Fraudulent Direct Sales Schemes in the Home Improvement Industry under Nebraska Law

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FRAUDULENT DIRECT SALES SCHEMES
IN THE HOME IMPROVEMENT INDUSTRY
UNDER NEBRASKA LAW

I. INTRODUCTION

Day after day the consumer is confronted with deceptive selling practices. The widespread existence of such practices has led to renewed recognition of the problem and vocal concern for consumer protection. Following presidential notice of the problem by President Kennedy in 1962,1 President Johnson in 1964 called for an "intensified campaign . . . against the selfish minority who defraud and deceive consumers, charge unfair prices, or are engaged in other sharp practices."2 President Nixon has acknowledged the fact that in today's marketplace the consumer is confronted with merchandising methods which result "in a degree of confusion that often confounds the unwary, and too easily can be made to favor the unscrupulous."3 The result of such confusion is that about 200 billion dollars of the 750 billion dollars spent by consumers last year was squandered through fraud, deception, and marketing inequities.4

There is evidence that consumer fraud and deception are most commonly encountered by low income consumers who lack the education or sophistication necessary to protect themselves.5 The President's Commission on Civil Disorders also noted that the ill will and frustration caused by unconscionable marketing practices has been a contributing cause of riots in the poverty areas of American cities.6 However, while many problems do arise from the exploitation of the poor, the uneducated and the elderly, the problem is not

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1 108 Cong. Rec. 4167, 4263 (1962) (message from President Kennedy to Congress concerning consumer problems).
2 110 Cong. Rec. 1958, 2095 (1964) (message from President Johnson to Congress concerning consumer interests).
6 See Report of the National Advisory Commission on Civil Disorders 4, 81-82, 139-40 (1968).
confined to these groups. The more affluent and the educated are also exposed to and succumb to improper sales practices.

Of course, not all manufacturers and merchants participate in questionable sales practices. The majority of sellers find it commercially feasible to stand behind their representations, and many go to great lengths to please their customers, not stopping with their legal obligations but taking any reasonable action to promote goodwill. But the fact that most sellers are responsible makes it easier for the dishonest seller to trick the unwary. The consumer expects honesty from the merchant. He has come to trust the seller and his salesmen.

Such trust has resulted in vast numbers of new consumer complaints each year. Specifically, complaints of home improvement sales rank second in the incidence of all complaints filed with Better Business Bureaus across the country. These statistics suggest that fraudulent selling techniques are more frequently employed in the field of direct selling than in any other phase of merchandising. Several factors offer an explanation of this phenomenon.

First, while the average retail establishment at a fixed location needs to maintain consumer goodwill to assure the repeat business which will enable it to operate profitably over an extended period of time, a direct seller is not bound by these same restrictions. Since he can operate nearly as simply and economically over an extended geographic area as over a small area, return business based on consumer satisfaction is a less important consideration to his continued operations. Secondly, the selling company has no chance to police the actions of their salesmen in the buyer's home as it does when they operate within a store. And since the door-to-door salesman nearly always operates on a commission basis, the pressures upon him to resort to any method which is likely to produce a sale are great. Finally, since the consumer lacks a means of screening the type of salesman who comes to his door, in contrast to the discretion he may exercise in choosing the store in which he shops, he is less likely to be able to distinguish the reputable from the disreputable. Both have equal access to his living room.

7 "Magazine sales" rank first, accounting for 8.2% of the Better Business Bureau complaints; "home improvement and maintenance" is second at 6.4%. See the testimony of Allan E. Bachman, Executive Vice-President of the National Better Business Bureau, Hearings on S. 1599 Before the Consumer Subcomm. of the Senate Comm. on Commerce, 90th Cong., 2d Sess., ser. 90-63, at 130 (1968) [hereinafter cited as 1968 Hearings].

8 See Cuming, Consumer Protection—The Itinerant Seller, 32 SASK. L. Rev. 113, 115-16 (1967).

9 See 1968 Hearings 79 (statement of Senator Brewster).
One would naturally suspect that the existence of these factors tends to make fraud a more frequent accompaniment to direct selling than to other types of merchandising. In fact, Chairman Paul R. Dixon of the Federal Trade Commission has stated that in the Commission’s experience “dishonest and unethical businessmen gravitate to ... door-to-door [sic] selling.”

Nebraska has recently been confronted with two cases involving deceptive sales practices in a classic direct selling context. In Central Construction Co. v. Osbahr and Dembowski v. Central Construction Co., the Nebraska Supreme Court came to seemingly conflicting conclusions in two cases that presented strikingly similar factual situations involving deceptive direct sales practices. The purpose of the following analysis is to outline prior Nebraska law in this area, to investigate the present status of Nebraska law in this area, and to compare the decisions against the backdrop of the Federal Trade Commission Act, the Nebraska Uniform Deceptive Trade Practices Act, and Nebraska’s constitutional prohibition of lotteries.

