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The Journal of Legal Studies, Vol. 7, No. 1. (Jan., 1978), pp. 1-34.

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MISTAKE, DISCLOSURE, INFORMATION, AND THE LAW OF CONTRACTS*

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"[The greater part of the writers on natural law] are of opinion, that the good faith which ought to govern the contract of sale, only requires that the vendor should represent the thing sold as it is, without dissimulating its defects, and not to sell it above the price which it bears at the time of the contract; that he commits no injustice in selling it at this price, although he knows that the price must soon fall; that he is not obliged to disclose to the vendee a knowledge which he may have of the circumstances that may produce a depression of the price; the vendee having no more right to demand that the vendor should impart this knowledge than that he should give away his property. . . ."

Pothier, *Traité du Contract de Vente****

INTRODUCTION

THIS paper attempts to explain an apparent inconsistency in the law of contracts. On the one hand, there are many contract cases—generally classified under the rubric of unilateral mistake—which hold that a promisor is excused from his obligation to either perform or pay damages when he is mistaken about some important fact and his error is known (or should be known) to the other party. On the other hand, cases may also be found which state that in some circumstances one party to a contract is entitled to withhold information he knows the other party lacks. These latter cases typically rest upon the proposition that the party with knowledge does not owe the other party a "duty of disclosure."

Although these two lines of cases employ different doctrinal techniques, they both address essentially the same question: if one party to a contract knows or has reason to know that the other party is mistaken about a

* I would like to thank Gerhard Casper, Richard Epstein, Walter Hellerstein, Thomas Jackson, Edmund Kitch, William Landes, Richard Posner, George Priest, and George Stigler for their helpful comments on an earlier draft of this paper. Work on this paper was made possible by a grant from the Charles R. Walgreen Foundation.

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*** As quoted in *Laidlaw v. Organ*, 15 U.S. (2 Wheat.) 187-88, note b.

particular fact, does the knowledgeable party have a duty to speak up or may he remain silent and capitalize on the other party's error? The aim of this paper is to provide a theory which will explain why some contract cases impose such a duty and others do not.

The paper is divided into three parts. In the first part, I discuss the problem of unilateral mistake and offer an economic justification for the rule that a unilaterally mistaken promisor is excused when his error is known or should be known to the other party. In the second part of the paper, I propose a distinction between two kinds of information—information which is the result of a deliberate search and information which has been casually acquired. I argue that a legal privilege of nondisclosure is in effect a property right and attempt to show that where special knowledge or information is the fruit of a deliberate search the assignment of a property right of this sort is required in order to insure production of the information at a socially desirable level. I then attempt to show that a distinction between deliberately and casually acquired information is useful in explaining why disclosure is required in some contract cases but not in others.

In the third, and concluding, part of the paper, I return briefly to the problem of unilateral mistake, in order to reconcile the apparent conflict between the two lines of cases described above. I argue that this apparent conflict disappears when the unilateral mistake cases are viewed from the perspective developed in the second part of the paper.

I. MISTAKE AND THE ALLOCATION OF RISK.

Every contractual agreement is predicated upon a number of factual assumptions about the world. Some of these assumptions are shared by the parties to the contract and some are not. It is always possible that a particular factual assumption is mistaken.¹ From an economic point of view, the risk of such a mistake (whether it be the mistake of only one party or both) represents a cost.² It is a cost to the contracting parties themselves and to

¹ In a strictly economic sense, not all predictive errors are mistakes. An individual may fail to correctly predict a particular outcome merely because his knowledge of the world is incomplete. But unless it would be cost-justified for him to reduce the incompleteness of his knowledge by acquiring new information about the world, it would be incorrect—from an economic point of view—to regard a predictive error of this sort as a genuine mistake. An economist would be likely to define a mistake as an error in prediction resulting from a state of uncertainty which the mistaken party himself would agree could have been cured at a reasonable cost (by augmenting his knowledge of the world). In ordinary parlance, however, the term "mistake" is often used in a much broader sense to mean simply an error which would not have been made if the mistaken party's knowledge of the world had been more complete. It is in this ordinary sense that I use the term here.

² Traditionally, academic writers have urged that a variety of different factors be considered in deciding when to excuse a mistaken promisor. The following have been thought especially important: 1) the "nature" of the mistake: Samuel Williston, 13 *A Treatise on the Law of*

society as a whole since the actual occurrence of a mistake always (potentially) increases the resources which must be devoted to the process of allocating goods to their highest-valuing users.

There are basically two ways in which this particular cost can be reduced to an optimal level. First, one or both of the parties can take steps to prevent the mistake from occurring. Second, to the extent a mistake cannot be prevented, either party (or both) can insure against the risk of its occurrence

Contracts §§ 1544, 1569, 1570 (3d ed. 1970 [hereinafter cited as Williston]; Arthur Linton Corbin, 3 Corbin on Contracts § 597 (1960) [hereinafter cited as Corbin]; Restatement of Restitution § 9, comment c, § 16, comment c (1937); Restatement of Contracts § 502 (1932); 2) the likelihood of unjust enrichment if the promise is enforced: James Bradley Thayer, *Unilateral Mistake and Unjust Enrichment as a Ground for the Avoidance of Legal Transactions*, in *Harvard Legal Essays* 467-99 (1934); George E. Palmer, *Mistake and Unjust Enrichment* 8, 53, 96 (1962) [hereinafter cited as Palmer]; 3) the magnitude of the promisor's potential loss: Warren A. Seavey, *Problems in Restitution*, 7 Okla. L. Rev. 257, 267 (1954); Edward H. Rabin, *A Proposed Black-Letter Rule Concerning Mistaken Assumptions in Bargaining Transactions*, 45 Tex. L. Rev. 1273, 1288-91 (1967) [hereinafter cited as Rabin]; 4) the difficulty of compensating the promisee for any costs he may have incurred in reliance on the promise: Annot., 59 A.L.R. 809 (1929); Rabin at 1299; and 5) the allocation—to one party or the other—of the risk of the mistake: Rabin at 1292-94; Richard A. Posner, *Economic Analysis of Law*, 73-74 (2d ed. 1977) [hereinafter cited as Posner].

It has usually been assumed that each of these factors ought to be given some unspecified weight in deciding when to excuse a mistaken promisor. See Rabin at 1275. Recent treatments of mistake, however, particularly emphasize the importance of determining which party to the contract bears the risk of the mistake in question. This tendency to emphasize the importance of risk-allocation is quite apparent, for example, in the proposed chapter on mistake in the *Second Restatement of Contracts*. See *Restatement (Second) of Contracts* §§ 294-96 and *Introductory Note* (Tent. Draft No. 10, 1975).

The idea that the law often performs a risk-allocating function is of course not a new one. See Edwin W. Patterson, *The Apportionment of Business Risks Through Legal Devices*, 24 Colum. L. Rev. 335 (1924). But a growing and increasingly sophisticated literature on the subject has deepened our understanding of the concept of risk and has refined its use as an analytical tool. See, for example, Richard A. Posner & Andrew M. Rosenfield, *Impossibility and Related Doctrines in Contract Law: An Economic Analysis*, 6 J. Leg. Studies 83 (1977); Stephen S. Ashley, *The Economic Implications of the Doctrine of Impossibility*, 26 Hastings L. J. 1251 (1975); Paul L. Joskow, *Commercial Impossibility, The Uranium Market and the Westinghouse Case*, 6 J. Leg. Studies 119 (1977); Posner at 73-74; John P. Brown, *Product Liability: The Case of an Asset with a Random Life*, 64 Am. Econ. Rev. 149 (1974); Alan Schwartz, *Sales Law and Inflation*, 50 S. Cal. L. Rev. 1 (1976); Kenneth J. Arrow, *Insurance, Risk and Resource Allocation*, in *Theory of Risk-Bearing* (1971). An older, but useful, book is Charles O. Hardy, *Risk and Risk-Bearing* (1923).

