Appeal No. 03-1225 **Cir. Ct. No. 02CV000893**

WISCONSIN COURT OF APPEALS
DISTRICT II

KALOTI ENTERPRISES, INC.,

PLAINTIFF-APPELLANT,

V.

KELLOGG SALES COMPANY AND GERACI & ASSOCIATES, INC.,

DEFENDANTS-RESPONDENTS.

FILED

May 12, 2004

Cornelia G. Clark
Clerk of Supreme Court

CERTIFICATION BY WISCONSIN COURT OF APPEALS

Before Anderson, P.J., Brown and Nettesheim, JJ.

Pursuant to WIS. STAT. RULE 809.61 this court certifies the appeal in this case to the Wisconsin Supreme Court for its review and determination.

ISSUES

(1) Whether this case presents a ***Huron Tool***[1]-type cause of action and, if so, whether Wisconsin recognizes or should recognize a ***Huron Tool*** fraud-in-the-inducement exception to the economic loss doctrine.

(2) Whether a duty to disclose facts arises between a sophisticated seller and a sophisticated buyer in a commercial transaction where the parties have an

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[1] ***Huron Tool and Eng'g Co. v. Precision Consulting Servs., Inc.***, 532 N.W.2d 541 (Mich. Ct. App. 1995).

established course of business and the facts pertain to a change in the course of business.

FACTS

This is an appeal of a motion to dismiss for failure to state a claim, and therefore, we accept as true, for purposes of this certification, the following facts from the complaint. This case arose out of a commercial transaction for the sale and purchase of certain Kellogg Company food products. The complaint states that at all times material to the action, Kellogg Sales Company was a wholly owned subsidiary of the Kellogg Company and that Geraci & Associates, Inc. acted as Kellogg's agent or broker. Kaloti Enterprises, Inc. is a Wisconsin corporation that does business as a wholesaler of food products. Geraci had acted as the broker for Kellogg in various transactions with Kaloti over a number of years. According to the complaint, each of the transactions took substantially the same form, which can be plainly stated as follows: Geraci, as a broker for Kellogg, would approach and sell Kellogg products to Kaloti. In doing so, Geraci negotiated for Kellogg all elements of the transaction, including product specifics, price, delivery dates, allowances, terms of sale and all other matters relating to the purchases of food products. The orders Geraci procured from Kaloti were ultimately subject to acceptance by Kellogg and Geraci acted as agent for Kellogg, its disclosed principal. In the course of the above-described transactions, and in each case, following the negotiation of contract terms between Geraci and Kaloti, Kellogg would ship the agreed upon product directly to Kaloti and utilize Fleming Marshfield, Inc. as a billing intermediary.

The complaint alleges that through these transactions, a course of dealing arose between Kaloti, Kellogg and Geraci and all parties were aware of all

matters respecting these transactions. Specifically, Kellogg was aware, either directly or through Geraci that the products being purchased by Kaloti were to be marketed by Kaloti as a secondary supplier to large market stores.

In the early Spring of 2001, Kellogg acquired Keebler Foods Company and the merged entity become known as Kellogg-Keebler. The complaint alleges that during or subsequent to the acquisition of Keebler, Kellogg had made certain business decisions with respect to the discontinuance of certain Kellogg products and the manner in which then-existing Kellogg products would be marketed. The complaint further states that among these decisions was the determination to market its products in a new manner. The alteration to the marketing scheme was such that, after Kellogg's acquisition of Keebler, the products would be marketed directly through the manufacturer as opposed to being marketed, as it had been, through distributors or wholesalers.

In May 2001, Geraci solicited for Kellogg an order from Kaloti, known as a quarterly promotion order, for the purchase of $124,000 worth of products. Kaloti asserted that it had purchased the products with the basic understanding that it would market the product, as it had in prior instances, as a secondary supplier to large major stores and that in purchasing the products, it had relied on those markets being available. Kaloti alleged that both Kellogg and Geraci knew that the order was known as a quarterly promotion order and accordingly it would take Kaloti at least three months to distribute and/or sell the products it purchased.

