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The Economic Loss Doctrine: Intrinsic Or Extrinsic Fraud

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THE ECONOMIC LOSS DOCTRINE: INTRINSIC OR EXTRINSIC FRAUD

RALPH ANZIVINO

The economic loss doctrine provides that when a product is sold and results in economic loss for the buyer (no property or personal injury), the buyer's sole remedy is to sue for breach of contract, not in tort. The two exceptions to the economic loss doctrine are contracts that are predominately for services and contracts where a party is fraudulently induced to enter into the contract.

Fraudulent inducement occurs when one party either fails to disclose a material fact or knowingly misrepresents a significant fact, and thereby induces the other party to enter into a contract. The fraudulent inducement, however, may only be asserted as a claim against the fraudulent perpetrator if the court determines that the fraud is extraneous fraud and not intrinsic fraud. In other words, the fraud claim cannot be raised against the tortfeasor in subsequent litigation if the fraud is determined to be intrinsic fraud.

This Article serves two purposes. First, the Article explains the difference between intrinsic fraud and extraneous fraud as required by the economic loss doctrine. Second, the Article offers two recommendations that attorneys must adopt to protect their client from intrinsic fraud if the client is fraudulently induced to enter into a contract. Otherwise, the other party's fraudulent conduct will go unpunished.

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I. INTRODUCTION

The economic loss doctrine bars a contracting party from pursuing tort recovery for solely economic losses associated with a contractual relationship.¹ In Wisconsin, the doctrine has been so widely applied that it applies to virtually every type of contract with only two exceptions.² One exception is a contract that predominantly involves services, and the other is one that involves a narrow type of fraud in the inducement, which is the subject of this Article.³ Only in those two limited circumstances can a fraudulent inducement case proceed in court.⁴

Fraudulent inducement involves one party committing fraud either by an affirmative misrepresentation or by failing to disclose a material fact, thereby inducing the other party to enter into a contract under false pretenses.⁵ Under the narrow fraud in the inducement exception to the economic loss doctrine, a court must determine whether the fraud committed by the offending party is intrinsic fraud or extraneous fraud.⁶ Only fraud that is considered extraneous to the contract can proceed as a tort claim.⁷ If the court determines that the fraud is intrinsic fraud, the tort claim will be dismissed, and only a breach of contract action, if available, can thereafter proceed.⁸

The purpose of this Article is twofold. First, the Article will illustrate and explain how to distinguish intrinsic fraud from extraneous fraud. Intrinsic fraud is fraud that relates to the quality or characteristics of the product or, otherwise, involves performance under the parties' contract.⁹ As one might expect, most fraud committed in

1. *Kaloti Enters. v. Kellogg Sales Co.*, 2005 WI 111, ¶ 27, 283 Wis. 2d 555, 699 N.W.2d 205.

2. *Id.* ¶ 42; *Ins. Co. of N. Am. v. Cease Elec. Inc.*, 2004 WI 139, ¶ 52, 276 Wis. 2d 361, 688 N.W. 2d 462.

3. *Kaloti*, 2005 WI 111, ¶ 42; *Cease Elec. Inc.*, 2004 WI 139, ¶ 52.

4. *Kaloti*, 2005 WI 111, ¶ 42; *Cease Elec. Inc.*, 2004 WI 139, ¶ 52.

5. *Kaloti*, 2005 WI 111, ¶ 33.

6. *Id.* ¶ 42.

7. *Id.*

8. *Id.* ¶ 35.

9. *Id.* ¶ 33.

conjunction with a contract involves intrinsic fraud with the result that the tort claim is barred.¹⁰ As a result, the only remedy left is a breach of contract action.¹¹ Unfortunately, many attorneys do not anticipate the intrinsic fraud finding by a court and have not drafted the contract to properly protect their client.¹² The second purpose of this Article is to recommend to counsel how to protect their client in the event intrinsic fraud is committed and their only possible remaining remedy is a breach of contract claim.

II. THE ECONOMIC LOSS DOCTRINE

The basic precept of the economic loss doctrine is that contract law and, more particularly, the law of warranty is better suited than tort law for addressing wrongs that involve only economic loss.¹³ There are three policies underlying the economic loss doctrine.¹⁴ They are (1) to maintain the basic distinction between tort and contract law so that each is applied in its own realm; (2) to protect the parties' freedom to allocate the risks inherent in a transaction; and (3) to encourage the party best situated to assess the risk in the transaction, and the buyer to be able to assume, allocate, or insure against the risk.¹⁵

In 1989, the Wisconsin Supreme Court adopted the economic loss doctrine in the case of *Sunnyslope Grading Inc. v. Miller, Bradford & Risberg, Inc.*¹⁶ In *Sunnyslope*, the court held that a commercial purchaser of a product cannot pursue solely economic losses under negligence or strict liability theories from a manufacturer.¹⁷

The first element that must be satisfied in applying the economic loss doctrine is that the transaction must involve a product.¹⁸ Originally, the product was understood to be a good that was subject to the protections of the Uniform Commercial Code.¹⁹ Today, however, the definition of the product has been so broadly interpreted by the courts to cover

10. *See id.* ¶ 33.

11. Ralph C. Anzivino, *The Fraud in the Inducement Exception to the Economic Loss Doctrine*, 90 MARQ. L. REV. 921, 941 (2007).

12. *See Budgetel Inns, Inc. v. Micros Sys., Inc.*, 8 F. Supp. 2d 1137 (E.D. Wis. 1998).

13. *Kaloti*, 2005 WI 111, ¶ 28.

14. *Id.*

15. *Id.*

16. 148 Wis. 2d 910, 921, 437 N.W.2d 213, 217–18 (1989).

17. *Id.*

18. *See Rodman Indus., Inc. v. G & S Mill, Inc.*, 145 F.3d 940, 943 (7th Cir. 1998).

19. *Sunnyslope*, 148 Wis. 2d at 920–21.

virtually every type of transaction, except for a contract that predominately involves services.²⁰ For example, the economic loss doctrine has been held to apply to a component part of an integrated structure,²¹ the general contract for the construction of a home,²² the sale of raw land,²³ a sump and drain tile system,²⁴ the sale of telephone calling plans,²⁵ a component of a manufactured product,²⁶ the construction of a 42-unit condominium complex,²⁷ a commercial real estate contract,²⁸ and the grant of an option to purchase.²⁹ When a contract involves both services and non-goods, the courts use the predominant purpose test to determine whether the economic loss doctrine will apply.³⁰ In other words, the court has to determine whether the contract is predominately one for services or not.

The second element that must be satisfied is whether the damages suffered are economic or involve personal injury or property damage.³¹ A prior article addresses the distinction between economic and non-economic damages.³² *Sunnyslope* made clear that the economic loss doctrine precluded a tort claim in negligence or strict liability when the damages suffered were solely economic loss.³³ But what went unanswered for many years was whether the economic loss doctrine would apply to preclude a tort claim for fraud in the inducement when the damages suffered were solely economic loss.

20. *Ins. Co. of N. Am. v. Cease Elec. Inc.*, 2004 WI 139, ¶ 52, 276 Wis. 2d 361, 688 N.W.2d 462.

21. *Bay Breeze Condo. Ass'n v. Norco Windows, Inc.*, 2002 WI App 205, 257 Wis. 2d 511, 651 N.W.2d 738.

22. *Linden v. Cascade Stone Co.*, 2005 WI 113, 283 Wis. 2d 606, 699 N.W.2d 189.

23. *Mose v. Tedco Equities*, 228 Wis. 2d 848, 598 N.W.2d 594 (Ct. App. 1999).

24. *Komorowski v. Jeff Janssen Builders, Inc.*, 2006 WI App 244, 297 Wis. 2d 585, 724 N.W.2d 703 (unpublished disposition).

25. *Digicorp, Inc. v. Ameritech Corp.*, 2003 WI 54, 262 Wis. 2d 32, 662 N.W.2d 652.