As yet, no one has employed the idea of risk-allocation to give a systematic account of the law of mistake as a whole. Posner and Rosenfield, however, offer such an account of the closely allied problems of impossibility and frustration. A theory of mistake based upon the notion of risk-allocation may easily be constructed by generalizing from what has already been said about these related subjects.

Since it rests upon the principle of efficiency and is inspired by the work of scholars writing in the so-called "law and economics" field, I often characterize the point of view adopted in this paper as the "economic" point of view. There is, of course, much more to the economic theory of law in general and contract law in particular than the notion of risk-allocation. See, for example, Posner at 65-69, and Richard A. Posner, *Gratuitous Promises in Economics and Law*, 6 J. Leg. Studies 411 (1977).

by purchasing insurance from a professional insurer or by self-insuring.³

In what follows, I shall be concerned exclusively with the prevention of mistakes. Although this limitation might appear arbitrary, it is warranted by the fact that most mistake cases involve errors which can be prevented at a reasonable cost. Where a risk cannot be prevented at a reasonable cost—which is true of many of the risks associated with what the law calls “supervening impossibilities”—insurance is the only effective means of risk reduction. (This is why the concept of insurance unavoidably plays a more prominent role in the treatment of impossibility than it does in the analysis of mistake.)⁴

Information is the antidote to mistake. Although information is costly to produce,⁵ one individual may be able to obtain relevant information more cheaply than another. If the parties to a contract are acting rationally, they will minimize the joint costs of a potential mistake by assigning the risk of its occurrence to the party who is the better (cheaper) information-gatherer. Where the parties have actually assigned the risk—whether explicitly, or implicitly through their adherence to trade custom and past patterns of dealing—their own allocation must be respected.⁶ Where they have not—and there is a resulting gap in the contract⁷—a court concerned with economic efficiency should impose the risk on the better information-gatherer. This is so for familiar reasons: by allocating the risk in this way, an

³ Posner, *supra* note 2, at 74-79; Richard A. Posner & Andrew M. Rosenfield, *supra* note 2.

⁴ Many of the events which constitute supervening impossibilities cannot be prevented at a reasonable cost by either contracting party. For example, it is impossible to prevent the outbreak of war (*Paradine v. Jane*, 82 Eng. Rep. 897 (K.B., 1647), *Société Franco Tunisienne d'Armement v. Sidermar S.P.A.*, [1961] 2 Q.B. 278), a crop failure (*Howell v. Coupland*, [1874] 9 Q.B. 462, *Anderson v. May*, 50 Minn. 280, 52 N.W. 530 (1892)), the establishment of a government regulation (*Lloyd v. Murphy*, 25 Cal. 2d 48, 153 P.2d 47 (1944)), or the cancellation of a coronation parade (*Krell v. Henry*, [1903] 2 K.B. 740 (C.A.)). Where an event cannot be prevented from occurring, the risk of its occurrence can be effectively reduced only through insurance. This is the principal reason why insurance plays a more important role in impossibility cases than it does in dealing with mistake. Richard A. Posner & Andrew M. Rosenfield, *supra* note 2, at 91.

⁵ George J. Stigler, *The Economics of Information*, 69 J. Pol. Econ. 213 (1961), reprinted in *The Organization of Industry* 171 (1968).

⁶ For a discussion of the way in which trade customs may affect the allocation of risk, see Harold J. Berman, *Excuse for Nonperformance in the Light of Contract Practices in International Trade*, 63 Colum. L. Rev. 1413 (1963), and Note, *Custom and Trade Usages: Its Application to Commercial Dealings and the Common Law*, 55 Colum. L. Rev. 1192 (1955).

⁷ Whether such a gap exists will depend upon the intentions of the parties as reconstructed by a process of judicial interpretation. The fact that a contract does not cover a particular point explicitly does not mean that the parties failed to reach an understanding with respect to the point in question. Only if no such understanding exists can the contract be said to contain a genuine gap or lacuna. The difficult problems of interpretation which are involved in identifying and then filling gaps are explored in two articles by Professor Farnsworth. See E. Allen Farnsworth, “Meaning” in the Law of Contracts, 76 Yale L.J. 939 (1967), and *id.*, *Disputes Over Omissions in Contracts*, 68 Colum. L. Rev. 860 (1968).

efficiency-minded court reduces the transaction costs of the contracting process itself.⁸

The most important doctrinal distinction in the law of mistake is the one drawn between “mutual” and “unilateral” mistakes. Traditionally, courts have been more reluctant to excuse a mistaken promisor where he alone is mistaken than where the other party is mistaken as to the same fact.⁹ Although relief for unilateral mistake has been liberalized during the last half-century¹⁰ (to the point where some commentators have questioned the utility of the distinction between unilateral and mutual mistake and a few have even urged its abolition),¹¹ it is still “black-letter” law that a promisor whose mistake is not shared by the other party is less likely to be relieved of his duty to perform than a promisor whose mistake happens to be mutual.¹²

Viewed broadly, the distinction between mutual and unilateral mistake makes sense from an economic point of view. Where both parties to a contract are mistaken about the same fact or state of affairs, deciding which of them would have been better able to prevent the mistake may well require a detailed inquiry regarding the nature of the mistake and the (economic) role or position of each of the parties involved.¹³ But where only one party is mistaken, it is reasonable to assume that he is in a better position than the other party to prevent his own error. As we shall see, this is not true in every case, but it provides a useful beginning point for analysis and helps to explain the generic difference between mutual and unilateral mistakes.

The case of *Bowser v. Hamilton Glass Co.*¹⁴ provides a simple illustration. In *Bowser*, the plaintiff was a contractor working on a government project. He solicited bids from subcontractors for the production, among other things, of “variable reflector glasses.” In response to the solicitation, the defendant submitted a bid of \$.22 each for 1,400 glasses. The plaintiff sent the defendant a formal “purchase order,” which constituted his offer to enter a binding contract. Detailed specifications and blueprints were attached to the purchase order. The defendant acknowledged receipt of the purchase

⁸ Posner, *supra* note 2, at 74-79; Richard A. Posner & Andrew M. Rosenfield, *supra* note 2, at 88-89.

⁹ Restatement (Second) of Contracts, § 295, Comment A (Tent. Draft No. 10, 1975).

¹⁰ *Id.*

¹¹ 3 Corbin, *supra* note 2, at § 608; Palmer, *supra* note 2, at 67, 96-98; Rabin, *supra* note 2, at 1277-79.

¹² Although it liberalizes relief for unilateral mistake, the Second Restatement of Contracts preserves the basic doctrinal distinction between unilateral and mutual mistake, and makes relief less freely available in the former case than in the latter. In this regard, compare Restatement (Second) of Contracts, §§ 294-95 (Tent. Draft No. 10, 1975) with Restatement of Contracts §§ 502-03 (1932).