II. NEBRASKA’S FRAUDULENT DIRECT SALES PRACTICES LAW PRIOR TO OSBAHR AND DEMBOWSKI

The idea of deceptive sales practices in a classic direct selling context is not foreign to Nebraska law. In the case of Schuster v. North American Hotel Co., the plaintiffs had purchased stock in the North American Hotel Company from agents of the defendant company. At the time of the sale the agents represented that American Hotel and the Bankers Realty Company “were the same company and the same people,” and that American Hotel would return to the purchaser the money paid for the stock after two years if requested to do so. The subscription contract signed by the plaintiffs when they purchased the stock was complete on its face and contained a disclaimer that “no conditions, agreements or representations, other than those printed above, shall bind the

10 Id. at 14.
16 106 Neb. 672, 184 N.W. 136 (1921), motion for rehearing denied, 106 Neb. 679, 186 N.W. 87 (1921).
company." The plaintiffs alleged that they tendered their stock to the defendant and requested a repayment of the purchase price, but the defendant refused; therefore $2,000 with interest was due from the defendant to the plaintiffs. The lower court directed a verdict in favor of the plaintiffs, and the case was presented to the Nebraska Supreme Court as an action based both upon the fraud of the agent and upon the contract. On motion for rehearing, the two issues presented for the determination of the court were the admissability of parol evidence to prove the fraudulent representations and the responsibility of the principal for the representations of his agents.

The supreme court first noted that when fraudulent promises act as an inducement to the execution of a written contract, the proper remedy is for fraud and not upon the oral promise as a contractual obligation, for the oral promise as an obligation has become merged in the written agreement and cannot, as such, be legally proved. However, the court was quick to point out that although evidence of a parol promise cannot be shown for the purpose of enlarging or changing the written contract where the action is one to enforce the contract, such a rule is inapplicable where the action is in fraud to rescind the contract and to prove the oral promise as the fraudulent representation which acted as the inducement to the sale.

As to the issue of whether an oral promise, made in violation of the limitation of the agent's authority as expressed by the disclaimer clause of a written sales contract, will constitute a fraud for which the principal is responsible upon an action for recission or for damages, the court articulated a specific test which has become well-recognized in Nebraska agency law, the subject-matter test.

The court noted that a principal may not relieve himself from liability as to certain basic representations even by placing the third party on notice that the agent is unauthorized to make representations, and has in fact been directed not to make them:

17 106 Neb. 672, 184 N.W. 136 (1921).
18 106 Neb. 679, 682, 186 N.W. 87, 88 (1921). Crook v. O'Shea, 126 Neb. 67, 74, 252 N.W. 456, 458 (1934), provides: "[W]hen fraudulent promises act as the inducement to the execution of a written contract, the remedy is for fraud, and not upon the oral promise as a contractual obligation;" Paper v. Galbreth, 121 Neb. 454, 237 N.W. 582 (1931), provides: "The defense on the ground of fraud may be shown by parol, not to contradict or vary, but to destroy the legal and binding effect of a written instrument."
It is quite generally held that a provision in a contract, to the effect that the agent cannot bind the company by any representations, statements or agreements, will not relieve the principal from responsibility for the fraudulent representations, as to the subject-matter of the contract, made by the agent, since such representations are within the scope of the agent's actual or ostensible authority . . . . Where he makes false representations concerning the subject-matter of the contract, as distinguished at least from the agreements and promises which are to be undertaken, the company is responsible, and the buyer, when injured, may rescind the contract on the ground of fraud.22

Therefore, an agent has ostensible authority to describe the goods that he is selling, and when he makes representations as to their quality and character he does so within the scope of his authority. While the agent does have the authority to describe what he has to sell, even in view of a written limitation of his authority, he does not have the power to make a contract or to add stipulations to the written contract furnished by his principal. When he fraudulently represents himself as acting for the company in adding stipulations to a self-limiting written contract, the agent acts outside the scope of his ostensible authority, and the principal is not responsible for his fraud.

In applying these enumerated principles of law to the facts of the case, the court found the American Hotel Company not liable for their agents' representation that the company would repurchase the stock because the principal had restricted its obligation to the stipulations contained in the written contract.23 The buyer was bound to take notice that the agent had no authority to make additional agreements for the company. Although the agents may have been personally responsible for the fraud, the court did not find that the representations made were a sufficient basis for actionable fraud against the company.

Regarding the agents' representation that American Hotel and the Bankers' Realty Company "were the same company and the same people," the court classified it as one that dealt with the subject-matter of the contract. As such, it was within the scope of authority of the agents to make, and the defendant company could not set up the contractual provision that it would not be bound by the representation of its agents to bar an action for fraud.24

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22 106 Neb. at 684, 186 N.W. at 89 (1921) (emphasis added).
23 Id. at 687, 186 N.W. at 90.
24 Id at 688, 186 N.W. at 90.
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There are times, however, when the principal will be liable for the promissory representations made by his agent. In the case of Johnson v. Nebraska Building & Investment Co., a written contract contained the same provisions limiting the agent’s authority to bind the company as were contained in Schuster, and the agent made statements similar to those made in the Schuster case. The court held the defendant liable. The promise made by the agent to the third party to repurchase the stock was found to be so worded as to be a representation of fact in view of a prospectus of the defendant which read: “Provision is made for withdrawal of your money after twelve months if you so desire.” In addition, the principal will be liable even for those representations made by the agent to matters outside of the subject-matter of the contract if the oral agreement is communicated to the principal before it acts to ratify the contract.