26. *Wausau Tile, Inc. v. Cty. Concrete Corp.*, 226 Wis. 2d 235, 593 N.W.2d 445 (1999).

27. *1325 N. Van Buren, LLC v. T-3 Grp., Ltd.*, 2006 WI 94, 293 Wis. 2d 410, 716 N.W.2d 822.

28. *Van Lare v. Vogt, Inc.*, 2004 WI 110, 274 Wis. 2d 631, 683 N.W.2d 46.

29. *Wickenhauser v. Lehtinen*, 2007 WI 82, 302 Wis. 2d 41, 734 N.W.2d 855.

30. *Linden v. Cascade Stone Co.*, 2005 WI 113, ¶ 8, 283 Wis. 2d 606, 699 N.W.2d 189; *Biese v. Parker Coatings, Inc.*, 223 Wis. 2d 18, 24–25, 588 N.W.2d 312, 316 (Ct. App. 1998).

31. *Digicorp, Inc. v. Ameritech Corp.*, 2003 WI 54, ¶ 33, 262 Wis. 2d 32, 662 N.W.2d 652.

32. See Ralph C. Anzivino, *The Economic Loss Doctrine: Distinguishing Economic Loss From Non-Economic Loss*, 91 MARQ. L. REV. 1081 (2008).

33. *Sunnyslope Grading, Inc. v. Miller, Bradford and Risberg, Inc.*, 148 Wis. 2d 910, 921, 437 N.W.2d 213, 217–18 (1989).

III. THE FRAUD IN THE INDUCEMENT EXCEPTION

States have generally taken three approaches to whether the economic loss doctrine bars a claim for fraud in the inducement when the aggrieved party has suffered only economic loss.³⁴ Some states do not recognize the exception and bar the fraud in the inducement claim the same as a negligence or strict liability claim;³⁵ some states provide a general exception for all fraud in the inducement claims;³⁶ and finally, some states recognize only a very narrow fraud in the inducement exception.³⁷

The policy reasons supporting the economic loss doctrine are said to be consistent with adopting the narrow fraud in the inducement exception.³⁸ First, the narrow exception preserves the distinction between tort and contract law by requiring the parties' contract to address matters that relate to the quality or character of the product and performance under the contract.³⁹ Second, the narrow exception respects the parties' freedom to contract by holding the parties to the terms of their contract.⁴⁰ And finally, the narrow exception anticipates that the party best able to assess the risks inherent in the contract will address those risk and either assume, allocate, or insure against those risks.⁴¹

Sixteen years after *Sunnyslope*, the Wisconsin Supreme Court adopted the narrow exception to the economic loss doctrine for fraud in the inducement.⁴² It should be noted, however, that the Legislature rejected the narrow exception only for residential real estate sales and adopted the broad exception.⁴³ The statute provides that a transferee in a residential real estate transaction may maintain an action in tort against a real estate transferor for fraud committed, or an intentional

34. *Kaloti Enters. v. Kellogg Sales Co.*, 2005 WI 111, ¶ 31, 283 Wis. 2d 555, 699 N.W.2d 205.

35. *Id.*

36. *Id.*

37. *Id.*; see also *HTP, Ltd. v. Lineas Aereas Costarricenses*, 685 So. 2d 1238, 1239 (Fla. 1996); *Wyle v. Lees*, 33 A.3d 1187, 1191 (N.H. 2011); *Huron Tool and Eng'g Co. v. Precision Consulting Servs.*, 532 N.W.2d 541, 543 (Mich. Ct. App. 1995).

38. *Kaloti*, 2005 WI 111, ¶ 46.

39. *Id.*

40. *Id.* ¶ 48.

41. *Id.* ¶ 50.

42. *Id.* ¶ 42; see also Anzivino, *supra* note 11, at 933.

43. WIS. STAT. § 895.10 (2013–2014).

misrepresentation made, by the transferor in the real estate transaction.⁴⁴

There are three primary components to the narrow fraud in the inducement exception and each must be established.⁴⁵ The first component is that there must be an intentional misrepresentation.⁴⁶ There are five elements to intentional misrepresentation that must be proven by clear, satisfactory, and convincing evidence⁴⁷ to establish an intentional misrepresentation. First, the offending party must make a factual representation.⁴⁸ The representation can be by writing, word of mouth, conduct, or even silence if there is a duty to speak.⁴⁹ Second, the representation must be untrue.⁵⁰ Third, the offending party must have made the representation knowing it to be untrue or made it recklessly without caring whether it was true or not.⁵¹ Fourth, the representation was made with the intent to deceive the other party and to induce the other party to rely upon it.⁵² And fifth, the injured party believed the offending party and relied upon the representation.⁵³

The second component of the fraud in the inducement exception requires that the aggrieved party prove that the intentional misrepresentation occurred before the contract was formed.⁵⁴ And finally, the third component requires proof that “the fraud was extraneous to, rather than interwoven with, the contract.”⁵⁵ In other words, fraud that is considered to be extraneous to the contract is not barred by the economic loss doctrine, but fraud that is considered to be interwoven with, or intrinsic to the contract, is barred by the economic loss doctrine.⁵⁶ Thus, a complaint that alleges and proves extraneous fraud can proceed as a tort action; one that alleges only interwoven, or

44. WIS. STAT. § 895.10(2) (2013–2014).

45. *Kaloti*, 2005 WI 111, ¶ 42.

46. *Id.*

47. Wis. JI—Civil 205 (2012); Wis. JI—Civil 2401 (2014).

48. Wis. JI—Civil 2401 (2014).

49. *Id.*

50. *Id.*

51. *Id.*

52. *Id.*

53. *Id.*

54. *Kaloti Enters. v. Kellogg Sales Co.*, 2005 WI 111, ¶ 42, 283 Wis. 2d 555, 699 N.W.2d 205.

55. *Id.*

56. *Id.* ¶ 34.

intrinsic fraud, will be dismissed; and only a breach of contract action, if any, can proceed.⁵⁷

Courts have attempted to sharpen the difference between intrinsic fraud and extraneous fraud by providing various explanatory statements.⁵⁸ For example, a common explanation of the difference is the statement that extraneous fraud concerns matters whose risk and responsibility do not relate to the quality or the characteristics of the goods under contract or otherwise involve performance of the contract.⁵⁹ Thus, it is apparent that the intrinsic/extraneous fraud determination is based on a court identifying the intentional misrepresentation and, then, determining whether the misrepresentation relates to (1) the quality of the product; (2) the characteristics of the product; or (3) otherwise involves performance under the contract.⁶⁰ These are three separate and distinct areas of inquiry that the court must consider when making the intrinsic/extraneous fraud determination.⁶¹

Misrepresentations that relate to the quality of the product or its characteristics are further explained to be either “expressly dealt with in the contract’s terms” or if they are not dealt with explicitly in the contract terms, they go to the reasonable expectations of the parties regarding the risk that the product might not meet the buyer’s expectations.⁶² Stated more succinctly, if the misrepresentation relates to a matter expressly covered by the contract or was a foreseeable risk inherent to the contract, the fraud will be deemed to be intrinsic fraud.⁶³

IV. INTRINSIC FRAUD

When one party has made an intentional misrepresentation that has induced the other party to enter into a contract, it must be determined whether the fraud is intrinsic to the contract or extraneous to it.⁶⁴ That determination is made by identifying the intentional misrepresentation and, then, determining whether the misrepresentation relates to (1) the quality of the product, (2) the characteristics of the product, or (3)

57. *Id.* ¶¶ 34–49.

58. *See* Anzivino, *supra* note 11, at 935.

59. *Kaloti*, 2005 WI 111, ¶ 45.

60. *See* Anzivino, *supra* note 11, at 935.

61. *Id.*

62. *Kaloti*, 2005 WI 111, ¶ 43.