¹³ Professor Posner's discussion of *Sherwood v. Walker* illustrates this point. See Posner, *supra* note 2.

¹⁴ 207 F.2d 341 (7th Cir. 1953).

order and produced the glasses. Upon learning that the finished glasses did not conform to the contract specifications, the defendant informed the plaintiff that it would “cancel” the agreement. The plaintiff obtained the glasses from another manufacturer and sued to recover the difference between what it eventually had to pay for them and what it had agreed to pay the defendant. The defendant asserted that it had been mistaken as to the nature of the goods to be produced. The court, in holding for the plaintiff, said that the defendant’s mistake did not justify relief, asserting that a unilateral mistake will excuse only where it is known to the other party.

Clearly, the result in *Bowser* makes economic sense. The defendant was in the best position to guard against his own mistake by carefully reading the specifications and examining the blueprints. Although the plaintiff could have prevented the mistake by acquiring the necessary expertise himself, by supervising the defendant’s own initial reading of the proposed contract, and by periodically checking to make sure that the produced goods conformed to the contract specifications, it would have been very expensive for him to do so. The joint costs of an error of this sort are minimized by putting the risk of the mistake on the mistaken party. This is the solution the parties themselves would have agreed to if they had been made aware of the risk at the time the contract was formed. It is also the solution which is optimal from a social point of view.

In the past, it was often asserted that, absent fraud or misrepresentation, a unilateral mistake never justifies excusing the mistaken party from his duty to perform or pay damages.¹⁵ This is certainly no longer the law, and Corbin has demonstrated that in all probability it never was.¹⁶ One well-established exception protects the unilaterally mistaken promisor whose error is known or reasonably should be known to the other party.¹⁷ Relief has long been available in this case despite the fact that the promisor’s mistake is not shared by the other party to the contract.

For example, if a bidder submits a bid containing a clerical error or miscalculation, and the mistake is either evident on the face of the bid or may reasonably be inferred from a discrepancy between it and other bids, the bidder will typically be permitted to withdraw the bid without having to

¹⁵ 3 Corbin, *supra* note 2, at § 608; Restatement of Contracts § 503 (1932).

¹⁶ 3 Corbin, *supra* note 2, at § 608; “Statements are exceedingly common, both in texts and in court opinions, that relief will not be given on the ground of mistake unless the mistake is ‘mutual’. Such a broad generalization is untrue. Seldom is it accompanied by either definition or analysis . . . Cases do not always submit to be classified with either ‘mutual mistake’ or ‘unilateral mistake’. And even when they do submit, the solution does not mechanically follow in accordance with a separate set of rules for each class. Very often relief has been and will be granted where the mistake is unilateral.”

¹⁷ 3 Corbin, *supra* note 2, at § 610; Benedict I. Lubell, Unilateral Palpable and Impalpable Mistake in Construction Contracts, 16 Minn. L. Rev. 137 (1932) [hereinafter cited as Lubell]; Rabin, *supra* note 2, at 1279-81.

pay damages (even after the bid has been accepted and in some cases relied upon by the other party).¹⁸ Or, to take another example, suppose that *A* submits a proposed contract in writing to *B* and knows that *B* has misread the document. If *B* accepts the proposed contract, upon discovering his error, he may avoid his obligations under the contract and has no duty to compensate *A* for *A*'s lost expectation.¹⁹ A closely related situation involves the offer which is "too good to be true." One receiving such an offer cannot "snap it up"; if he does so, the offeror may withdraw the offer despite the fact that it has been accepted.²⁰

In each of the cases just described, one party is mistaken and the other has actual knowledge or reason to know of his mistake. The mistaken party in each case is excused from meeting any contractual obligations owed to the party with knowledge.

A rule of this sort is a sensible one. While it is true that in each of the cases just described the mistaken party is likely to be the one best able to prevent the mistake from occurring in the first place (by exercising care in preparing his bid or in reading the proposed contract which has been submitted to him), the other party may be able to rectify the mistake more cheaply in the interim between its occurrence and the formation of the contract. At one moment in time the mistaken party is the better mistake-preventer (information-gatherer). At some subsequent moment, however, the other

¹⁸ "Suppose, first, a case in which a bidding contractor makes an offer to supply specified goods or to do specified work for a definitely named price, and that he was caused to name this price by an antecedent error of computation. If, before acceptance, the offeree knows, or has reason to know, that a material error has been made, he is seldom mean enough to accept; and if he does accept, the courts have no difficulty in throwing him out. He is not permitted 'to snap up' such an offer and profit thereby." 3 Corbin, *supra* note 2, at § 609. For a case in which a bidding contractor was permitted to withdraw his bid despite acceptance and reliance by the party to whom it was submitted, see *Union Tank Car Co. v. Wheat Brothers*, 15 Utah 2d 101, 387 P.2d 1000 (1964).

It would be irrational from an economic point of view to permit the party with knowledge (or reason to know) of the mistake to enforce the other party's promise on reliance grounds. A rule of this sort would encourage reliance precisely where it ought to be discouraged.

If the non-mistaken party has *no reason to know* of the error, however, the extent of his reliance is often a factor in determining the damages to which he is entitled. If he has substantially relied on the mistaken party's promise, the non-mistaken party will usually be given the right to enforce the contract (by suing to recover his lost expectation). If, on the other hand, the non-mistaken party has not substantially relied on the promise before the error is discovered, courts will often allow the mistaken party to withdraw from the contract on the condition that he compensate the non-mistaken party for any reliance expenses or incidental costs he has incurred (such as having to solicit new bids).

¹⁹ 3 Corbin, *supra* note 2, at § 607; Williston, *supra* note 2, at § 1577. See also *Restatement of Contracts* § 505, Comment A (1932) (dealing with the mistaken party's right to have the contract reformed).

²⁰ 1 Williston, *supra* note 2, at § 94. See *Bell v. Carroll*, 212 Ky. 231, 278 S.W. 541 (1925), *Germain Fruit Co. v. Western Union Tel Co.*, 137 Cal. 598, 70 P. 658 (1902), *United States v. Braunstein*, 75 F. Supp. 137 (S.D.N.Y. 1947).

party may be the better preventer because of his superior access to relevant information that will disclose the mistake and thus allow its correction. This may be so, for example, if he has other bids to compare with the mistaken one since this will provide him with information which the bidder himself lacks.²¹ Of course, if the mistake is one which cannot reasonably be known by the non-mistaken party (that is, if he would have to incur substantial costs in order to discover it), there is no reason to assume that the non-mistaken party is the better (more efficient) mistake-preventer at the time the contract is executed. But if the mistake is actually known or could be discovered at a very slight cost, the principle of efficiency is best served by a compound liability rule which imposes initial responsibility for the mistake on the mistaken party but shifts liability to the other party if he has actual knowledge or reason to know of the error. Compound liability rules of this sort are familiar in other areas of the law: the tort doctrine of "last clear chance" is one example.²²

The cases in which relief is granted to a unilaterally mistaken promisor on the grounds that his mistake was known or reasonably knowable by the other party appear, however, to conflict sharply with another line of cases. These cases deal with the related problems of fraud and disclosure: if one party to a contract knows that the other is mistaken as to some material fact, is it fraud for the party with knowledge to fail to disclose the error and may the mistaken party avoid the contract on the theory that he was owed a duty of disclosure?²³ This question is not always answered in the same way. In some cases, courts typically find a duty to disclose and in others they do not.²⁴ It is the latter group of cases—those not requiring disclosure—which

²¹ See Lubell, *supra* note 17, at 147-54.