Where the remedy available to the third party is recission due to the fraudulent representations of the agent regarding the subject-matter of the contract, the question arises as to how soon the third party must act in bringing his action against the principal. Because recission requires the return to the seller of any goods received by the buyer and an allowance to the seller for their fair and true rental value, it may be unfair to always allow recission to take place after performance by the principal when it is impossible to return the goods to the seller. However, the Nebraska Supreme Court has held in Faulkner v. Klamp that although the general rule is that a party must restore the benefits received before he can rescind a contract for fraud, he does not have to do so where the consideration received is without value or where it is impossible,

26 Shimonek v. Nebraska Bldg. & Inv. Co., 109 Neb. 424, 425-26, 191 N.W. 668 (1922), provides: “Under the decision in Schuster v. North American Hotel Co., 106 Neb. 679, it is clear that the representations made by the agent as to the return of the plaintiff’s money were unauthorized by the defendant. It is equally clear that, after the facts as to the making of such oral contract by the agent had been fully communicated to the defendant company, it adopted and ratified the contract as its own by making a series of payments according to such contract, whereby the amount remaining due was reduced to $1,131.87. This ratification had the same effect as an express authorization to make the contract. Oberne v. Burke, 50 Neb. 764.”
impractical, or futile to restore the consideration. What is required is that the right to rescind be promptly exercised upon discovery of the fraud.

III. THE OSBAHR AND DEMBOWSKI DECISIONS

Central Construction Co. v. Osbahr involved an action to foreclose a mechanic's lien. The dispute was based on a home improvement contract for the installation of plastic siding and aluminum doors on the defendants' home. The district court, finding that the written contract was procured by the Central Construction Company through fraud and misrepresentation, ordered that the written contract be reformed to conform to the oral agreement of the parties.

The Central Construction Company had initially contacted the defendants, arranging a meeting to discuss the use of their residence as a "model home." At the conclusion of a visit to the defendants' home by two of the plaintiff's salesmen, the Osbahrs signed a printed form contract that contained the following disclaimer clause:

There are no representations, guarantees or warranties except such as may herein be incorporated, if any, nor any agreement collateral hereto, nor is this contract dependent upon or subject to any conditions not herein stated. Any subsequent agreement in reference hereto shall be binding only if in writing and if signed by all parties. Owner(s) understand and agree that contractor does not make, and no agent of contractor is authorized to make, any agreement with Owner(s) either concerning the use of the Owner(s)' premises as a 'model home' or concerning any payments, credits or commissions to be received by Owner(s) for referrals of prospective customers. Owner(s) further understand and agree that, in the event Owner(s) make any such agreements with any person whomsoever, Contractor has no responsibility whatsoever for the performance of such agreements. Contractor does hereby expressly disaffirm any such agreements purportedly made on his behalf.

[20] "Where in a trade or barter of property the trade is procured by one of the parties by false and fraudulent representations as to the quality of the property disposed of by him, the defrauded party may, upon the discovery of the fraud, rescind the contract and maintain replevin for the property procured by such fraud. And this may be done without returning the property received by the defrauded party when such return is impossible, or where the party guilty of the fraud has by his own act put it out of the power of such defrauded party to make such return." Id. (emphasis added).


[32] Id. at 2, 180 N.W.2d at 140.
The defendants told the plaintiff's salesmen that they could not afford the expense of any home improvements. However, the salesmen assured them that since their home would be used as a "model," certain payments resulting from the sale of the plaintiff's products arising out of the use of the defendants' home as a "model" would be credited to and would discharge the defendants' obligation under the contract. An oral agreement to that effect was made. The defendants were told that the written contract did not really apply to them because theirs was to be a "model home," and the printed form was only the form for standard contracts.

The issues on appeal to the Nebraska Supreme Court were whether the trial court erred in admitting parol evidence to vary the terms of the written contract and in finding that the written contract was procured by the plaintiff through fraud and misrepresentation.33

In a unanimous opinion the court held that parol evidence was admissible to show, for the purpose of invalidating a written instrument, that the execution of such instrument was procured by fraud and that it does not express the true intent of the parties. Furthermore, such a rule is not to be rendered inapplicable because there is an agreement in the contract to the effect that "no verbal agreements affecting its validity will be recognized."34

Upon the issue of fraud in the procurement of the contract, the court said:

Fraud in a transaction may be proved by inferences which may reasonably be drawn from intrinsic evidence respecting the transaction itself, such as inadequacy of consideration, or extrinsic circumstances surrounding the transaction.35

Dembowski v. Central Construction Co.36 was an action brought in equity to reform a contract. The district court granted the homeowner's prayer for reformation. The facts in this case were essentially the same as in Osbahr; however, the Dembowski's contract with Central Construction was signed a month earlier. In Dembowski the defendant construction company had different counsel who raised a different issue on appeal to the Nebraska Supreme Court,37 i.e., the responsibility of the defendant principal for the

33 Id. at 3, 180 N.W.2d at 141.
34 Id.
35 Id. at 5, 180 N.W.2d at 142.
37 Attorneys may often be heard to lament that they have no chance of winning a case because the facts are against them. The result in Dembowski clearly shows the influence new counsel can have on a case.
fraud of his agent. The court, with two justices dissenting, brushed aside the Dembowskis' reliance on the Osbahr decision and said that "[a]lthough based on similar facts, this case must be distinguished from the one before us as the issue here [agency] was not raised or presented in the Osbahr case."