63. *Id.*

64. *Id.* ¶¶ 33–34.

otherwise involves performance under the contract.⁶⁵ If the intentional misrepresentation relates to any of the three criteria, the fraud will be considered to be intrinsic fraud.⁶⁶ The result of an intrinsic fraud determination is that any fraud claim will be barred by the economic loss doctrine, and the aggrieved party can only proceed with a contract claim.⁶⁷ The courts have decided a number of cases under each of the three criteria, and those cases are discussed below.⁶⁸ In addition to discussing the cases in each section, an explanation is provided to assist in distinguishing each criterion from the other.⁶⁹

A. Intentional Misrepresentations that Relate to the Quality of the Product

Any intentional misrepresentations that relate to the quality of the product are considered to be intrinsic fraud.⁷⁰ A review of the cases indicates that this is a complaint about whether the product functioned the way it was represented to function.⁷¹ In other words, when the product fails to perform or operate as represented, the misrepresentation will be deemed to be one regarding the quality of the product.⁷²

For example in *Barden v. Hurd Millwork Co.*,⁷³ buyers bought gas-filled, insulated glass products that were represented to be free from defects for the life of the products.⁷⁴ The buyers complained that the seller made intentional misrepresentations in its brochures and other sales material that falsely represented the insulation value of its products.⁷⁵ The court concluded that the fraud was interwoven with the

65. Anzivino, *supra* note 11, at 935.

66. *Id.*

67. *Id.* at 933.

68. See discussion *infra* Sections IV.1, IV.2, IV.3.

69. See discussion *infra* Sections IV.1, IV.2, IV.3. It should be further noted that a few of the cases could arguably fit into more than one category, but the essential point is that if they fit into any of the three categories, the fraud is intrinsic or interwoven.

70. *Kaloti Enters. v. Kellogg Sales Co.*, 2005 WI 111, ¶ 42, 283 Wis. 2d 555, 699 N.W.2d 205.

71. See discussion *infra* pp. 9–11.

72. See discussion *infra* pp. 9–11.

73. No. 06-C-46, 2006 WL 2560109 (E.D. Wis. Sept. 5, 2006).

74. *Id.* at *2.

75. *Id.*

contract because the fraud related to the quality of the goods that were the subject matter of the contract.⁷⁶

In *Borchardt v. Gore*,⁷⁷ the buyer purchased a used bulldozer from the seller.⁷⁸ At the time of sale, the seller advised the buyer that the seller had replaced various parts in the machine and had no problem operating it after installing the new parts.⁷⁹ The seller's statement was false, and after a few hours of operation, the bulldozer stopped working.⁸⁰ The court dismissed the buyer's fraud claim because the seller's fraud was interwoven with the contract.⁸¹ The court indicated that the alleged fraud went to the quality of the product sold, specifically, the bulldozer's functional ability.⁸²

In *D & B Automotive Equipment, Inc. v. Snap-On, Inc.*,⁸³ a buyer purchased a system called "the Shark," which was a frame-straightening system that would make accurate and consistent measurements when repairing a vehicle.⁸⁴ Unfortunately, the system woefully failed to function as represented.⁸⁵ The buyer's complaint alleged that the seller defrauded the buyer by engaging in a scheme that intentionally misrepresented the capability of the system.⁸⁶ The court concluded that the fraud perpetrated was intrinsic fraud because the entire basis of the fraud claims related to the false statements made about the Shark system.⁸⁷

In *Neuser v. Carrier Corp.*,⁸⁸ a class action was brought by a number of buyers who had purchased new furnaces from the seller.⁸⁹ Although the expected useful life of a furnace is twenty years, the heat exchangers in the furnaces prematurely failed.⁹⁰ The buyers alleged that Carrier knew that the heat exchangers would prematurely fail and fraudulently

76. *Id.* at *4.

77. 2011 WI App 114, 336 Wis. 2d 477, 801 N.W.2d 350 (unpublished disposition).

78. *Id.* ¶ 4.

79. *Id.*

80. *Id.* ¶ 5.

81. *Id.* ¶ 12.

82. *Id.*

83. No. 03-CV-141, 2006 WL 776749 (E.D. Wis. Mar. 27, 2006).

84. *Id.* at *1.

85. *Id.*

86. *Id.* at *2.

87. *Id.* at *5.

88. No. 06-C-645-5, 2007 WL 1470855 (W.D. Wis. Mar. 15, 2007).

89. *Id.* at *3.

90. *Id.* at *1.

withheld such information from the public.⁹¹ The court, however, concluded that the fraud claim could not go forward because the misrepresentation related to the quality of the goods.⁹²

Finally in *U-Line Corp. v. Ranco North America, LP*,⁹³ U-Line purchased V16 valves from Ranco for use in U-Line's refrigeration units.⁹⁴ Subsequently, the valves failed, and U-Line asserted that Ranco made false statements regarding the compatibility of the V16 valve with U-Line's refrigerant.⁹⁵ In addition, U-Line argued that Ranco also committed fraud when it lied about whether other customers were experiencing problems with the valves.⁹⁶ The court concluded that the fraud committed by Ranco was intrinsic fraud because the fraud related to the quality of the valves.⁹⁷

In each of these cases, the essence of the aggrieved party's claim was that the product did not function or operate as it was represented to function. The misrepresentations were deemed to be intrinsic, or interwoven, because these were product representations that could have, and should have, been dealt with in the contract by the aggrieved party.

B. Intentional Misrepresentations About the Characteristics of the Product

Any misrepresentations that relate to the characteristics of a product are also considered to be intrinsic fraud.⁹⁸ These misrepresentations are not about whether the product functioned as represented, but rather, these representations are about whether the product received is the product that was represented.⁹⁹ Stated differently, the misrepresentation is about whether the buyer received the product that was described in the contract and not about the performance of that product. The essence of the buyer's complaint is that the buyer received

91. *Id.*

92. *Id.* at *7.

93. 2006 WI App 78, 292 Wis. 2d 485, 713 N.W.2d 192 (unpublished disposition).

94. *Id.* ¶ 5.

95. *Id.* ¶¶ 15–16.

96. *Id.*

97. *Id.* ¶ 54.

98. *See Digicorp, Inc. v. Ameritech Corp.*, 2003 WI 54, ¶ 48, 262 Wis. 2d 32, 662 N.W.2d 652.

99. *See id.*

a different product than what was represented in the contract negotiations.¹⁰⁰

For example in *S&C Bank v. Wisconsin Community Bank*,¹⁰¹ S&C Bank purchased a portfolio of loans in conjunction with the purchase of a branch of Wisconsin Community Bank.¹⁰² Three of the loans purchased were from a borrower who defaulted shortly after the transaction closed.¹⁰³ At the time of the sale of the branch and its portfolio, the sellers represented that the borrowers on the loans personally guaranteed them.¹⁰⁴ It was subsequently learned that the loans were not guaranteed.¹⁰⁵ Thereafter, S&C sued and asserted a claim for intentional misrepresentation.¹⁰⁶ The court concluded that the fraud committed was intrinsic fraud.¹⁰⁷ In the court's opinion, it was "difficult to imagine a misrepresentation more interwoven with the contract than this one."¹⁰⁸ In other words, the three loans were represented by the seller to be guaranteed loans, but the loans actually sold were not guaranteed loans. The product actually received by the buyer was a different product than the one the seller represented it was selling.

Also in *Bob Thompson & Sons, Inc. v. Van Gorden*,¹⁰⁹ a buyer purchased a large parcel of land on the Chippewa flowage with the intent of subdividing the large parcel and selling individual lots.¹¹⁰ The large parcel was connected to contiguous land by a narrow strip of land that during high water periods would become submerged.¹¹¹ After the sale and as the buyer began to make a roadway over the sometimes submerged land, the Department of Natural Resources (DNR) stopped the construction.¹¹² The DNR indicated that the large parcel was actually an island and not a peninsula as the buyer had anticipated.¹¹³ In

100. *See id.*

101. 2008 WI App 51, 309 Wis. 2d 233, 747 N.W.2d 527 (unpublished disposition).

102. *Id.* ¶¶ 1–2.

103. *Id.* ¶ 2.

104. *Id.* ¶ 15.

105. *Id.* ¶ 17.

106. *Id.* ¶ 19.