²² See Richard A. Posner, A Theory of Negligence, 1 J. Leg. Studies 29, 58 (1972); Charles O. Gregory, Harry Kalven, Jr., & Richard A. Epstein, Cases and Materials on Torts, 400-06 (3d ed. 1977). It might be argued that a compound liability rule of this sort will encourage the mistaken party to reduce his own initial investment in mistake prevention. This may be true to a limited extent. But since the (potentially) mistaken party has no way of knowing whether any mistake he might make would be known or reasonably knowable by the other party, he takes a substantial risk in reducing the level of his own efforts at mistake prevention. The larger this risk, the smaller his reduction will be. For a general discussion of how liability rules affect individual behavior and accident prevention in the context of a single activity, see Peter A. Diamond, Single Activity Accidents, 3 J. Leg. Studies 107 (1974).

²³ Although the nondisclosure cases are often discussed in connection with the problem of unilateral mistake, the relation between the doctrines of nondisclosure and mistake has frequently puzzled commentators. Thus, in a classic article one commentator writes: "A case of some difficulty arises where the unilateral mistake is known to the other party and he joins in the formation of the contract with the mistake uncorrected. The question of how far he is under a duty to disclose his superior knowledge is determined by principles of the law other than those we have under discussion [that is, the principles of mistake], and where there is such a duty to disclose and failure to observe it, there is generally a case of fraud." Roland R. Foulke, Mistake in the Formation and Performance of a Contract, 11 Colum. L. Rev. 197, 229 (1911). See also Rabin, *supra* note 2, at 1279; Palmer, *supra* note 2, at 80-89.

²⁴ 12 Williston, *supra* note 2, at §§ 1497-99. See text at notes 49-76 *infra*.

appear to conflict with the rule that a unilateral mistake will excuse if the other party knows or has reason to know of its existence.

In the cases not requiring disclosure, one party is mistaken and the other party knows or has reason to know it. Can these cases be reconciled with those which stand for the proposition that a unilateral mistake plus knowledge or reason to know will excuse the mistaken party? More particularly, can the apparent divergence between these two lines of cases be explained on economic grounds?

The rest of this paper is devoted to answering these two questions. In brief, the answer I propose is as follows. Where nondisclosure is permitted (or put differently, where the knowledgeable party's contract rights are enforced despite his failure to disclose a known mistake), the knowledge involved is typically the product of a costly search. A rule permitting nondisclosure is the only effective way of providing an incentive to invest in the production of such knowledge. By contrast, in the cases requiring disclosure,²⁵ and in those excusing a unilaterally mistaken promisor because the other party knew or had reason to know of his error, the knowledgeable party's special information is typically not the fruit of a deliberate search. Although information of this sort is socially useful as well, a disclosure requirement will not cause a sharp reduction in the amount of such information which is actually produced. If one takes into account the investment costs incurred in the deliberate production of information, the two apparently divergent lines of cases described above may both be seen as conforming (roughly) to the principle of efficiency, which requires that the risk of a unilateral mistake be placed on the most effective risk-preventer.

II. THE PRODUCTION OF INFORMATION AND THE DUTY TO DISCLOSE

A. *General Considerations*

It is appropriate to begin a discussion of fraud and nondisclosure in contract law with the celebrated case of *Laidlaw v. Organ*.²⁶ Organ was a New Orleans commission merchant engaged in the purchase and sale of tobacco.

²⁵ Although throughout the paper I use the expression "duty to disclose," the duty involved is typically not a true legal obligation. If the party with knowledge fails to disclose the other party's error, his failure to do so will give the mistaken party grounds for avoiding any contract which has been concluded between them. In the absence of such a contract, however, the knowing party has no positive duty to disclose—that is, nondisclosure will not by itself give the mistaken party the right to sue him for damages. Of course, in some cases—for example, where there is a fiduciary relation between the parties—a positive duty of this latter sort may exist. Where it does, a failure to disclose is not simply a defense to the knowing party's suit to enforce the other party's contractual obligations; it also provides the mistaken party with an independent cause of action for damages.

²⁶ *Laidlaw v. Organ*, 15 U.S. (2 Wheat.) 178.

Early on the morning of February 19, 1815, he was informed by a Mr. Shepherd that a peace treaty had been signed at Ghent by American and British officers, formally ending the War of 1812. Mr. Shepherd (who was himself interested in the profits of the transaction involved in *Laidlaw v. Organ*) had obtained information regarding the treaty from his brother who, along with two other gentlemen, brought the news from the British Fleet. (What Shepherd's brother and his companions were doing with the British Fleet is not disclosed.)

Knowledge of the treaty was made public in a handbill circulated around eight o'clock on the morning of the nineteenth. However, before the treaty's existence had been publicized ("soon after sunrise" according to the reported version of the case), Organ, knowing of the treaty, called on a representative of the Laidlaw firm and entered into a contract for the purchase of 111 hogsheads of tobacco. Before agreeing to sell the tobacco, the Laidlaw representative "asked if there was any news which was calculated to enhance the price or value of the article about to be purchased." It is unclear what response, if any, Organ made to this inquiry.²⁷

As a result of the news of the treaty—which signalled an end to the naval blockade of New Orleans—the market price of tobacco quickly rose by 30 to 50 percent. Laidlaw refused to deliver the tobacco as he had originally promised. Organ subsequently brought suit to recover damages and to block Laidlaw from otherwise disposing of the goods in controversy. Although the report of the case is unclear, it appears that the trial judge directed a verdict in Organ's favor. The case was appealed to the United States Supreme Court which in an opinion by Chief Justice Marshall remanded with directions for a new trial. The Court concluded that the question "whether any imposition was practiced by the vendee upon the vendor ought to have been submitted to the jury" and that as a result "the absolute instruction of the judge was erroneous." Marshall's opinion is more famous, however, for its dictum than for its holding:

The question in this case is, whether the intelligence of extrinsic circumstances, which might influence the price of the commodity, and which was exclusively within the knowledge of the vendee, ought to have been communicated by him to the vendor? The court is of opinion that he was not bound to communicate it. It would be difficult to circumscribe the contrary doctrine within proper limits, where the means of intelligence are equally accessible to both parties. But at the same time, each party must take care not to say or do anything tending to impose upon the other.

²⁷ If Organ denied that he had heard any news of this sort, he would have committed a fraud. It may even be, in light of Laidlaw's direct question, that silence on Organ's part was fraudulent. William W. Story, *A Treatise on the Law of Contracts* 444 n.2 (2d ed. 1847). In my discussion of the case, and of the general rule which Marshall lays down in his famous dictum, I have put aside any question of fraud on Organ's part. See note 49 *infra*.

Although Marshall's dictum in *Laidlaw v. Organ* has been sharply criticized,²⁸ it is still generally regarded as an accurate statement of the law (when properly interpreted).²⁹ The broad rule which Marshall endorses has usually been justified on three related grounds: that it conforms to the legitimate expectations of commercial parties and thus accurately reflects the (harsh) morality of the marketplace;³⁰ that in a contract for the sale of goods each party takes the risk that his own evaluation of the worth of the goods may be erroneous;³¹ or finally, that it justly rewards the intelligence and industry of the party with special knowledge (in this case, the buyer).³² This last idea may be elaborated in the following way.