Kellogg delivered the product to Kaloti on June 1, 2001. Following delivery, Fleming-Marshfield sent an invoice to Kaloti, which Kaloti subsequently paid. On June 14, Kaloti was notified by its customers in its traditional markets

that they would no longer purchase the products from Kaloti because Kellogg, in connection with its new marketing and distribution scheme, was now marketing the products directly.

According to the complaint, on June 15 a representative of Geraci informed an employee of Kaloti that the reason Geraci had not advised Kaloti of the marketing shift was that Geraci was under a confidentiality contract with respect to Kellogg's new marketing strategy. Kaloti alleges that Kellogg's concealment of its new marketing policy was material and intentional. Further, the complaint states that Kellogg and Geraci knew that when Kaloti placed its order, it was relying upon its prior ability to market and sell the products as a secondary supplier to major stores and that Kellogg's shift in the marketing of the products would shut out Kaloti from the markets it traditionally turned to for business.

Finally, the complaint states that on June 15, Kaloti advised Kellogg and Geraci that it would not have placed the May order or accepted delivery of the products if it had known of the change in Kellogg's marketing scheme and gave timely notice to Kellogg and Geraci of its rescission of its order. Kellogg has refused to accept delivery of the rescinded products and to reimburse Kaloti for the amount it had already paid. Kaloti subsequently initiated a lawsuit against Kellogg.

The seven-count complaint alleged intentional misrepresentation, strict responsibility misrepresentation, negligent misrepresentation, rescission resulting from mistake, conspiracy, rescission resulting from impossibility or impracticability and breach of contract. Following briefing and a motions hearing,

the circuit court dismissed the entire complaint. Kaloti appeals from the dismissal of its intentional misrepresentation claim only.

DISCUSSION

This appeal presents the court with the opportunity to resolve several important issues of first impression in Wisconsin. First, this case raises the two-part question the court declined to resolve in ***Tietsworth v. Harley-Davidson, Inc.***, 2004 WI 32, No. 02-1034: (1) what is the scope of the ***Huron Tool*** fraud-in-the-inducement exception to the economic loss doctrine, and (2) whether such an exception is even recognized in Wisconsin. Second, the resolution of this case requires the court to resolve when a duty to disclose arises in a commercial transaction between two sophisticated parties who have an already established course of business. We address these questions in turn.

The economic loss doctrine is a judicially created doctrine providing that a commercial purchaser of goods cannot sue in tort to recover from the product's manufacturer a loss that is solely economic in nature. *See* ***Sunnyslope Grading, Inc. v. Miller, Bradford & Risberg, Inc.***, 148 Wis. 2d 910, 921, 437 N.W.2d 213 (1989). In ***Huron Tool***, the Michigan Court of Appeals recognized a narrow fraud exception to the economic loss doctrine where the fraud is extraneous to, rather than interwoven with, the contract. ***Huron Tool and Eng'g Co. v. Precision Consulting Servs., Inc.***, 532 N.W.2d 541, 546 (Mich. Ct. App. 1996). In defining extraneous versus interwoven, the ***Huron Tool*** court intimated that extraneous fraud concerns those matters whose risk and responsibility were not expressly or impliedly dealt with in the contract. ***Id.*** at 545-46. Applying this definition, the ***Huron Tool*** court wrote that "where the only misrepresentation by the dishonest party concerns the quality or character of the goods sold, the other

party is still free to negotiate warranty and other terms to account for possible defects." ***Id.*** at 545.

Notwithstanding the question of whether Wisconsin even recognizes such an exception, recently in ***Tietsworth***, our supreme court applied the ***Huron Tool*** extrinsic versus intrinsic definition. There, a purchaser of Harley-Davidson motorcycles alleged that the motorcycles were diminished in value by a defect that created a propensity for premature engine failure. ***Tietsworth***, 2004 WI 32, ¶1. The court held that the fraud was interwoven with the contract because the fraud "plainly pertain[ed] to the character and quality of the goods that [were] the subject matter of the contract." ***Id.***, ¶35. Accordingly, the court held that even if it did recognize a ***Huron Tool*** exception, it would not apply to the facts in that case and the claim was barred by the economic loss doctrine. ***Tietsworth***, 2004 WI 32, ¶¶36-37.