107. *Id.* ¶ 27.

108. *Id.*

109. 2010 WI App 1, 322 Wis. 2d 735, 778 N.W.2d 171 (unpublished disposition).

110. *Id.* ¶ 4.

111. *Id.* ¶ 3.

112. *Id.* ¶ 5.

113. *Id.*

the subsequent litigation, it was argued that the seller and the seller's agent intentionally misrepresented the nature of the parcel offered for sale.¹¹⁴ The court concluded that the fraud, if any, was intrinsic because the alleged misrepresentation involved the physical characteristics of the property.¹¹⁵

Similarly in *Shaw v. American State Equipment Co.*,¹¹⁶ a buyer bought a piece of used machinery that the seller represented had 7,000 hours of prior use.¹¹⁷ It was subsequently learned that the machine had 50,000 hours of use at the time of its sale.¹¹⁸ After the discovery of the actual hours on the machine, the buyer sued on an intentional misrepresentation claim seeking to rescind the sale and recover damages.¹¹⁹ The court found that the seller had made an intentional misrepresentation to the buyer.¹²⁰ However, the court dismissed the buyer's fraudulent inducement claim because the fraud committed by the seller was deemed to be intrinsic fraud.¹²¹

Along these same lines in *Voyager Village P.O.A., Inc. v. Letourneau*,¹²² a buyer purchased a vacant lot in a development that was subject to a recorded declaration of covenants.¹²³ Several years later, the buyer received a sales mailer indicating that the Home Owner's Association (the Association) would permit current owners to own up to four lots, and the four lots could be combined to pay only one annual assessment rather than four assessments.¹²⁴ After the buyer purchased three additional lots, the buyer received notice from the Association that he would be required to pay four separate assessments on each of his lots.¹²⁵ The buyer refused to pay the assessments, and the Association sued.¹²⁶ The buyer defended the Association's claim by asserting a counterclaim based on intentional misrepresentation.¹²⁷ The

114. *Id.* ¶ 7.

115. *Id.* ¶ 16.

116. 2007 WI App 138, 302 Wis. 2d 263, 732 N.W.2d 864 (unpublished disposition).

117. *Id.* ¶¶ 2, 5.

118. *Id.* ¶ 5.

119. *Id.* ¶ 2.

120. *Id.* ¶¶ 5, 8.

121. *Id.*

122. 2012 WI App 73, 342 Wis. 2d 250, 816 N.W.2d 351 (unpublished disposition).

123. *Id.* 2.

124. *Id.* ¶ 3.

125. *Id.* ¶ 6.

126. *Id.*

127. *Id.* ¶ 8.

court noted that even if the Association made an intentional misrepresentation, the fraud claim was barred by the economic loss doctrine.¹²⁸ The court reasoned that the fraudulent statements were intertwined in the contract and, thus, intrinsic.¹²⁹ The court specifically noted that the representation regarding the merger of the four lots into the single lot for assessment purposes clearly implicated the characteristics of the lots.¹³⁰

Finally in *Roundy's Supermarkets, Inc. v. Nash-Finch Co.*,¹³¹ Roundy's sold two distribution centers to Nash, and thereafter, Nash failed to pay some post-closing adjustments.¹³² Roundy's sued, and Nash defended the claim by asserting that Roundy's had misrepresented the value of the distribution centers.¹³³ One issue before the court was whether the misrepresentations regarding the value of the distribution centers was intrinsic fraud or extraneous fraud.¹³⁴ The court concluded that any misrepresentations regarding the value of the distribution centers that were the subject of the contract were clearly interwoven in the contract and, thereby, intrinsic.¹³⁵ In other words, the distribution centers that were actually sold were different than what the seller's representations portrayed them to be.¹³⁶

In each of these cases, the essence of the aggrieved party's claim was that the product it received was different than the product it was sold. The misrepresentations were deemed to be interwoven or intrinsic because these were product characteristics that could have, and should have, been dealt with in the contract by the aggrieved party.

C. Intentional Misrepresentations that "Otherwise" Involve Performance Under the Contract

The third criterion to be considered in making the intrinsic/extraneous determination is whether the misrepresentation "otherwise" involves performance under the contract.¹³⁷ "Otherwise"

128. *Id.* ¶ 10.

129. *Id.* ¶ 11.

130. *Id.* ¶ 10.

131. No. 08C0142, 2008 WL 5377907 (E.D. Wis. Dec. 23, 2008).

132. *Id.* at *1.

133. *Id.*

134. *Id.* at *2.

135. *Id.*

136. *Id.*

137. *Kaloti Enters. v. Kellogg Sales Co.*, 2005 WI 111, ¶ 42, 283 Wis. 2d 555, 699 N.W.2d

obviously means that the misrepresentation does not fall within the “quality” or “characteristic” categories,¹³⁸ which have already been explained.¹³⁹ These misrepresentations are not about the functioning or operating capabilities of a product, nor about the description of the product but, rather, are about other performance issues under the contract.¹⁴⁰ There are two different types of circumstances that fall within this third criterion.¹⁴¹ A finding of either circumstance by the court results in a determination of intrinsic fraud.¹⁴² First, are those circumstances where the alleged fraudulent conduct is dealt with in the contract and are not issues of “quality” or “characteristics” about the product.¹⁴³ Essentially, this criterion is the catchall for matters included in the contract but don’t fit into the first two criteria.¹⁴⁴ The second part of the “otherwise” criterion includes those matters or risks that were not dealt with in the contract but should have been because the matter or risk was a foreseeable one.¹⁴⁵ There are a number of cases that illustrate each circumstance.¹⁴⁶

There are three cases that illustrate intrinsic fraud that involve matters that are covered by the contract but are not issues of “quality” or “characteristics.” In *Digicorp, Inc. v. Ameritech Corp.*,¹⁴⁷ Digicorp was an authorized dealer for Ameritech products, and requested approval to sell an Ameritech calling plan called “Value-Link” through a distributor that was not an Ameritech-authorized distributor.¹⁴⁸ Ameritech approved the request, and a contract was negotiated between the parties. The letter identified the sales people of the non-Ameritech-authorized distributor as “1099 employees.”¹⁴⁹ The contract further

205.

138. *Id.*

139. See discussion *supra* Sections IV.1, IV.2.

140. See *Digicorp, Inc. v. Ameritech Corp.*, 2003 WI 54, ¶ 48, 262 Wis. 2d 32, 662 N.W.2d 652.

141. See *id.*

142. See *id.*

143. See *id.*

144. See *id.*

145. *Wausau Tile, Inc. v. Cty. Concrete Corp.*, 226 Wis. 2d 235, 252–53, 593 N.W.2d 445, 454 (1999).

146. See, e.g., *1st Rate Mortg. Corp. v. Vision Mortg. Servs. Corp.*, No. 09-C-471, 2011 WL 666088 (W.D. Wis. Feb. 15, 2011); *Superl Sequoia Ltd. v. C.W. Carlson Co.*, 535 F. Supp. 2d 931 (W.D. Wis. 2008); *Digicorp, Inc.*, 2003 WI 54.

147. 2003 WI 54, 262 Wis. 2d 32, 662 N.W.2d 652.

148. *Id.* ¶ 6.