News of the treaty of Ghent affected the price of tobacco in New Orleans. Price measures the relative value of commodities: information regarding the treaty revealed a new state of affairs in which the value of tobacco—relative to other goods and to tobacco-substitutes in particular—had altered.³³ An alteration of this sort is almost certain to affect the allocation of social resources.³⁴ If the price of tobacco to suppliers rises, for example, farmers will be encouraged to plant more tobacco and tobacco merchants may be prepared to pay more to get their goods to and from market. In this way, the

²⁸ See, for example, Palmer, *supra* note 2, at 84.

²⁹ 12 Williston, *supra* note 2, at § 1497; Restatement of Contracts § 472, Comment B (1932); Rabin, *supra* note 2, at 1279; W. Page Keeton, Fraud—Concealment and Non-Disclosure, 15 Tex. L. Rev. 1, 21-23 (1936) [hereinafter cited as Keeton]; Edwin W. Patterson, Essentials of Insurance Law 447 (1957).

³⁰ Classic statements of this idea may be found in William W. Story, *supra* note 27, at 442-43, and James Kent, 2 Commentaries §§ 484, 485 (12th ed. 1873).

³¹ "If in an arm's-length bargaining transaction A has assumed the risk concerning the existence or nonexistence of certain facts, and he is mistaken concerning these facts, and there has been no fraud or imposition, A will not be able to rescind his contract, regardless of B's knowledge of A's mistake" [citing *Laidlaw v. Organ*, 15 U.S. (2 Wheat.) 178 (1817)]. Rabin, *supra* note 2, at 1279.

³² In his excellent law review article on fraud and nondisclosure, Professor Keeton draws attention to the fact that courts, in deciding when to impose a duty to disclose special information, have been influenced by the way in which the information was acquired. At one point, for example, he states that "the way in which the buyer acquires the information which he conceals from the vendor should be a material circumstance. The information might have been acquired as a result of his bringing to bear a superior knowledge, intelligence, skill or technical judgment; it might have been acquired by mere chance; or it might have been acquired by means of some tortious action on his part." Keeton, *supra* note 29, at 25. The main purpose of the present article is to develop this distinction between different kinds of information in a more rigorous fashion, to justify the distinction on economic grounds, and to demonstrate its explanatory power as a principle for ordering the disclosure cases.

³³ See generally Jack Hirshleifer, The Private and Social Value of Information and the Reward to Inventive Activity, 61 Am. Econ. Rev. 561 (1977) [hereinafter cited as Hirshleifer].

³⁴ This will not be true in a regime of "pure exchange," that is, in a regime where goods are only exchanged and not produced (the pool of exchanged goods remaining constant). In "the more realistic regime in which production and exchange both take place," however, information of the sort involved in *Laidlaw v. Organ* will have allocative consequences. Hirshleifer, *supra* note 33, at 566-67.

proportion of society's (limited) resources devoted to the production and transportation of tobacco will be increased. Information revealing a change in circumstances which alters the relative value of a particular commodity will always have some (perhaps unmeasurable) allocative impact. (In addition, of course, information of this sort will have distributive consequences: the owners of tobacco or of rights to tobacco will be relatively wealthier after the price rise, assuming that other prices have not risen or have not risen as fast.)

From a social point of view, it is desirable that information which reveals a change in circumstances affecting the relative value of commodities reach the market as quickly as possible (or put differently, that the time between the change itself and its comprehension and assessment be minimized).³⁵ If a farmer who would have planted tobacco had he known of the change plants peanuts instead, he will have to choose between either uprooting one crop and substituting another (which may be prohibitively expensive and will in any case be costly), or devoting his land to a nonoptimal use. In either case, both the individual farmer and society as a whole will be worse off than if he had planted tobacco to begin with. The sooner information of the change reaches the farmer, the less likely it is that social resources will be wasted.

Consider another (and perhaps more realistic) illustration of the same point. *A* is a shipowner who normally transports goods between New Orleans and various other ports. However, because of the naval blockade, he is unable to enter the New Orleans harbor. Some time after the treaty is signed, but before its existence is publicized, *A* enters a contract to ship cotton from Savannah to New York City. After news of the treaty reaches New Orleans, a tobacco merchant in that city offers *A* a "bonus" if he will agree to deliver a shipment of tobacco to Baltimore. If we assume that the offer is sufficiently attractive to induce *A* to breach his first contract and pay damages,³⁶ although his ship will be properly allocated to its highest-valuing

³⁵ "To gain an advantage from better knowledge of facilities of communication or transport is sometimes regarded as almost dishonest, although it is quite as important that society make use of the best opportunities in this respect as in using the latest scientific discoveries. This prejudice has in a considerable measure affected the attitude toward commerce in general compared with that toward production. Even economists who regard themselves as definitely above the crude materialist fallacies of the past constantly commit the same mistake where activities directed toward the acquisition of such practical knowledge are concerned—apparently because in their scheme of things all such knowledge is supposed to be 'given'. The common idea now seems to be that all such knowledge should as a matter of course be readily at the command of everybody, and the reproach of irrationality leveled against the existing economic order is frequently based on the fact that it is not so available. This view disregards the fact that the method by which such knowledge can be made as widely available as possible is precisely the problem to which we have to find an answer." F. A. Hayek, *The Use of Knowledge in Society*, 35 *Am. Econ. Rev.* 519, 522 (1945).

³⁶ Which it will be if the new offer is for an amount greater than the old contract plus whatever damages *A* will have to pay *B* for breach of his original promise to carry *B*'s cotton to

user, the cost of allocating it will be greater than it would have been had information of the treaty reached *A* before he entered his first contract. Resources will be consumed by *A* in transacting out of the first contract; from a social point of view, their consumption represents a pure waste.

Allocative efficiency is promoted by getting information of changed circumstances to the market as quickly as possible. Of course, the information doesn't just "get" there. Like everything else, it is supplied by individuals (either directly, by being publicized, or indirectly, when it is signalled by an individual's market behavior).

In some cases, the individuals who supply information have obtained it by a deliberate search; in other cases, their information has been acquired casually.³⁷ A securities analyst, for example, acquires information about a particular corporation in a deliberate fashion—by carefully studying evidence of its economic performance. By contrast, a businessman who acquires a valuable piece of information when he accidentally overhears a conversation on a bus acquires the information casually.³⁸

As it is used here, the term "deliberately acquired information" means information whose acquisition entails costs which would not have been incurred but for the likelihood, however great, that the information in question would actually be produced. These costs may include, of course, not only direct search costs (the cost of examining the corporation's annual statement) but the costs of developing an initial expertise as well (for example, the cost of attending business school). If the costs incurred in acquiring the information (the cost of the bus ticket in the second example) would have been incurred in any case—that is, whether or not the information was forthcoming—the information may be said to have been casually acquired. The distinction between deliberately and casually acquired information is a shorthand way of expressing this economic difference. Although in reality it may be difficult to determine whether any particular item of information has been acquired in one way or the other, the distinction between these two types of information has—as I hope to show—considerable analytical usefulness.

If information has been deliberately acquired (in the sense defined above), and its possessor is denied the benefits of having and using it, he will have an

New York. See John H. Barton, *The Economic Basis of Damages for Breach of Contract*, 1 *J. Leg. Studies* 277 (1972); Posner, *supra* note 2, at 88-93.