The court, apparently overlooking that the equitable relief granted by the lower court was reformation, found that the principal had no knowledge of his agent's fraudulent acts until after the contract had been entered into and fully performed by the defendant, and applied the Restatement (Second) of Agency § 260 in holding that "the equitable remedy of recission is denied after performance by the principal."

In Osbahr, based on the previous decision of Chapin v. Noll, the court correctly held that parol evidence is admissible to show, for the purpose of invalidating a written instrument, that its execution was procured by fraud, or that, by reason of fraud, it does not express the true intentions of the parties. However, in affirming the lower court's order that the written contract be reformed to conform to the oral agreement of the parties instead of rescinding the agreement, the Osbahr court seems to have erred by acting contrary to the Schuster opinion which noted that when fraudulent promises act as an inducement to the execution of a written contract, the proper remedy is either in tort for damages or in contract for rescission, but in any case, no action can be had upon the oral promise as a contractual obligation. Why the Osbahr court

38 186 Neb. 624, 625, 185 N.W.2d 461, 463 (1971).
39 Id. at 628, 185 N.W.2d at 464 (Spencer & McCown, JJ., dissenting).
40 Throughout the litigation the Dembowskis were represented by the same counsel that had successfully represented the Osbahrs.
41 186 Neb. at 625-26, 185 N.W.2d at 463 (1971).
42 RESTATEMENT (SECOND) OF AGENCY § 260 (1958), cited by the court in Dembowski, states:
"(1) An innocent principal can, by contract with another, relieve himself of liability for deceit because of unauthorized fraud by a servant or other agent upon the other party.
(2) A contract with, or conveyance to, the principal obtained by his agent through misrepresentations can be rescinded by the other party to the contract or conveyance prior to a change or position by the principal, even though the contract provides that it shall not be affected by misrepresentations not contained therein and includes a statement that the agent has made no representations."
43 186 Neb. at 626, 185 N.W.2d at 463 (1971).
44 118 Neb. 318, 224 N.W. 687 (1929).
46 106 Neb. 679, 186 N.W. 87 (1921).
failed to comment on this distinction is not clear. The Chapin case, cited by the Osbahr court for the proposition that parol evidence is always admissible for invalidating a written agreement due to fraudulent promises, expressly followed the Schuster rule that evidence of a parol promise cannot be shown for the purpose of enlarging or changing the written contract, although such evidence is admissible where the action is in fraud for damages or to rescind the contract and prove the oral promises as the fraudulent representation which acted as an inducement to contract.47

In Dembowski the plaintiff sought reformation of the written contract. Although the supreme court did not deal with the issue of the admissibility of parol evidence in that case, it is clear that the remedy of reformation is inappropriate based on the Schuster holding for it seeks the enlargement and enforcement of the original contract.48 The plaintiff might well have lost his case at this stage due to his improper choice of remedies.

In Dembowski, unlike Osbahr, the question of the principal's liability for the fraudulent representations of his agent was raised. Although the same issue was raised in Schuster v. North American Hotel Co.49 and Shimonek v. Nebraska Building & Investment Co.,50 the Dembowski court treats the issue differently. In Schuster the court held that a principal could not relieve himself of liability by a disclaimer clause for those representations made by his agent regarding the subject-matter of the contract, because the agent has actual or ostensible authority to describe the goods, and he is acting within such authority when he makes representations as to their quality and character. However, when the contract contains a disclaimer clause and the agent adds promissory stipulations not dealing with the subject-matter of the contract, the agent acts outside the scope of his authority; the principal is not responsible for his fraud. If the principal became aware that his agent made such unauthorized representations, ratification after notification was held by Shimonek to have the same effect as express authorization.51 Instead of routinely following the Schuster and Shimonek opinions as controlling, the Dembowski court, having found that the principal had no knowledge of his agent's fraudulent acts until after the contract had been entered into and fully performed by the de-

48 Note 18 supra.
49 106 Neb. 679, 186 N.W. 87 (1921).
50 109 Neb. 424, 191 N.W. 668 (1922).
51 Note 26 supra.
fendant, applied the *Restatement (Second) of Agency* § 260 in holding that "the equitable remedy of recission is denied after performance by the principal." Does the adoption of this new line of reasoning work any changes in prior Nebraska law?