149. *Id.* ¶ 7.

provided that in the event any calling plan contracts were determined to have forged signatures, Ameritech had the right to terminate the contract.¹⁵⁰ At the time of negotiating the Ameritech-Digicorp contract, Ameritech was aware that one of the non-Ameritech-authorized distributor's sales people had a history of forging customers' names on calling plan contracts.¹⁵¹ Ameritech never disclosed that information to Digicorp.¹⁵² A few weeks after sales began, it was discovered that the sales person—who had a history of committing forgery—had forged nearly 250 customers' signatures.¹⁵³ Pursuant to the contract, Ameritech terminated Digicorp as an authorized distributor.¹⁵⁴ Thereafter, Digicorp sued Ameritech for intentional misrepresentation because of its failure to disclose the history of the salesman that committed the forgeries.¹⁵⁵ The court indicated that its task was to determine whether the fraud involved was extraneous to or interwoven into the contract.¹⁵⁶ The court noted that the misrepresentation did not involve the actual "Value-Link" service that was the primary subject matter of the contract but, rather, which party would bear the risk and responsibility for the 1099 employees.¹⁵⁷ Further, the court indicated that the contract between the parties did address the responsibility for the 1099 employees.¹⁵⁸ As a result, the court concluded that the fraudulent behavior by Ameritech was interwoven with the subject matter of the contract and intrinsic fraud.¹⁵⁹ The court reasoned that Ameritech's misrepresentation concerned a matter that related to the performance of the contract and, as such, was not extraneous to the contract dispute.¹⁶⁰

Similarly in *Superl Sequoia Ltd. v. C.W. Carlson Co.*,¹⁶¹ the parties entered into a joint venture enterprise, and they agreed that they would

150. *Id.* ¶ 8.

151. *Id.* ¶ 6.

152. *Id.*

153. *Id.* ¶ 10.

154. *Id.* ¶ 11.

155. *Id.* ¶ 12.

156. *Id.* ¶ 53.

157. *Id.* ¶ 54.

158. *Id.* ¶ 60.

159. *Id.* ¶ 62.

160. *Id.*

161. 535 F. Supp. 2d 931 (W.D. Wis. 2008), *partial summary judgment granted by, partial summary judgment denied by*, *Superl Sequoia Ltd. v. C.W. Carlson Co.*, No. 07-CV-640-BBC, 2008 WL 2940734 (W.D. Wis. Jul. 22, 2008).

share gross profits equally after both parties were reimbursed for their costs.¹⁶² Prior to the formation of the contract, representations were made regarding how each party would calculate its costs before sharing profits.¹⁶³ Thereafter, plaintiff did not calculate its costs according to the pre-contractual representations, which became the basis of the defendant's fraudulent inducement claim.¹⁶⁴ The parties' contract, however, did provide a definition on how costs were to be calculated under the joint venture.¹⁶⁵ Because the contract did specifically address the alleged fraud in the inducement, the court concluded that the fraud was interwoven into the contract and, thus, intrinsic fraud.¹⁶⁶

Finally in *1st Rate Mortgage Corp. v. Vision Mortgage Services Corp.*,¹⁶⁷ a part owner of 1st Rate Mortgage's (1st Rate) business negotiated a buyout of his interest with the other owners while indicating that he was leaving the mortgage business.¹⁶⁸ Unbeknownst to the other owners of 1st Rate Mortgage, the departing owner was secretly forming his own mortgage business and began soliciting 1st Rate's customers.¹⁶⁹ 1st Rate sued the departing owner and alleged fraud as one of its claims.¹⁷⁰ The court concluded that when the fraud claim is based on the same conduct as the breach of contract claim, the economic loss doctrine bars the tort claim.¹⁷¹ Essentially, if the contract covers the conduct, the contractual remedy is the sole remedy and not tort law.¹⁷²

Furthermore, there are two cases that illustrate those matters or risks that were not dealt with in the contract but should have been because the matter or risk was a foreseeable one. In *Schreiber Foods, Inc. v. Lei Wang*,¹⁷³ an American seller and an agent for a Chinese entity negotiated the sale of 200 tons of whey powder.¹⁷⁴ The seller subsequently shipped a different composition of whey to the buyer, and

162. *Superl*, 535 F. Supp. 2d at 933.

163. *Id.* at 935.

164. *Id.*

165. *Id.*

166. *Id.*

167. No. 09-C-471, 2011 WL 666088 (E.D. Wis. Feb 15, 2011).

168. *Id.* at *6.

169. *Id.* at *1.

170. *Id.*

171. *Id.* at *6.

172. *Id.*

173. 651 F.3d 678 (7th Cir. 2011).

174. *Id.* at 679.

the buyer refused to pay for the shipment.¹⁷⁵ Thereafter, the seller sued the agent for fraudulent inducement on the grounds that the Chinese buyer never intended to buy the whey despite the agent's representations to the contrary.¹⁷⁶ The agent moved for summary judgment on the fraud claim on the basis that the claim was barred by the economic loss doctrine.¹⁷⁷ The court indicated that the risk of nonpayment was so obvious a risk that it should have been dealt with in the contract.¹⁷⁸ The court further indicated that extraneous frauds are those risks that one would not expect to deal with in the contract.¹⁷⁹ Thus, the risk of nonpayment should have been dealt with in the contract, and any fraud relating to payment would be considered intrinsic fraud.

In *Taurus IP, LLC v. DaimlerChrysler Corp.*,¹⁸⁰ Taurus brought an action against DaimlerChrysler and Mercedes-Benz alleging patent infringement.¹⁸¹ In response, DaimlerChrysler pled a counterclaim for fraudulent inducement on the basis that in prior patent infringement litigation between DaimlerChrysler and entities related to plaintiff, a comprehensive settlement agreement was reached whereby all patent disputes between the parties were resolved.¹⁸² Unknown to DaimlerChrysler at the time of the negotiation of the prior settlement agreement, the '658 patent, which was the subject matter of this litigation, was transferred to a related entity that was not bound by the prior settlement agreement.¹⁸³ Taurus moved to dismiss the fraudulent inducement claim as barred by the economic loss doctrine.¹⁸⁴ The court agreed that the tort claim should be barred because the fraudulent inducement claim related to the scope of the settlement agreement.¹⁸⁵ As a result, the fraud was found to be interwoven with the contract.¹⁸⁶

175. *Id.* at 680.

176. *Id.* at 679–80.

177. *Id.* at 679.

178. *Id.* at 683.

179. *Id.* at 682.

180. 519 F. Supp. 2d 905 (W.D. Wis. 2007); *patent interpreted by* Taurus IP, LLP v. DaimlerChrysler Corp., 07-C-158-C, 2007 U.S. Dist. LEXIS 83510 (W.D. Wis. Oct. 15, 2007); *aff'd* by 726 F.3d 1306, 2013 U.S. App. (Fed. Cir. 2013).

181. *Taurus*, 519 F. Supp. 2d at 911.

182. *Id.* at 927.

183. *Id.*

184. *Id.*

185. *Id.* at 928.

186. *Id.*

The court reasoned that DaimlerChrysler should have ensured greater protection from future lawsuits by bargaining for a broader definition of licensed technology in the settlement agreement.¹⁸⁷ DaimlerChrysler's failure to protect itself in the contract from a foreseeable risk caused the fraud to be categorized as intrinsic fraud.¹⁸⁸

As illustrated, there are two different types of circumstances that fall within this "otherwise" or third criterion. First, are those circumstances where the alleged fraudulent conduct is dealt with in the contract and are not issues of "quality" or "characteristics" about the product. Second, are those circumstances where the contract fails to deal with foreseeable matters or risks that were not dealt with in the contract, but should have been because the matter or risk was a foreseeable one. A finding of either circumstance by the court results in a determination of intrinsic fraud.

V. EXTRANEOUS FRAUD

In 2005, the Wisconsin Supreme Court adopted the intrinsic/extraneous fraud distinction for claimants asserting fraud in the inducement in the case of *Kaloti Enterprises v. Kellogg Sales Co.*¹⁸⁹ In *Kaloti*, Kaloti was a wholesaler who purchased cookies from Kellogg to subsequently resell to retail grocery stores.¹⁹⁰ Kellogg and Kaloti had a prior course of dealing with each other.¹⁹¹ At some point, Kellogg decided to change its marketing approach and intended to sell directly to the retail grocery stores rather than through wholesalers.¹⁹² Thereafter, Kellogg solicited a large sale of cookies to Kaloti without disclosing that Kellogg had changed its marketing approach, which would essentially eliminate the ability of Kaloti to resell its cookies to the grocery stores.¹⁹³ In fact, after Kaloti paid for the cookie order, Kaloti's major customers advised Kaloti that they would no longer be buying cookies from Kaloti, but rather, they would be buying them directly from Kellogg.¹⁹⁴ Because Kaloti was unable to resell the

187. *Id.*

188. *See id.*

189. 2005 WI 111, 283 Wis. 2d 555, 699 N.W.2d 205.