³⁷ Compare the distinction between "professional" and "altruistic" rescuers drawn by William M. Landes & Richard A. Posner in *Salvors, Finders, Good Samaritans, and Other Rescuers: An Economic Study of Law and Altruism*, 7 *J. Leg. Studies* 83 (1978). The costs of searching for information are analyzed in Stigler, *The Economics of Information in the Organization of Industry* (1968).

³⁸ Unless, of course, he rides buses for this very purpose. In this improbable case, he would acquire his information deliberately.

incentive to reduce (or curtail entirely) his production of such information in the future. This is in fact merely a consequence of defining deliberately acquired information in the way that I have, since one who acquires information of this sort will by definition have incurred costs which he would have avoided had it not been for the prospect of the benefits he has now been denied. By being denied the same benefits, one who has casually acquired information will not be discouraged from doing what—for independent reasons—he would have done in any case.

It might be claimed that whenever the benefits of possessing any kind of information are either increased or decreased, one would expect to find *some* overall adjustment in the level of investment in the production of such information. If he is not permitted to benefit from the information he acquires, even the bus rider will in the future pay less attention to the conversations going on around him (although it would certainly be strange if he stopped riding buses altogether). But while it is true that in reality every adjustment (upwards or downwards) in the benefits of possessing a particular kind of information will have an incentive effect of some sort, the effect may vary in magnitude—it may be greater or lesser. Strictly speaking, casually acquired information (as I have used the term up to this point) represents the ideal limit of a continuum—the case in which the change in magnitude that results from eliminating one of the benefits of possessing certain information is zero. In any real case there will be incentive effects which fall somewhere along the continuum. However, where the decline in the production of a certain kind of information which is caused by denying its possessor the right to appropriate the information for his own benefit is small, it is likely to be more than offset by the corresponding social gain that results from the avoidance of mistakes. In the argument that follows, I shall use the term “casually acquired information” in a somewhat looser sense than I have used it so far to refer to information of this sort.

One effective way of insuring that an individual will benefit from the possession of information (or anything else for that matter) is to assign him a property right in the information itself—a right or entitlement to invoke the coercive machinery of the state in order to exclude others from its use and enjoyment.³⁹ The benefits of possession become secure only when the state transforms the possessor of information into an owner by investing him with a legally enforceable property right of some sort or other. The assignment of property rights in information is a familiar feature of our legal system. The legal protection accorded patented inventions and certain trade secrets are two obvious examples.⁴⁰

³⁹ See Harold Demsetz, *Toward a Theory of Property Rights*, 57 *Am. Econ. Rev.* 347 (Papers & Proceedings 1967).

⁴⁰ See Arnold Plant, *The Economic Theory Concerning Patents for Inventions*, in *Selected Economic Essays and Addresses* 35 (1974).

One (seldom noticed) way in which the legal system can establish property rights in information is by permitting an informed party to enter—and enforce—contracts which his information suggests are profitable, without disclosing the information to the other party.⁴¹ Imposing a duty to disclose upon the knowledgeable party deprives him of a private advantage which the information would otherwise afford. A duty to disclose is tantamount to a requirement that the benefit of the information be publicly shared and is thus antithetical to the notion of a property right which—whatever else it may entail—always requires the legal protection of private appropriation.⁴²

Of course, different sorts of property rights may be better suited for protecting possessory interests in different sorts of information.⁴³ It is unlikely, for example, that information of the kind involved in *Laidlaw v. Organ* could be effectively protected by a patent system.⁴⁴ The only feasible way of assigning property rights in short-lived market information is to permit those with such information to contract freely without disclosing what they know.

It is unclear, from the report of the case, whether the buyer in *Laidlaw* casually acquired his information or made a deliberate investment in seeking it out (for example, by cultivating a network of valuable commercial “friendships”). If we assume the buyer casually acquired his knowledge of the treaty, requiring him to disclose the information to his seller (that is, denying him a property right in the information) will have no significant effect on his future behavior. Since one who casually acquires information makes no investment in its acquisition, subjecting him to a duty to disclose is not likely

⁴¹ This notion is suggested—but not developed—by Hirshleifer. In discussing the fate of Eli Whitney, who “invested considerable resources in the attempt to protect his patent and prosecute infringements” (to no avail), Hirshleifer has this to say:

“But what seems to have been overlooked is that there were other routes to profit for Whitney. The cotton gin had obvious speculative implications for the price of cotton, the value of slaves and of cotton-bearing land, the business prospects of firms engaged in cotton warehousing and shipping, the site values of key points in the transportation network that sprang up. There were also predictable implications for competitor industries (wool) and complementary ones (textiles, machinery). It seems very likely that some forethoughted individuals reaped speculative gains on these developments, though apparently Whitney did not. And yet, he was the first in the know, the possessor of an unparalleled opportunity for speculative profit. Alternatively, of course, Whitney could have attempted to keep his process secret except to those who bought the information from him.”

Hirshleifer, *supra* note 33, at 571.

⁴² If one party to a contract is under a duty to disclose, he must speak up whether or not the other party to the contract asks him what he knows. The fact that the knowledgeable party is *not* under a duty of disclosure does not mean, however, that he can lie when asked a question of this sort. That would be fraud. However, the knowledgeable party who is not under such a duty may refuse to respond to the other party’s inquiries, and put the other party to the risk of deciding whether to go ahead with the contract or not. (The knowledgeable party may, of course, simply sell his information to the other party if he wishes.)

⁴³ On the general costs of establishing property rights in information, see Harold Demsetz, *Information and Efficiency: Another Viewpoint*, 12 *J. Law & Econ.* 1, 10-11 (1969).

⁴⁴ See Arnold Plant, *supra* note 40 for a discussion of the costs of the patent system, as compared with other legal devices for the assignment of property rights in information.

to reduce the amount of socially useful information which he actually generates. Of course, if the buyer in *Laidlaw* acquired his knowledge of the treaty as the result of a deliberate and costly search, a disclosure requirement will deprive him of any private benefit which he might otherwise realize from possession of the information and should discourage him from making similar investments in the future.

In addition, since it would enable the seller to appropriate the buyer's information without cost and would eliminate the danger of his being lured unwittingly into a losing contract by one possessing superior knowledge, a disclosure requirement will also reduce the seller's incentive to search. Denying the buyer a property right in deliberately acquired information will therefore discourage both buyers and sellers from investing in the development of expertise and in the actual search for information. The assignment of such a right will not only protect the investment of the party possessing the special knowledge, it will also impose an opportunity cost on the other party and thus give him an incentive to undertake a (cost-justified) search of his own.

If we assume that courts can easily discriminate between those who have acquired information casually and those who have acquired it deliberately, plausible economic considerations might well justify imposing a duty to disclose on a case-by-case basis (imposing it where the information has been casually acquired, refusing to impose it where the information is the fruit of a deliberate search). A party who has casually acquired information is, at the time of the transaction, likely to be a better (cheaper) mistake-preventer than the mistaken party with whom he deals—regardless of the fact that both parties initially had equal access to the information in question. One who has deliberately acquired information is also in a position to prevent the other party's error. But in determining the cost to the knowledgeable party of preventing the mistake (by disclosure), we must include whatever investment he has made in acquiring the information in the first place. This investment will represent a loss to him if the other party can avoid the contract on the grounds that the party with the information owes him a duty of disclosure.