The adoption of the Restatement position does not appear to make any changes in the parol evidence rules adopted by the court in the *Schuster* case. The important question raised by the Restatement position [a contract which the principal obtained through misrepresentations by the agent can be rescinded by the other party to the contract prior to a change in position by the principal] is whether or not the *Schuster* distinction between misrepresentations concerning the subject-matter of the contract and those outside of the subject-matter is destroyed. Although the *Dembowski* opinion does not deal elaborately with the law in this area, the better view is that the use of the term "misrepresentations" in Section 260 should be limited to those made with reference to matters outside of the subject-matter of the contract, thereby not abolishing the

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52 Note 42 supra.
53 Note 43 supra.
54 *RESTATEMENT (SECOND) OF AGENCY* § 260, Comment d at 569 (1958) provides: "The rule stated in this Subsection does not offend the parol evidence rule, since the rule prevents the modification of an integrated contract by statements not a part of it, whereas by this rule the effect of the contract is avoided. If the agent, instead of making a statement of existing facts, makes a promise which is at variance with the statements in the integrated contract, the other party cannot show such promise to vary the terms of the agreement, under the rules stated in the Restatement of Contracts, Sections 237-244. If, however, the unauthorized promises are not at variance with the integrated contract and would be enforceable against the principal if authorized, the principal cannot enforce the terms authorized without ratifying the unauthorized promises, although the other party had notice that the agent was not authorized to make them."

55 See *RESTATEMENT (SECOND) OF AGENCY* § 260, Comment c at 567-68 (1958) which provides: "A statement in the contract between the principal and a third person that the agent has no authority to make statements is a notification that *any statements not implicit in the transaction . . . are unauthorized* . . . [Statements "not implicit in the transaction" must mean those outside the subject-matter of the contract as those concerning the subject-matter are implicit in the transaction and part of the agent's ostensible authority for which the principal is liable under Nebraska law.] On the face of the document, these statements place the entire risk of reliance upon the third person. . . . But where such statements are inserted in the contract the purchaser tends to regard them as merely formal statements and is not put upon his guard against deceptions. The document has been prepared by the principal, usually on advice of attorneys and, at least if the purchaser is not expert in business, should not override the fact
Schuster distinctions, but adding a new expression of the Shimonek rule.\(^{58}\)

In the Schuster opinion the court did not deal with how soon the third party must act to rescind the contract due to the fraudulent representations of the agent concerning the subject-matter of the contract; however, Nebraska cases hold rescission must be promptly exercised in instances of fraudulent representations as to the subject-matter of the contract.\(^6\) Change of position by the defrauding party is no defense.\(^{57}\) This is also the position adopted by the Restatement (Second) of Agency § 259.\(^{58}\) While Schuster held that the defrauded party was unable to rescind due to the fraudulent representations of the agent concerning matters outside of the subject-matter, the Restatement position\(^{59}\) allowing rescission if exercised before performance by the principal when representations by the agent fall outside the subject-matter of the contract, is not in conflict with the Shimonek view holding the principal liable when ratification follows notification of such representations.

The only shortcoming of the rule adopted by Dembowski, i.e., limiting rescission to a time before a change in position by the principal in those instances of fraud relating to matters outside the subject-matter of the contract, is that such a rule is poorly suited to the home improvement sales area. It allows the principal to escape liability in almost every instance. Since the mere shipping or delivery of the goods covered by the contract is not considered such a change of position as will deprive the buyer of his remedy,\(^{61}\) the

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\(^{59}\) Restatement (Second) of Agency § 259 (1958) states:

"(1) A transaction into which one is induced to enter by reliance upon untrue and material representations as to the subject-matter, made by a servant or other agent entrusted with its preliminary or final negotiations, is subject to rescission at the election of the person deceived.

"(2) Change of position by the principal:

(a) is a defense if the agent has no power to bind the principal by the misrepresentations;

(b) is not a defense if the principal was liable for the misrepresentations."

\(^{60}\) Note 42 supra.

seller is well-advised to act quickly in installing his product so as to effectuate a change in position before the buyer discovers any possible fraud relating to matters outside the subject-matter of the contract and communicates such findings to the principal. The effect is to use the law to deny recission to the buyer in those many instances where he is not likely to discover he was defrauded until after the work on his home is completed. In this respect the Dombowski opinion effectively condones such fraudulent practices and allows businessmen to benefit from fraud, thereby promoting a disrespect for our legal system by both the fraudulent and the defrauded.

IV. ARGUMENTS FOR A DIFFERENT DECISION

A. THE FEDERAL TRADE COMMISSION ACT AND THE NEBRASKA UNIFORM DECEPTIVE PRACTICES ACT

The Federal Trade Commission Act, as amended, imposes upon the Federal Trade Commission not only the duty to prevent unfair methods of competition but also "unfair or deceptive acts or practices in commerce." The Commission has proceeded not only against practices forbidden by statute or the common law, but also against practices not previously considered unlawful, and thus it has created a new body of law—a law of unfair trade practices adapted to the diverse and changing needs of our complex competitive system.