190. *Id.* ¶ 4.

191. *Id.* ¶ 3.

192. *Id.* ¶ 5.

193. *Id.* ¶ 6.

194. *Id.* ¶ 7.

cookies, Kaloti suffered a loss in the amount of \$100,000.¹⁹⁵ Kaloti sued to recover its loss on the theory that Kellogg's failure to disclose the change in marketing strategy constituted fraud in the inducement to the cookie contract.¹⁹⁶ Kellogg defended on the ground that Kellogg had no duty to disclose its change in marketing strategy to Kaloti, and in either event, the economic loss doctrine barred Kaloti's misrepresentation tort claim.¹⁹⁷ The court concluded Kellogg did have a duty to disclose its change in marketing strategy to Kaloti.¹⁹⁸ As a result, Kellogg's failure to disclose constituted a fraudulent inducement that induced Kaloti to enter into the cookie agreement.¹⁹⁹ Nevertheless, Kellogg asserted that, because Kaloti's damages were solely economic, the economic loss doctrine barred any tort claim, including fraud in the inducement, by Kaloti.²⁰⁰ The Wisconsin Supreme Court disagreed and adopted the narrow fraud in the inducement exception to the economic loss doctrine.²⁰¹ In other words, only fraud in the inducement claims that are extraneous to the parties' contract are actionable in tort.²⁰² The court defined extraneous fraud as fraud that "concerns matters whose risk and responsibility [do] *not* relate to the quality or the characteristics of the goods for which the parties contracted, or otherwise involves performance of the contract."²⁰³ Essentially, the court's definition was that extraneous fraud is simply not intrinsic fraud.²⁰⁴ However, the court provided a more useful indication of extraneous fraud when it stated that the relevant inquiry is to examine the relationship between the inducing representation and the essential requirements of the contract.²⁰⁵ Stated differently, if the inducing misrepresentation concerns matters or risks that are dealt with in the contract or should have been dealt with in the contract because the matter or risk was foreseeable, the misrepresentation is intrinsic fraud.²⁰⁶ On the other hand, if the inducing misrepresentation does not concern matters or

195. *Id.* ¶ 9.

196. *Id.*

197. *Id.* ¶ 1.

198. *Id.* ¶ 22.

199. *Id.* ¶ 6.

200. *Id.* ¶ 27.

201. *Id.* ¶ 42.

202. *Id.*

203. *Id.* (emphasis added).

204. *Id.*

205. *Id.*

206. *Id.* ¶ 43.

risks that are dealt with in the contract or matters or risk that were not foreseeable at the time of contracting, the misrepresentation is extraneous fraud.²⁰⁷ Applying the extraneous fraud standard to the case, the court concluded that the intentional misrepresentation committed by Kellogg was extraneous fraud.²⁰⁸ The court remarked that the inducing misrepresentation did not concern any performance under the contract, nor the quality or characteristics of the cookies sold.²⁰⁹ Rather, the court noted that the inducing misrepresentation related to a matter or risk that was never contemplated to be part of the contract.²¹⁰ Further, the court reasoned that the change in marketing strategy is not a matter that was dealt with in the contract, nor would one expect that to have been dealt with in the contract.²¹¹ To further amplify the difference between intrinsic fraud and extraneous fraud after *Kaloti*, another court quipped that had the Rice Krispy treats that Kellogg sold to Kaloti turned out to be strawberry rice bubbles (an Australian version of the Rice Krispy treat) that would have been intrinsic fraud.²¹²

After *Kaloti*, there are a few other cases that have found extraneous fraud. In *Wickenhauser v. Lehtinen*,²¹³ the Wisconsin Supreme Court was again faced with the intrinsic/extraneous fraud determination. In *Wickenhauser*, the Wickenhausers, who had a farming operation, borrowed money from Lehtinen on a number of occasions and gave Lehtinen a mortgage on their 300-acre parcel to secure their loans.²¹⁴ Thereafter, Lehtinen presented an option to purchase to the Wickenhausers, which gave Lehtinen the right to purchase the 300 acres for three years.²¹⁵ Lehtinen told the Wickenhausers that he would not record the option and that the option was just a form of additional collateral to secure their loans.²¹⁶ Thereafter, Lehtinen exercised the option and the Wickenhausers refused to sell.²¹⁷ In the prior case between the same parties, the court ruled for the Wickenhausers and

207. *Id.*

208. *Id.* ¶ 45.

209. *Id.*

210. *Id.*

211. *Id.*

212. *White v. Marshall*, 693 F. Supp. 2d 873, 880 (E.D. Wis. 2009).

213. 2007 WI 82, 302 Wis. 2d 41, 734 N.W.2d 855.

214. *Id.* ¶ 4.

215. *Id.* ¶ 5.

216. *Id.*

217. *Id.* ¶ 6.

rescinded the option.²¹⁸ In this case, the Wickenhausers sought damages for the alleged fraud committed by Lehtinen in inducing them to grant the option to purchase.²¹⁹ The court noted that the Wickenhausers' claim was for an intentional misrepresentation that induced them to grant the option to Lehtinen.²²⁰ Further, the court reasoned that the fraud was extraneous because the inducing misrepresentations related to the option to purchase and did not relate to the loan contract, which was the primary contractual relationship between the parties.²²¹ As a result, the tort case was permitted to go forward.²²²

A less convincing case of extraneous fraud is *Triad Group, Inc. v. Vi-Jon, Inc.*²²³ In *Triad*, Vi-Jon and Triad had an ongoing relationship whereby Vi-Jon provided raw materials to Triad, Triad would purchase additional raw materials, and then Triad would manufacture a final product for Vi-Jon.²²⁴ In 2011, the parties again entered into a continuing contractual relationship for the manufacture by Triad of the final product.²²⁵ Subsequently, the government seized a number of products at Triad's production facility due to contamination.²²⁶ As a result of the seizure, Vi-Jon terminated its contract with Triad, and litigation ensued between the parties.²²⁷ During the litigation, Vi-Jon alleged that Triad committed fraud in the inducement because at the time of renewing their contractual relationship, Triad failed to disclose a pending FDA investigation to Vi-Jon.²²⁸ The court concluded that Triad's fraud was extraneous because Vi-Jon's complaint was not about the completed product, but rather, it was about Triad's inability to perform on the contract.²²⁹ It is true that the complaint was not about the quality of the completed product or its characteristics.²³⁰ But, the third criterion for intrinsic fraud is about performance under the

218. *Id.* ¶ 1.

219. *Id.* ¶ 7.

220. *Id.* ¶ 41.

221. *Id.*

222. *Id.*

223. 870 F. Supp. 2d 645 (E.D. Wis. 2012).

224. *Id.* at 648.

225. *Id.*

226. *Id.*

227. *Id.*

228. *Id.* at 652.

229. *Id.* at 653.

230. *Id.*

contract, to which Triad's fraud is directly related.²³¹ In fact, the court acknowledged that Vi-Jon's complaint was "closely related to Triad's performance on the contract."²³² Although the court stated that the fraud in Triad was akin to the fraud in *Kaloti*, the cases are really not parallels. The standard set by *Kaloti* is to examine the relationship between the inducing misrepresentation and the essential requirements of the contract.²³³ The inducing misrepresentation in *Kaloti* was the failure to disclose a change in marketing strategy that would affect Kaloti's ability to resell the cookies to a third party.²³⁴ No one would have expected Kaloti to address in its contract, with Kellogg, any issues about Kaloti's ability to sell its cookies to third parties. On the other hand, in *Triad* the inducing misrepresentation was directly about Triad's ability to perform on the contract between Triad and Vi-Jon.²³⁵ Vi-Jon should have protected itself with warranties regarding performance under the contract. Performance issues would certainly be foreseeable ones that should have been addressed in the contract, and any fraud related to performance issues is intrinsic fraud. It is certainly arguable whether *Triad* is truly a credible case of extraneous fraud.