If we take this cost into account, it is no longer clear that the party with knowledge is the cheaper mistake-preventer when his knowledge has been deliberately acquired. Indeed, the opposite conclusion seems more plausible. In this case, therefore, a rule permitting nondisclosure (which has the effect of imposing the risk of a mistake on the mistaken party) corresponds to the arrangement the parties themselves would have been likely to adopt if they had negotiated an explicit allocation of the risk at the time they entered the contract. The parties to a contract are always free to allocate this particular risk by including an appropriate disclaimer in the terms of their agreement. Where they have failed to do so, however, the object of the law of contracts should be (as it is elsewhere) to reduce transaction costs by

providing a legal rule which approximates the arrangement the parties would have chosen for themselves if they had deliberately addressed the problem.⁴⁵ This consideration, coupled with the reduction in the production of socially useful information which is likely to follow from subjecting him to a disclosure requirement, suggests that allocative efficiency is best served by permitting one who possesses deliberately acquired information to enter and enforce favorable bargains without disclosing what he knows.⁴⁶

A rule which calls for case-by-case application of a disclosure requirement is likely, however, to involve factual issues that will be difficult (and expensive) to resolve. *Laidlaw* itself illustrates this point nicely. On the facts of the case, as we have them, it is impossible to determine whether the buyer actually made a deliberate investment in acquiring information regarding the treaty. The cost of administering a disclosure requirement on a case-by-case basis is likely to be substantial.⁴⁷

As an alternative, one might uniformly apply a blanket rule (of disclosure or nondisclosure) across each class of cases involving the same sort of information (for example, information about market conditions or about defects in property held for sale). In determining the appropriate blanket rule for a particular class of cases, it would first be necessary to decide whether the

⁴⁵ Posner, *supra* note 2, at 65-69; Richard A. Posner & Andrew M. Rosenfield, *supra* note 2, at 88-89.

⁴⁶ In recent years, there has been considerable disagreement among economists regarding the optimal level of private investment in the production of information. This problem has been discussed in Kenneth J. Arrow, Higher Education as a Filter, 2 J. Pub. Econ. 193 (1973); Harold Demsetz, Information and Efficiency: Another Viewpoint, 12 J. Law & Econ. 1 (1969); John M. Marshall, Private Incentives and Public Information, 64 Am. Econ. Rev. 373 (1974); Eugene F. Fama & Arthur B. Laffer, Information and Capital Markets, 44 J. Bus. 289 (1971); Hirshleifer, *supra* note 33; and Yoram Barzel, Some Fallacies in the Interpretation of Information Costs, 20 J. Law & Econ. 291 (1977).

The economists who have discussed the problem agree that under a legal system which recognized no property rights in information, too little information would be produced. Several economists, however, have expressed a concern that a system of property rights in information may, under some circumstances, induce an overinvestment in the production of information. See, for example, Hirshleifer, *supra* note 33, at 573. Assuming that our legal rules cannot be more finely tuned, in deciding whether to permit the nondisclosure of certain information (that is, grant a property right in the information), we may be forced to make a practical choice between over- and underinvestment—between two less-than-optimal alternatives. However, since it is certain that the elimination of property rights will result in underproduction, and merely a danger that the recognition of such rights will lead to overproduction, there is a strong (but not conclusive) economic case for recognizing property rights in information, at least where the information is deliberately acquired. From an economic point of view, this may not be an optimal solution, but it is more attractive than the other (practical) alternative.

⁴⁷ For a general discussion of the costs (and benefits) of specificity in the formulation of legal rules, see Isaac Ehrlich & Richard A. Posner, An Economic Analysis of Legal Rulemaking, 3 J. Leg. Studies 257 (1974). One of the disadvantages of a case-by-case approach is that it may encourage information seekers to invest more than they would otherwise invest merely in order to "stake" their proprietary claims. For a discussion of this problem, in the context of water rights, see Jack Hirshleifer, James C. DeHaven, & Jerome W. Milliman, Water Supply: Economics, Technology, and Policy 59-66 (1960).

kind of information involved is (on the whole) more likely to be generated by chance or by deliberate searching. The greater the likelihood that such information will be deliberately produced rather than casually discovered, the more plausible the assumption becomes that a blanket rule permitting non-disclosure will have benefits that outweigh its costs.

In *Laidlaw*, for example, the information involved concerned changing market conditions. The results in that case may be justified (from the more general perspective just described) on the grounds that information regarding the state of the market is typically (although not in every case) the product of a deliberate search. The large number of individuals who are actually engaged in the production of such information lends some empirical support to this proposition.⁴⁸

B. *The Case Law*

The distinction between deliberately and casually acquired information helps us to understand the pattern exhibited by the cases in which a duty to disclose is asserted by one party or the other. By and large, the cases requiring disclosure involve information which is likely to have been casually acquired (in the sense defined above). The cases permitting nondisclosure, on the other hand, involve information which, on the whole, is likely to have been deliberately produced. Taken as a group, the disclosure cases give at least the appearance of promoting allocative efficiency by limiting the assignment of property rights to those types of information which are likely to be the fruit of a deliberate investment (either in the development of expertise or in actual searching).⁴⁹

⁴⁸ In its 42nd annual report for the fiscal year ending June 30, 1976, the Securities and Exchange Commission states that at the end of fiscal year 1976 total broker-dealer registrations numbered 5,308 and total investment adviser registrations numbered 3,857; 42 S.E.C. Ann. Rep. 182 (1976). The number of individuals actually engaged in the deliberate collection and dissemination of market information is, of course, much larger than these figures would indicate since a single broker-dealer or investment adviser may well be a large firm with many employees.

⁴⁹ I note, before turning to disclosure cases themselves, that many of the cases raise two problems which are not addressed in this paper. The first problem involves the existence or nonexistence of a confidential or fiduciary relation between the parties to the contract. Where such a relation exists, courts are more likely to require disclosure than they would otherwise be. "Where a fiduciary relationship exists between the parties, such as attorney and client, guardian and ward, trustee and *cestui que trust*, executor and legatee, principal and agent, partner and copartners, joint venturer and fellow joint venturers, there is a positive duty to disclose material facts; a failure to do so is constructively fraudulent. As mentioned earlier, a similar obligation exists where a broker dealing in securities or real estate represents a principal.

Also, the nature of the transaction or the relation of the parties may be such that as to the particular transaction in question, the duties of a fiduciary are imposed upon one or the other party, and such a relation involves a duty of disclosure." 12 Williston, *supra* note 2, at § 1499. See

The economic rationale for permitting nondisclosure is nicely illustrated by several cases involving the purchase of real estate where the buyer had reason to believe in the existence of a subsurface oil or mineral deposit unknown to the seller.⁵⁰ For example, in *Neill v. Shamburg*,⁵¹ the parties were cotenants⁵² of an oil lease on a 200-acre tract. The buyer (Shamburg) bought his cotenant's interest in the tract for \$550 (with a provision for an additional \$100 in case a well producing six or more barrels of oil a day should be found). At the time of the sale, Shamburg was operating several wells on an adjacent tract of land. One of the wells was quite valuable. Shamburg "directed his employees not to give information on this subject" and said nothing to his cotenant regarding the well when he purchased her interest in the 200-acre tract. The court held that Shamburg did not owe Neill any duty of disclosure and refused to set aside the sale of her half-interest in the oil lease. The court supported its conclusion with the following argument:

The plaintiff [the seller] had no interest in the 50-acre lease, but we may concede that, when she was about to sell her part of the other lease to her co-tenant, she became entitled to know such facts with regards to its production as would bear upon the value of the other. [In light of what follows, the meaning of this sentence is not entirely clear.] But, unless there is some exceptional circumstance to put on him the duty to speak, it is the right of every man to keep his business to himself. Possibly,

also William W. Kerr, *Kerr on the Law of Fraud and Mistake* 185-86 (7th ed. 1952); George Spencer Bower, *Actionable Non-Disclosure* 273-74 (1915).