In contrast to the fraud in ***Tietsworth***, the alleged fraud in this matter, the failure to disclose a new marketing strategy, does not "plainly pertain" to the character and quality of the goods that are the subject matter of the transaction. Thus, the court is squarely confronted with the question of the scope of the ***Huron Tool*** fraud-in-the-inducement exception.

As noted in Chief Justice Shirley S. Abrahamson's dissent in ***Tietsworth***, ***Huron Tool*** has resulted in conflicting views about what constitutes an intentional misrepresentation "extraneous to" or "interwoven with" a contract:

> Some courts have "taken the view that the issue is strictly temporal." That is, if the intentional misrepresentation occurs prior to the execution of the contract, it is extraneous to the contract and excepted from the economic loss rule. Other courts have taken the view that the timing of the intentional misrepresentation is not as important as

> "a substantive comparison of the allegedly fraudulent statements against the contract's provisions."

Tietsworth, 2004 WI 32, ¶61 (Abrahamson, C.J., dissenting) (citations omitted). Although the court in ***Digicorp, Inc. v. Ameritech Corp.***, 2003 WI 54, ¶52, 262 Wis. 2d 32, 662 N.W.2d 652, wrote "[i]t seems clear that, generally, in order for the fraud in the inducement exception to apply, the misrepresentation would have occurred before the formation of the contract," given the splintered opinion in that case, it is unclear whether that is the formulation of the ***Huron Tool*** test the court would embrace. However, it appears that the allegations in the complaint satisfy both formulations of the test.

Kellogg's alleged misrepresentation concerning the change in its marketing and distribution strategy occurred prior to Kaloti's decision to purchase the products. Kaloti's complaint alleges that the marketing change and the system designed to address the transition into the new scheme of marketing was in place prior to the solicitation of the subject order by Geraci on Kaloti's behalf. The complaint further alleges that, notwithstanding the fact that Kaloti appeared on Kellogg's customer lists (and the customer lists of the newly created entity—Kellogg-Keebler), it was provided with no notice of the change in the marketing of the products. In addition, the complaint states that Kellogg and Geraci knew that when Kaloti placed its order, it was relying upon its prior ability to market and sell the products as a secondary supplier to major stores and that Kellogg's shift in the marketing of the products would shut out Kaloti from the markets it traditionally turned to for business.

Further, Kellogg's marketing scheme was not dealt with in the contract. The complaint points out that the parties contract negotiations concerned the common elements of a commercial transaction, including product specifics,

price, delivery dates, allowances, terms of sale and all other matters solely relating to the purchase of food products.

Kellogg and Geraci maintain that this case falls outside the scope of ***Huron Tool***, suggesting that Kaloti's losses were a consequence of risks the contract allocated to Kaloti and that Kaloti could have protected itself by inserting in the contract an exclusivity clause concerning the marketing of the products. Were the court to adopt Kellogg's argument, the court would be exacting a requirement on contracting parties to anticipate every potential hazard flowing from the contract and to develop provisions in the contract protecting themselves against the consequences of those hazards, regardless of prior dealings and common business practices. It can be argued that such a holding would be unreasonable and would completely swallow the ***Huron Tool*** fraud-in-the-inducement exception. Accordingly, we conclude that the alleged fraud in this case might well be found to be extrinsic to the contract, and that the ***Huron Tool*** fraud-in-the-inducement exception would then apply.

Assuming we are correct, our conclusion brings us to the core issue in this certification—that being, whether the ***Huron Tool*** fraud-in the-inducement exception is even viable in Wisconsin. In their briefs, which were submitted prior to ***Tietsworth***, the parties relied on language in ***Douglas-Hanson Co. v. BF Goodrich Co.***, 229 Wis. 2d 132, 137-38, 598 N.W.2d 262 (Ct. App. 1999) (holding that the economic loss doctrine does not preclude a claim for intentional misrepresentation when the misrepresentation fraudulently induces the party to enter into the contract), and ***Digicorp***, 262 Wis. 2d 32, ¶3 (considering a narrow fraud-in-the-inducement exception to the economic loss doctrine), to state their respective claims concerning the viability of the ***Huron Tool*** exception. In ***Tietsworth***, however, the court noted that in ***Digicorp*** a majority of the justices