Because the Federal Trade Commission Act only prohibits those unfair practices "in commerce," the states surrounding Nebraska have adopted strong legislation permitting court-ordered restitution to consumers in situations where the state attorney general is authorized to seek injunctions prohibiting "any deception, deceptive act or practice, fraud, false pretense, false promise, or misrepresentation . . . in connection with the sale or advertisement of any

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62 Restatement (Second) of Agency § 260 (1958).
merchandise. ...”64 The courts are empowered to make such order, including appointment of a receiver, as may be necessary “to restore any person in interest any monies or property ... real or personal” acquired by any of the practices declared unlawful.65

The statutory law regarding deceptive trade practices in Nebraska has not developed to the extent of that enacted in her surrounding sister states. A Nebraskan who may be damaged by a deceptive trade practice “may be granted an injunction against it under the principles of equity.”66 Included in the practices deemed deceptive by the Nebraska Legislature upon the adoption of the Nebraska Uniform Deceptive Trade Practices Act67 are the making of “false or misleading statements of fact concerning the reasons for, existence of, or amounts of price reductions,”68 and engaging “in any other conduct which similarly creates a likelihood of confusion or of misunderstanding.”69 This latter definition should allow the state courts to apply the crystallized principles and examples of unfair trade practice law developed under the Federal Trade Commission Act.70 And there is a great wealth of law from which to analogize.

For example, it has been designated unfair to alter printed contracts as an inducement for the purchaser's signature, and then enforce the contract as though no change has been made.71 It has also been held that inserting in an order blank a disclaimer of liability for promises or representations made to purchasers by salesmen is an unfair practice.72

In addition, the Federal Trade Commission has prohibited representing that a customer's building is to be used for advertising the

65 See COLO. REV. STAT. ANN. § 55-5-7(1) (Supp. 1969); IOWA CODE ANN. § 713.24(7) (Supp. 1969); KAN. STAT. ANN. § 50-608 (Supp. 1968); MO. ANN. STAT. § 407.100 (Supp. 1968); S.D. COMPIL. LAWS ANN. § 37-24-29 (1967). It should be noted that the Missouri statute makes no specific provision for the appointment of a receiver but the court might have this power under its authority to “make such orders or judgments as may be necessary.”
70 See NEB. REV. STAT. § 87-305 (Supp. 1969).
72 Beho Rubber Co., 34 F.T.C. 457 (1941).
seller's product with benefits to the customer by way of reduced prices, discounts or refunds. In a specific case involving the home improvement sale of siding, the Commission has prohibited representing that a prospective purchaser's home had been selected as a "model home" or that owners would receive money or other things of value predicated upon similar work being done on other homes in the community. And in a particularly interesting case, the Central Construction Company of Omaha, Nebraska, the principal actor in both the Osbahr and the Dembowski cases, was ordered to cease and desist from representing that the building of their purchasers would be used for demonstrations or advertising purposes or that they would pay commissions to purchasers when sales were made as the result of such demonstrations.

Thus, it should be obvious that cases such as Osbahr and Dembowski involve more than just contract law or agency law; both cases involve deceptive trade practices which are unlawful under Section Five of the Federal Trade Commission Act if "in commerce," and which, by analogy, have now been made unlawful in Nebraska with the adoption of the Nebraska Uniform Deceptive Trade Practices Act. Therefore, in the future, contracts similar to those in Osbahr and Dembowski may be properly classified as against public policy and not enforceable by the court.

B. THE NEBRASKA PROHIBITION AGAINST LOTTERIES

There is no dispute that lotteries are prohibited in Nebraska. In addition to the constitutional prohibition, the setting up, pro-

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74 Central Constr. Co., 59 F.T.C. 966 (1961). This consent order required the Central Construction Company to cease representing falsely in advertising and through its salesmen that: (1) it offered reduced rates to home and building owners who permitted their property to be used for demonstrations and advertising; (2) that it would pay them commissions on resulting sales to others; (3) that said offers must be accepted at once; and (4) that the soliciting salesman was an officer, co-owner, or engineer of the corporation. It should be noted that a respondent's execution of a "consent to cease and desist" is for settlement purposes only and does not constitute an admission of the charges summarized therein.
76 See 6A A. Corbin, Contracts §§ 1371-75, 1529 (1952); Reinforcement of Contracts § 580 (1932); 3 S. Williston, Sales §§ 663-81 (1948).
77 Neb. Const. art III, § 24 provides: "The Legislature shall not authorize any game of chance nor any lottery or gift enterprise where the consideration for a chance to participate involves the payment of money for the purchase of property, services, chance or admission ticket, or requires an expenditure of substantial effort or time . . . ."
moting or conducting of a lottery is made a crime by statute.\textsuperscript{78} It logically follows that if the methods used in the inducement of a contract constituted an illegal lottery, any sales contract so induced by such methods should be unenforceable by the courts because the contract would be against public policy. In adopting this logic, several jurisdictions have held sales contracts unenforceable where accompanied by referral-sales schemes similar to those found in \textit{Osbahr} and \textit{Dembowski}.\textsuperscript{79}

In \textit{Sherwood & Roberts-Yakima, Inc. v. Leach}\textsuperscript{80} Lifetone Electronics, Inc. had sold the respondent consumer a radio intercom and fire alarm system on a conditional sales contract. As part of the transaction a representative’s commission agreement was executed by which the consumer would receive a commission for each sale to any person referred to Lifetone by the consumer. The consumer was assured that the commission would be at least adequate to cover his purchase price so that by purchasing the equipment he thought he was getting it for nothing. The sales contract was then assigned to the appellant who sued the respondent consumer for the unpaid purchase price. The Washington Supreme Court pointed out that lotteries were illegal in Washington,\textsuperscript{81} and held that the representative’s commission agreement was an illegal lottery and that the conditional sales contract, having been an integral part of the same transaction, was tainted with such illegality and unenforceable.