On the other hand, in *Zimmerman v. Logemann*,²³⁶ a court found both intrinsic fraud and extraneous fraud in the same transaction. In *Zimmerman*, the Zimmermans alleged that their mortgage broker, appraiser, and lenders falsified plaintiffs' financial information and knowingly inflated the appraisal of the property the Zimmermans wished to purchase in order to dupe them into accepting a home loan that they could not afford.²³⁷ The Zimmermans sued the defendants on a number of theories including fraud in the inducement.²³⁸ The Zimmermans identified the following misrepresentations as the basis of their fraudulent inducement claim:

- (1) defendants . . . promised plaintiffs that the monthly mortgage payment would be less than \$ 1000;
- (2) defendants . . . inflated plaintiffs' income on the application

231. *Id.*

232. *Id.*

233. *Kaloti Enters. v. Kellogg Sales Co.*, 2005 WI 111, ¶ 42, 283 Wis. 2d 555, 699 N.W.2d 205.

234. *Id.* ¶ 9.

235. *Triad*, 870 F. Supp. 2d at 653.

236. No. 09-CV-210-slc, 2009 WL 4407205 (W.D. Wis. Nov. 30, 2009).

237. *Id.* at *1.

238. *Id.* at *4.

- form without their knowledge;
- (3) defendants . . . promised plaintiffs that refinancing would be available the following year;
 - (4) defendants . . . knowingly appraised the property at higher than fair market value;
 - (5) defendants represented to plaintiffs that they qualified for the mortgage;
 - (6) defendants failed to disclose that one of the mortgages included a prepayment penalty;
 - (7) defendants failed to disclose that one of the mortgages contained a balloon payment;
 - (8) defendants failed to “check or confirm” plaintiffs’ income before approving the loan.²³⁹

The *Kaloti* test for distinguishing intrinsic from extraneous fraud is to examine the relationship between the inducing misrepresentation and the essential requirements of the contract.²⁴⁰ If there is a relationship, and the matter is or should have been covered by the contract, the fraud is intrinsic.²⁴¹ In *Zimmerman*, the contract entered into by the Zimmermans was a mortgage contract.²⁴² The court first noted that the misrepresentations about the mortgage payment being less than \$1,000 (#1), the failure to disclose the prepayment penalty (#6), and the failure to disclose the balloon payment (#7) were about the terms of the mortgage and, as such, were clearly intrinsic fraud.²⁴³ Further, the court observed that the defendants failure to “check or confirm” plaintiffs’ income before approving the loan (#8) was not a misrepresentation at all but a failure to act.²⁴⁴ Finally, the court concluded that items (#2)–(#5) were extraneous fraud.²⁴⁵ Clearly, inflating the Zimmermans’ income on the application form (#2), artificially inflating the value of the appraisal (#4), and advising the Zimmermans that they qualified for the loan (#5) were not matters that were or would be expected to be in the loan contract, and as such, they were fairly determined to be extraneous fraud. The misrepresentation regarding the promise that refinancing

239. *Id.* at *9.

240. *Kaloti Enters. v. Kellogg Sales Co.*, 2005 WI 111, ¶ 42, 283 Wis. 2d 555, 699 N.W.2d 205.

241. *Id.* ¶¶ 34, 42.

242. *Zimmerman*, 2009 WL 4407205 at *3.

243. *Id.* at *9.

244. *Id.*

245. *Id.*

would be available the following year (#3) is not a factual representation at all but, rather, a statement about the future and, as such, cannot be the basis of a fraudulent misrepresentation.²⁴⁶ Nevertheless, the *Zimmerman* case is an excellent illustration of how a court distinguishes intrinsic fraud from extraneous fraud.

VI. PROTECTING YOUR CLIENT FROM AN INTRINSIC FRAUD DETERMINATION

A review of the preceding cases makes clear that a finding of intrinsic fraud is the most likely outcome when the issue before the court is whether the fraud is intrinsic or extraneous. In fact, it is logical to expect that most fraud would be about the quality of the product, the product's characteristics, or other bargained for performances expected under the contract. The effect of such a finding is that the fraud claim is barred by the economic loss doctrine and the sole remedy remaining for the aggrieved party is to sue for breach of contract.²⁴⁷ Unfortunately, in many cases the aggrieved party's attorney did not anticipate an intrinsic fraud finding by the court and did not lay the basis for a breach of contract action.²⁴⁸ As a result, the client is often left without a remedy against the perpetrator, and the only remaining remedy is to sue the offending attorney for malpractice.

There are many cases that expose this failure to prepare the contract claim as a backup to the tort claim in the event the court determines that the alleged fraud is intrinsic fraud. In *Shaw v. American State Equipment Co.*,²⁴⁹ the buyer purchased a piece of used machinery from the seller who represented that the machine had 7,000 hours of prior use.²⁵⁰ Upon learning that the machine had 50,000 hours of use,²⁵¹ the buyer sued for intentional misrepresentation.²⁵² The lower court awarded the buyer \$60,000 in damages on the tort claim.²⁵³ On appeal, the court concluded that the intentional misrepresentation was intrinsic

246. Wis. JI—Civil 2401 (2014).

247. *Kaloti Enters. v. Kellogg Sales Co.*, 2005 WI 111, ¶¶ 34–35, 283 Wis. 2d 555, 699 N.W.2d 205.

248. See *Budgetel Inns v. Micros Sys., Inc.*, 8 F. Supp. 2d 1137 (E.D. Wis. 1998).

249. 2007 WI App 138, 302 Wis. 2d 263, 732 N.W.2d 864 (unpublished disposition).

250. *Id.* ¶ 5.

251. *Id.*

252. *Id.* ¶ 1.

253. *Id.* ¶ 2.

fraud,²⁵⁴ reversed the lower court award, and dismissed the buyer's complaint.²⁵⁵ The buyer's complaint did not allege a backup claim for breach of contract.²⁵⁶

In *Gould v. Mitchell*,²⁵⁷ Gould entered into an investment agreement based on representations that his monies would be used to pay attorney's fees and develop prototypes; that the company had been in business for 10 years; and that the company had several new products at various stages of development.²⁵⁸ All these representations were false.²⁵⁹ Upon discovery of the false representations, Gould sued in tort, alleging fraud.²⁶⁰ The court concluded that the fraud was intrinsic fraud and affirmed the dismissal of Gould's tort action.²⁶¹ Gould's complaint did not allege a backup claim for breach of the investment contract.²⁶²

In *Creekwood Farms, Inc. v. Daybreak Foods, Inc.*,²⁶³ the buyer and seller entered into a contract for the sale of the seller's business.²⁶⁴ The contract anticipated that the buyer would need to secure financing to complete the sale.²⁶⁵ Prior to signing the contract, the buyer made representations that it would not be a problem for the buyer to secure financing.²⁶⁶ Based on that representation, the seller entered into the contract.²⁶⁷ At the time of the signing of the contract, however, the buyer failed to disclose that the buyer had to sell another property in order to get the financing.²⁶⁸ When the buyer failed to secure financing, the seller sued the buyer for fraud, breach of good faith, and breach of best efforts.²⁶⁹ The lower court dismissed the seller's complaint.²⁷⁰ On appeal, the appeals court affirmed the dismissal of the fraud claim on

254. *Id.* ¶ 5.

255. *Id.* ¶ 8.

256. *See id.*

257. 2014 WI App 16, 352 Wis. 2d 575, 842 N.W.2d 537 (unpublished disposition).

258. *Id.* ¶¶ 13–14.

259. *Id.* ¶ 5.

260. *Id.* ¶ 6.

261. *Id.* ¶ 1.

262. *See id.*

263. 2007 WI App 34, 299 Wis. 2d 783, 728 N.W.2d 374 (unpublished disposition).

264. *Id.* ¶ 3.

265. *Id.*

266. *Id.* ¶ 2.

267. *Id.* ¶¶ 2–3.