participating overruled ***Douglas-Hanson*** to the extent that it recognized a broad exception to the economic loss doctrine for all claims of fraud-in-the-inducement of a contract and that while a separate majority in ***Digicorp*** had announced a willingness to allow *some* type of fraud-in-the-inducement exception to the economic loss doctrine, three of the five justices participating rejected both ***Douglas-Hanson*** and ***Huron Tool***. ***Tietsworth***, 2004 WI 32, ¶34. Accordingly, the court ruled that ***Digicorp*** failed "to produce the majority agreement necessary for the authoritative recognition of an element-specific fraud-in-the-inducement tort cause of action as an exception to the economic loss doctrine." ***Tietsworth***, 2004 WI 32, ¶34. Because the court in ***Tietsworth*** concluded that the fraud in that case was interwoven with the contract, the court specifically declined to address whether "a ***Huron Tool***-type cause of action [is] an exception to the economic loss doctrine [that] would be recognized by a majority of this court." ***Tietsworth***, 2004 WI 32, ¶35. Thus, the ***Tietsworth*** court wiped the slate clean and left open the possibility that an element-specific fraud-in-the-inducement tort cause of action would be recognized. This case presents the court with the perfect vehicle for resolving that question.

The policies behind the economic loss doctrine and their relationship to the fraud-in-the-inducement exception are well understood and oft repeated in Wisconsin; we, therefore, will only briefly touch upon this subject. The economic loss doctrine promotes three important policies: (1) it preserves the fundamental distinction between contract law, which rests on bargained-for obligations, and tort law, which is based on legal obligations; (2) it protects the freedom of commercial contracting parties to allocate economic risk by contract; and (3) it encourages the parties best situated to assess the risk of economic loss—the contracting parties

themselves—to assume, allocate or insure against that risk. *See* ***Wausau Tile, Inc. v. County Concrete Corp.***, 226 Wis. 2d 235, 247, 593 N.W.2d 445 (1999).

On the one hand, Kellogg and Geraci argue that the creation of a fraud exception to the economic loss doctrine would undermine these important purposes and distinctions. They assert that the contracting party who alleges that he or she was fraudulently induced to enter into the contract already has adequate contract remedies: he or she can affirm the contract and seek damages for breach, or he can pursue the equitable remedy of rescission and seek restitutionary damages. *See* ***Tietsworth***, 2004 WI 32, ¶36. A contract fraudulently induced is void or voidable; a party fraudulently induced to enter into a contract "has the election of either rescission or affirming the contract and seeking damages." ***First Nat'l Bank & Trust Co. of Racine v. Notte***, 97 Wis. 2d 207, 225, 293 N.W.2d 530 (1980). This election of remedies requirement maintains the distinction between tort and contract law by conferring upon the aggrieved party the option of pursing one of two different contract remedies.

On the other hand, as Kaloti reminds us, Wisconsin has a long-standing principle that parties need a background of truth and fair dealing in commercial relationships. ***Douglas-Hanson,*** 299 Wis. 22d at 144. Contract negotiations that begin with the assumption that the other party is lying hardly encourage free, fair and open bargaining. Paul J. Schwiep, *Fraudulent Inducement Claims Should Always be Immune From Economic Loss Rule Attack*, 75 FLA. B.J., Apr. 2001, at 22, 26. An exception to the economic loss doctrine for a ***Huron Tool***-type fraud-in-the-inducement cause of action would promote the principles of honesty, good faith and fair dealing during contract negotiations because it would preclude a party from hiding behind the protections of the

economic loss doctrine. The difficult task of striking the proper balance between these and other policy considerations is one best left to the supreme court.

We now turn to the second question raised by this appeal. Kaloti's intentional misrepresentation claim is premised on the allegation that Kellogg failed to disclose or, in fact, concealed its shift in its marketing and distribution strategy. It is well-established that in a sales or business transaction, "silence, a failure to disclose a fact, is not an intentional misrepresentation unless the seller has a duty to disclose." ***Ollerman v. O'Rourke Co., Inc.***, 94 Wis. 2d 17, 26, 288 N.W.2d 95 (1980) (footnote omitted). In ***Ollerman***, our supreme court held that a "subdivider-vendor of a residential lot has a duty to a 'non-commercial' purchaser to disclose facts which are known to the vendor, which are material to the transaction, and which are not readily discernible to the purchaser." ***Id.*** at 42. The court, however, specified that this was a "narrow holding," based on certain policy considerations present in noncommercial real estate transactions. ***Id.*** at 41. Whether such a holding extends to arms-length commercial transactions where the parties have an established course of dealing is a significant policy issue in this state. *See* ***Fisher v. Simon***, 15 Wis. 2d 207, 211-12, 112 N.W.2d 705 (1961) (when a court resolves a question of legal duty the court is making a policy determination).