The court found that all three essential elements of a lottery, \textit{i.e.}, the distribution of money or property (prize), chance, and a valuable consideration paid or agreed to be paid for the chance, were present in a referral sales scheme.\textsuperscript{82} It was further determined by the court that the consumer’s hoped-for commissions constituted a prize and that the purchase price amounted to consideration paid in an effort to get the prize. Chance was found to permeate the

\textsuperscript{79} \textit{E.g.}, \textit{State v. ITM, Inc.}, 52 Misc.2d 39, 56-61, 275 N.Y.S.2d 303, 324-29 (Sup. Ct. 1966); \textit{Sherwood & Roberts-Yakima, Inc. v. Leach}, 67 Wash.2d 630, 409 P.2d 160 (1965).
\textsuperscript{80} \textit{67 Wash.2d 630, 409 P.2d 160 (1965).}
\textsuperscript{81} \textit{Was. Const.} art. II, § 24 provides: “The legislature shall never authorize any lottery . . . .”; \textit{Was. Rev. Code Ann.} § 9.59.010 (1961) further provides: “A lottery is a scheme for the distribution of money or property by chance, among persons who have paid or agreed to pay a valuable consideration for the chance, whether it shall be called a lottery, raffle, gift enterprise, or by any other name, and is hereby declared unlawful and a public nuisance.”
\textsuperscript{82} \textit{67 Wash.2d 630, 634-35, 409 P.2d 160, 162-63 (1965).}
scheme in that the consumers took a chance that other consumers might not be interested, that the salesmen might not make adequate presentations and that the salesmen might not even contact any more consumers.

A similar result was reached in *State v. ITM, Inc.* a special proceeding brought by the Attorney General of New York to enjoin the promoters of a referral sales program from further engaging in alleged fraudulent and illegal practices. The sales scheme consisted of inducing a consumer to sign an installment contract for the purchase of one of the seller's products and the execution of an additional commission agreement providing for payment to the consumer of an agreed amount for each sale resulting to buyers referred by the consumer to the respondent seller. In granting the injunction the court found, among other things, that "[t]he respondents were guilty of persistent illegal acts in conducting a lottery and all contracts are 'utterly void.'"

In Nebraska the term "lottery" is also defined by statute, and the Nebraska Supreme Court has consistently held that the three traditional elements constituting a lottery, i.e., a prize, consideration and chance, must be present in a scheme if it is to be labeled a lottery.

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84 The respondents were engaged in the home selling of color television sets, central vacuum cleaning systems and electric quartz boilers.
85 52 Misc. 2d 39, 62, 275 N.Y.S.2d 303, 329 (Sup. Ct. 1966). Noting that the Supreme Court of Washington had unanimously held a similar scheme to be a lottery in *Sherwood & Roberts-Yakima, Inc. v. Leach*, the court characterized New York's constitutional prohibition of lotteries (N.Y. Const. art I, §9) as stronger than its Washington counterpart and its statutory definitions (N.Y. Penal Law § 1370 (McKinney 1967)) as similarly containing the traditionally and universally recognized elements of a lottery, i.e., consideration, prize (distribution of property) and chance, all of which were contained in Washington's similar law, in reaching the same conclusion as to the voidability of a sales contract connected with an illegal sales scheme. *Id.* at 57-60, 275 N.Y.S.2d at 324-27.
86 Neb. Rev. Stat. § 28-963.01 (Reissue 1964) declares: "[A] lottery or scheme of chance shall mean any scheme, plan or promotion containing the elements of prize, chance, and consideration where the consideration for a chance to participate involves the payment of money for the purchase of property, services, chance, or admission ticket, or requires the expenditure of substantial effort or time . . . ."
87 State ex rel. Hunter v. Omaha Motion Picture Exhibitors Ass'n, 139 Neb. 312, 297 N.W. 547 (1941); Chamber of Commerce v. Kieck, 128 Neb. 13, 257 N.W. 493 (1934); State v. Nebraska Home Co., 66 Neb. 349, 92 N.W. 763 (1902).
Thus, the facts found by the court to have existed in both *Osbahr* and *Dembowski* clearly place the sales practices used in inducing the execution of the contracts in those cases within the meaning of a "lottery" as such term is defined in Nebraska. Both the Osbahrs and the Dembowskis were to receive commissions (the prize) and agreed to pay the purchase price of the siding (the consideration) in an effort to get the prize. The element of chance permeated the entire scheme in that the Osbahrs and Dembowskis took a chance that the salesmen might poorly make their presentations, that there was no market, that the salesmen might drop all efforts at completing more sales, and that they [the buyers] would get something for nothing. As such, selling schemes like those found in *Osbahr* and *Dembowski* are contrary to the terms and policy of Nebraska law and therefore illegal and unenforceable, and where such an illegal scheme is intimately connected with a contract, that contract becomes tainted with that illegality and is likewise unenforceable.  