268. *Id.* ¶ 2.

269. *Id.* ¶ 4.

270. *Id.* ¶ 1.

the basis that the alleged fraud was intrinsic fraud and barred by the economic loss doctrine.²⁷¹ The court also found no merit in the breach of best efforts and good faith claims.²⁷² Again, the contract was not drafted so as to anticipate an intrinsic fraud finding and preserve a breach of contract claim.²⁷³

These cases and others like them indicate that the unmistakable tort claim can be fool's gold in that the attorney's primary focus is on the fraudulent misrepresentation, when it should have originally been on the contract. A misrepresentation is not a breach of contract.²⁷⁴ Rather, to make a misrepresentation a breach of contract, the representation must be brought into the contract.²⁷⁵ This point is particularly compelling when one is dealing with intrinsic fraud. A finding of intrinsic fraud means that the misrepresentation claim is dismissed pursuant to the economic loss doctrine, and if that representation has not been brought into the contract, there is also no breach of contract claim.²⁷⁶ For example in *Shaw*, if the contract contained the simple representation that the machine had 7,000 hours use, the case could have proceeded on a contract claim even though it was dismissed as a tort claim. Also in *Gould*, had the various representations made by the seller been brought into the contract, the case would have proceeded as a breach of contract action despite the dismissal of the tort claim. Because of the likelihood that most misrepresentations will be found to be intrinsic fraud, it is essential that the attorney incorporate any and all representations made by the other party into the contract to provide a basis for a breach of contract action.

The case of *S&C Bank v. Wisconsin Community Bank*,²⁷⁷ illustrates the wisdom of having a breach of contract action as a backup claim in the event the court dismisses the fraud claim as intrinsic fraud. In *S&C*, S&C Bank purchased a bank branch from Wisconsin Community Bank.²⁷⁸ Also involved in the sale was Wisconsin Community Bank's parent bank, Heartland Bank.²⁷⁹ During the sale, several loans that

271. *Id.* ¶ 8.

272. *Id.* ¶ 9.

273. *Budgetel Inns v. Micros Sys., Inc.*, 8 F. Supp. 2d 1137 (E.D. Wis. 1998).

274. *White v. Marshall*, 693 F. Supp. 2d 873, 882 (E.D. Wis. 2009).

275. *Id.*

276. *Id.*

277. 2008 WI App 51, 309 Wis. 2d 233, 747 N.W.2d 527.

278. *Id.* ¶ 1.

279. *Id.* ¶ 11.

were in Wisconsin Community's portfolio were represented to be guaranteed loans, which turned out to be false.²⁸⁰ Upon default of those loans, S&C brought an action against Wisconsin Community for breach of contract and against Heartland for intentional misrepresentation.²⁸¹ At trial, the jury awarded \$2.1 million against each defendant.²⁸² Both appealed and on appeal, the court determined that the fraud committed by Heartland was intrinsic fraud.²⁸³ The result of the intrinsic fraud finding was that the intentional misrepresentation claim against Heartland was barred by the economic loss doctrine.²⁸⁴ Significantly, however, the \$2.1 million judgment against Wisconsin Community that was based on the breach of contract theory was affirmed.²⁸⁵ This case illustrates the fact that an attorney can no longer rely upon a fraud theory to remedy a wrong committed against a client. It is absolutely essential to include any and all representations into the contract because the fraud claim, in all likelihood, will be barred by the economic loss doctrine.

Placing greater emphasis on including any and all representations into the contract only addresses part of the problem presented by an intrinsic fraud finding. It has always been a foundational principle of contract drafting to include in the contract the representations and warranties relied upon in forming the contract. Now, much greater importance is placed upon that principle because any fraud claim, unless it is extraneous fraud, will be dismissed. But an even more problematic part of the intrinsic fraud issue is the situation where a party fails to disclose a material fact. For example in the *Creekwood* case noted above, the buyer never disclosed to the seller that there were limits on the ability of the buyer to get financing, and the seller went forward with the contract without the knowledge of those limitations.²⁸⁶ Eventually, the buyer was unable to get financing because of the undisclosed limitations, and the seller sued the buyer for the fraud committed by concealing the limitations.²⁸⁷ The court concluded that the fraud was

280. *Id.* ¶ 19.

281. *Id.*

282. *Id.* ¶ 20.

283. *Id.* ¶ 27.

284. *Id.* ¶ 4.

285. *Id.*

286. *Creekwood Farms, Inc. v. Daybreak Foods, Inc.*, 2007 WI App. 34, ¶ 2, 299 Wis. 2d 783, 728 N.W.2d 374 (unpublished disposition).

287. *Id.* ¶ 4.

intrinsic fraud and dismissed the tort claim.²⁸⁸ Absent a breach of contract claim as an alternative to the tort claim, Creekwood's complaint was dismissed.²⁸⁹

The way to address this problem is to turn a failure to disclose a material fact into a breach of contract. An example of a clause that is neutral and would accomplish this task is as follows: Both parties understand that they each have a duty to disclose any and all material facts about this transaction to the other party, and each hereby represents that each party has disclosed any and all material facts about this transaction to the other party.

The simple inclusion of the foregoing clause will cause a failure to disclose a material fact to become a breach of contract and avoid the trap of an intrinsic fraud determination. In sum, an attorney can avoid the perils of an intrinsic fraud finding by simply following two simple recommendations. First, it is imperative to include any and all representations made between the parties into the contract, which will thereby lay the basis, if needed, for a breach of contract action. Second, it is just as important to include a clause, such as the foregoing, in every contract, which will thereby ensure that the other party's failure to disclose material information will be a breach of contract. Such an approach will insure that either an affirmative misrepresentation or a failure to disclose a material fact will support a breach of contract action and protect your client from an intrinsic fraud determination that dismisses the tort claim.

VII. CONCLUSION

Far too often, one party fraudulently induces another to enter into a contract by either affirmatively misrepresenting or by failing to disclose a material fact. Naturally, an attorney's first instinct is to remedy the wrong through a fraudulent inducement claim. Unfortunately, when the only damages suffered are economic, as opposed to personal injury or property damage, the economic loss doctrine will most likely be used to preclude the tort remedy.²⁹⁰ Wisconsin courts permit a fraudulent inducement claim to go forward only when the fraudulent conduct is

288. *Id.* ¶ 8.

289. *Id.* ¶ 1.

290. *Digicorp, Inc. v. Ameritech Corp.*, 2003 WI 54, ¶ 45, 262 Wis. 2d 32, 662 N.W.2d 652.

considered to be extraneous as opposed to intrinsic.²⁹¹ Since intrinsic fraud concerns any fraud related to the quality or character of the product or other performance under the contract, most fraudulent inducements claims are intrinsic fraud.²⁹²

The net effect of an intrinsic fraud determination is that the only remaining remedy is through a breach of contract action.²⁹³ In most cases, the parties contract will not have anticipated a fraud being perpetrated in the transaction and may not support a breach of contract action.²⁹⁴ With the advent of this intrinsic/extraneous fraud determination, it is essential that the attorney has prepared the contract with the possibility that intrinsic fraud may have been an inducement to the contract.

There are two means available to an attorney to preserve a breach of contract action in the event intrinsic fraud has been committed. First, the attorney must insert in the contract any and all representations that may have been a basis of the contract for the client. Although that has always been a primary principle in contract drafting, it has become even more important with the advent of intrinsic fraud. Second, it is also as important to insert a clause that will require each party to disclose any and all material facts about the transaction and to represent that they have done so. By following these two simple recommendations, the attorney will have done everything possible to preserve a breach of contract action in the event of an intrinsic fraud determination by a court.

291. *Kaloti Enters. v. Kellogg Sales Co.*, 2005 WI 111, ¶ 42, 283 Wis. 2d 555, 699 N.W.2d 205.

292. *Id.*

293. *Id.* ¶ 34.

294. *Budgetel Inns, Inc. v. Micros Sys.*, 8 F. Supp. 2d 1137 (E.D. Wis. 1998).