Kaloti argues that Wisconsin has adopted the RESTATEMENT (SECOND) OF TORTS standard governing when nondisclosure of facts basic to business transaction may constitute misrepresentation. *See* ***Hennig v. Ahearn***, 230 Wis. 2d 149, 167-68, 601 N.W.2d 14 (Ct. App. 1999). Section 551(2)(e) of the RESTATEMENT (SECOND) OF TORTS (1977) provides:

> (2) One party to a business transaction is under a duty to exercise reasonable care to disclose to the other before the transaction is consummated,
>
> ….
>
> (e) facts basic to the transaction, if he [or she] knows that the other is about to enter into it under a mistake as to them, and that the other, because of the relationship between them, the customs of the trade or other objective circumstances, would reasonably expect a disclosure of those facts.

Kaloti maintains that given the parties established course of conduct and Geraci and Kellogg's awareness of this course of conduct, Kellogg's new marketing and distribution scheme was a "fact[] basic to the transaction" and Kaloti could "reasonably expect" disclosure from Kellogg of this new scheme. In support, Kaloti turns to the comment in sec. 551 of the RESTATEMENT (SECOND) OF TORTS, which states:

> There are situations in which the defendant not only knows that his [or her] bargaining adversary is acting under a mistake basic to the transaction, but also knows that the adversary, by reason of the relation between them, the customs of the trade or other objective circumstances, is reasonably relying upon a disclosure of the unrevealed fact if it exists. In this type of case good faith and fair dealing may require a disclosure.
>
> It is extremely difficult to be specific as to the factors that give rise to this known, and reasonable, expectation of disclosure. In general, the cases in which the rule stated in Clause (e) has been applied have been those in which the advantage taken of the plaintiff's ignorance is so shocking to the ethical sense of the community, and is so extreme and unfair, as to amount to a form of swindling, in which the plaintiff is led by appearances into a bargain that is a trap, of whose essence and substance he [or she] is unaware.

Kellogg and Geraci, on the other hand, suggest that they had no duty to notify Kaloti of changes in the marketing and distribution strategy. Kellogg and

Geraci argue that Wisconsin courts are reluctant to expand the limited duty to disclose beyond fiduciary or other special relationships that implicate important issues of public policy and such relationships are not present here. *See, e.g.,* ***Johnson by Adler v. Kokemoor***, 199 Wis. 2d 615, 545 N.W.2d 495 (1996); ***DeBaker v. Shah***, 194 Wis. 2d 104, 533 N.W.2d 464 (1995); ***Lecic v. Lane Co.***, 104 Wis. 2d 592, 312 N.W.2d 773 (1981). They further submit that this case reflects a situation where one party had superior information and better business acumen and that these are legitimate advantages, sanctioned by the customs and mores of the business community, which should not lead to liability. *See* **Guyer v. Cities Serv. Oil Co.**, 440 F. Supp. 630, 632-34 (E.D. Wis. 1977). They maintain that the seller in such a circumstance can reasonably expect the buyer to conduct its own investigation, draw its own conclusions and protect itself.

The ethical attitudes in many fields of modern business are changing. The concept of facts basic to the transaction may be expanding and the duty to use reasonable care to disclose the facts may also be increasing. We are primarily an error correcting court and, as indicated, these are significant issues of public policy, which are best left to the supreme court.

CONCLUSION

In sum, the scope and application of the ***Huron Tool*** fraud-in-the-inducement exception to the economic loss doctrine and a determination as to the scope of a seller's duty to disclose in an arms length transaction between parties with an established course of conduct are significant issues of public policy. Thus, the supreme court is the proper judicial authority to resolve these considerations. We respectfully ask the supreme court to provide definitive guidance on these issues, which are likely to recur in the future.