V. CONCLUSION

Considered carefully, the *Osbahr* and *Dembowski* decisions do not substantially change existing Nebraska law in the field of fraudulent direct sales practices established by the *Schuster* and *Shimonek* decisions of the early 1920's. The seller-principal, innocent of any wrongdoing on the part of his agent, remains strictly

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88 Note 76 supra. Of course, proceeding under an illegal lottery theory may still be limited in Nebraska when the principal divorces himself from liability for the unauthorized fraudulent representations of his agent in reference to matters outside the subject-matter of the completed contract. In both *Osbahr* and *Dembowski* the agent's representations were oral and outside of the "four corners" of the contract.  

89 Rescission of a contract is allowed by *Schuster* only if the agent made fraudulent representations as to the subject-matter of the contract, notwithstanding the presence of a disclaimer clause in the contract. Change of position by the principal is no defense to rescission for the fraudulent representations made concerning the subject-matter of the contract. Faulkner v. Klamp, 16 Neb. 174, 20 N.W. 220 (1884); Restatement (Second) of Agency § 259 (1958). The right to rescission in such instances depends upon the promptness of action in rescinding after discovery of the fraud. Arnold v. Dowd, 85 Neb. 108, 122 N.W. 680 (1909). 

Recission is now allowed if the agent's fraudulent representations are outside of the subject-matter of the contract but communicated to the principal before the principal acts to ratify the contract. Dembowsk v. Central Constr. Co., 186 Neb. 624, 185 N.W.2d 461 (1971); Restatement (Second) of Agency § 260 (2) (1958). Ratification after notification has the same effect as an express authorization to make the contract. Shimonek v. Nebraska Bldg. & Inv. Co., 109 Neb. 424, 425-26, 191 N.W. 668 (1922).
liable in an action for rescission only for those representations made as to the subject-matter of the contract, a disclaimer clause being effective to relieve the principal of liability for those unknown representations made by the agent which do not concern the subject-matter of the contract. In addition, parol evidence remains admissible for showing such fraudulent representations as a means to invalidate the contract; thus rescission of the contract or a suit in fraud for damages is the defrauded party's proper remedy, not reformation or any other remedy which seeks to enlarge and enforce the contract.

But to the layman the Osbahr decision appeared to indicate that in the area of merchant-consumer relations the Nebraska Supreme Court had taken into account the realities of the marketplace where false representations are frequently used to induce buyers to sign form contracts designed to cut off their legal remedies. However, the appearances generated by Osbahr proved to be short-lived. Shortly thereafter, the Dembowski case came before the court, and a victim of the same fraudulent sales practice used by the same salesman involved in the Osbahr case, the same fraudulent sales scheme for which the Central Construction Company had been cited by the Federal Trade Commission ten years earlier, found himself without a remedy because the admittedly fraudulent representations were outside of the subject-matter of the contract, and the innocent principal had already performed.

With an eye to the magnitude of the consumer fraud problem in the direct sales area, the usefulness of such distinctions as expressed by Schuster and Dembowski continue to be recognized by an increasingly smaller and smaller group of people both inside and outside the legal profession. As a result of this growing dissatisfaction, efforts have been made since 1930 to legislate these tenuous distinctions out of existence. Pending the passage of increasingly effective federal or state legislation, future Nebraska consumers who

In the presence of a disclaimer clause a plaintiff cannot recover damages in a tort action for fraud or deceit unless the principal is shown to be not "innocent." An innocent principal can, by contract with another, relieve himself of liability for tort actions because of unauthorized fraud by a servant or other agent upon another party. Dembowski v. Central Constr. Co., 186 Neb. 624, 626, 185 N.W.2d 461, 463 (1971); Restatement (Second) of Agency § 260(1) (1958). Of course, if the principal obtained knowledge of the unauthorized acts of his agent prior to a change in position, tort recovery would be allowed notwithstanding the presence of a disclaimer clause. Maxiner v. Travelers Ins. Co., 133 Neb. 574, 276 N.W. 163 (1937).

Note 74 supra and accompanying text.
proceed under either a strict unfair trade practices approach based on the Federal Trade Commission Act and the Nebraska Uniform Deceptive Trade Practices Act or an illegal activity approach based on Nebraska's constitutional prohibition of lotteries should find that the courts will grant recission of their contracts on the grounds that they are void as against public policy. The results obtained by proceeding under either of these theories should give consumers a viable weapon against the widespread use of fraudulent sales practices and end the confusion existing in this area of Nebraska law which can too easily be made to favor the unscrupulous.

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