPUTER FIELD

For most computer products there are a variety of manufacturers and systems. Each system or product can have similar and different capabilities or features. Purchasers frequently investigate and compare the equipment and systems. Furthermore, the purchasers know that computers and computer systems are constantly evolving and that there are inherent uncertainties in the debugging and use of any computer system. Consequently, the purchaser has a duty to investigate and must be bound by its investigation or failure to investigate. The legal principles outlined above should apply in the computer context.

IV. CONCLUSION

Claimant-purchasers are bound by their actions even when they assert fraud claims in an attempt to avoid the consequences of such actions. Consequently, a claimant must prove, as an element of a fraud claim, that its reliance was reasonable. The sophisticated commercial claimant-purchaser of a computer system must overcome the defense assertion that the purchaser had failed in its duty to investigate. This defense is qualified, but in many computer cases it can be an effective counter-attack for the manufacturer.

The post-transaction activity of a claimant-purchaser also can have a binding effect. When liability seems clear, the "Achilles heel" of a fraud action is the damage element. In situations involving fraudulent inducement of a contract for the purchase of a computer system, the contractual limitations of liability may limit the obtainable damages. By affirming the contract and retaining its benefits, the claimant must accept its limitations. The cases are divided

189, 142 P. 73 (1914), a case involving receipt by plaintiff of a report of the financial condition of a bank which was misleading as to the value of the bank's loans, discounts, bonds and securities: "It is sufficient, in order to maintain the action, that the false statement was one, although it may not have been the sole, inducement for the purchase." Id. at 201, 142 P.2d at 78. See also Davis v. Butler, 154 Cal. 623, 98 P. 1047 (1908); Friedberg v. Weissbuch, 135 Cal. App. 2d 750, 287 P.2d 785 (1955). In these situations a buyer is not required to employ experts to investigate matters of a technical nature of which a defendant expert has full knowledge, and where the defendant has certified its work. Hefferan v. Freebairn, 34 Cal. 2d 715, 720, 214 P.2d 386, 389 (1950). See also Ferguson v. Koch, 204 Cal. 342, 268 P. 342 (1928); Milmoe v. Dixon, 101 Cal. App. 2d 257, 225 P.2d 273 (1950); Blackman v. Howes, 82 Cal. App. 2d 275, 185 P.2d 1019 (1947). The computer field, however, does not frequently encompass such certified expert opinions or reports. Computer manufacturers and vendors are just that, and a customer must investigate what it is to purchase. The customer's degree of knowledge and sophistication will be an important element to determine whether its reliance upon representations was reasonable.
COMPUTER LITIGATION

on the application of contractual limitation of liability clauses in the
face of a fraud claim. The better authority, however, demonstrates
that affirmance of the contract by the purchaser makes the limita-
tion of liability clauses applicable.96

There is nothing in the nature of these limitation of liability
clauses to distinguish them from a clause compelling arbitration,97
from a clause waiving jury trial,98 or from a clause imposing a short
statute of limitations.99 All of these various contractual provisions
apply in fraud actions.

The courts may have occasion to construe a clause, as in Water-
man,100 to ascertain that the clause sought to be invoked is broad
enough to apply to the claimed wrongs. But once so construed the
clause does not become binding by virtue of the original intent of
the parties. The clause is made binding by the act of the claimant-
purchaser in affirming the contract and thereby making the choice
not to disaffirm the entire contract for fraud and, instead, to accept
the benefits of the contract and to thereby accept its burdens as
well.

Thus, when a claimant has affirmed the contract its recovery in
fraud should be restricted by the liability limits of the contract.

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96. Gates Rubber Co. v. USM Corp., 508 F.2d 603 (7th Cir. 1975). See supra note 41 and accompanying text.