The second problem concerns the line between nondisclosure, on the one hand, and fraud or positive misrepresentation, on the other. Even if a party to a contract is owed no duty of disclosure, fraud or misrepresentation by the other party will almost invariably give him a legal basis for avoiding the contract. 12 Williston, *supra* note 2, at §§ 1487, 1488; Keeton, *supra* note 29, at 1-6 (note especially the distinction drawn between nondisclosure and "active concealment").

Each of these two general rules or principles makes sense from an economic point of view: a fiduciary relation can be viewed as a deliberate form of risk sharing (the beneficiary in effect purchases the other party's information), and fraud is economically undesirable because it positively increases the amount of misinformation in the market and is therefore likely to reduce the efficiency of the market as a mechanism for allocating resources. See generally Michael R. Darby & Edi Karni, *Free Competition and the Optimal Amount of Fraud*, 16 J. Law & Econ. 67 (1973).

I have chosen not to discuss these two problems because they are centered on difficult questions of fact (when does a fiduciary relation exist? where do we draw the line between nondisclosure and fraud?) about which it is difficult to generalize in a way that is theoretically interesting. The cases selected for discussion have been chosen, in part, because they do not raise questions of this sort.

⁵⁰ *Fox v. Mackreth*, 2 Bro. Ch. 400, 420, 30 Eng. Rep. 148 (1788) (dictum); *Smith v. Beatty*, 2 Ired. Eq. 456 (N.C. 1843); *Harris v. Tyson*, 24 Pa. 347 (1855); *Stackpole v. Hancock*, 40 Fla. 362, 24 So. 914 (1898); *Holly Hill Lumber Co. v. McCoy*, 201 S.C. 427, 23 S.E. 2d 372 (1942); *William W. Story*, *supra* note 27, at 442; 12 Williston, *supra* note 2, at § 1498.

⁵¹ *Neill v. Shamburg*, 158 Pa. 263, 27 Atl. 992 (1893).

⁵² The court held, *inter alia*, that their cotenancy did not create a fiduciary relation between the parties.

Shamburg was unduly suspicious on this point, but the nature and position of his business suggested caution. Fogle testifies that Shamburg was the only person operating in that neighborhood, and James says that Shamburg told him he had spent near \$150,000 in developing that territory, "and now all these fellows are anxious to pry into my business." We do not find in the acts of Shamburg, under the circumstances, anything more than a *positive intention and effort to reap the benefit of his enterprise, by keeping the knowledge of its results to himself*, and we agree with the master that this "falls far short of establishing fraud."⁵³

A more recent—and certainly a more dramatic—case of this sort arose in connection with Texas Gulf Sulphur's discovery of the fabulously rich Kidd Creek mine near Timmins, Ontario.⁵⁴ After conducting extensive aerial surveys which revealed a geological anomaly indicating the presence of massive sulphide deposits, Texas Gulf Sulphur purchased options covering mineral and surface rights from the owners of several adjacent lots on which the anomaly was located. One of these options covered a parcel of land owned by the estate of Murray Hendrie. The Hendrie option (which was obtained for \$500) provided that Texas Gulf Sulphur could acquire mining rights to the property by the payment of \$18,000 at any time during the two years immediately following execution of the option.⁵⁵ The option also provided that in case a commercial deposit of ore were discovered, the Hendrie estate would be given 10 percent of any profits. After the existence of the deposit became publicly known, representatives of the Hendrie estate protested that Texas Gulf Sulphur had intentionally misled the seller by failing to disclose that it had "an unusually promising indication of economic mineralization on the Hendrie property." A lawsuit, brought by the representatives, was eventually settled out of court.⁵⁶

Both Shamburg and Texas Gulf Sulphur had reason to think that the land they were purchasing was far more valuable than the owner of the land believed it to be. In each case, the buyer's information regarding the value of

⁵³ Neill v. Shamburg, 27 Atl. 993 (1893). Italics added.

⁵⁴ For an account of the discovery, and subsequent events, see Morton Shulman, *The Billion Dollar Windfall* (1969).

⁵⁵ *Id.* at 82.

⁵⁶ As part of the settlement, Texas Gulf Sulphur agreed to purchase Hendrie's 10% share in the profits of the mine. The value of Hendrie's share has been estimated to be about \$100,000,000. This fact, of course, considerably weakened his misrepresentation claim; in addition, the 10% provision should probably be regarded as a device for deliberately allocating the risk in question.

It is interesting to note that in a litigated case arising out of a related transaction, the Ontario High Court of Justice remarked that Texas Gulf Sulphur was only doing "What any prudent mining company would have done to acquire property in which it knew a very promising anomaly lay" when it purchased property "without causing the prospective vendors to suspect that a discovery had been made." *Leitch Gold Mines, Ltd. v. Texas Gulf Sulphur*, 1 Ontario Reports 469, 492-93 (1969).

the property was the product of a deliberate search, in which the buyer had invested a substantial sum of money. (In the four years before its discovery of the Kidd Creek deposit, Texas Gulf Sulphur spent nearly \$3 million exploring other anomalies—with no results.)⁵⁷ The information, in both cases, revealed characteristics of the property which increased the efficiency of its utilization and, therefore, its value to society as a whole.

Information pertaining to the likelihood of a subsurface oil or mineral deposit will often be the fruit of a deliberate investment either in actual exploration or in the development of geological expertise. In order to encourage the production of such information, our legal system generally permits its possessor to take advantage of the ignorance of others by trading without disclosure.

A similar result is usually reached where the information concerns an anticipated development of some sort which will make the property more valuable.⁵⁸ In *Guaranty Safe Deposit & Trust Co. v. Liebold*,⁵⁹ for example, the trust company purchased an option on Liebold's property. It subsequently exercised the option and purchased the property for \$15,000. Liebold sought to avoid the sale on the grounds "that at the time the option was secured, a company known as the Standard Steel Car Company contemplated coming to Butler [Pa.] to establish a large manufacturing plant; that Mr. Reiber [an agent of the trust co.] had knowledge of this matter, and while defendant had heard of the coming of some contemplated company, his knowledge was indistinct and indefinite, and the certainty of its coming was known to the plaintiff, who withheld his knowledge from defendant." The trial court found that both parties had known of the "rumor" that a manufacturing plant would be established in Butler, and that they had adjusted the price of the option accordingly. The Pennsylvania Supreme Court, in affirming a judgment for the trust company, had this to say:

⁵⁷ Morton Shulman, *supra* note 54, at 7. It is unlikely that Texas Gulf Sulphur could have benefited from its information in any other way than by purchasing the property on which the anomaly was located. If it had attempted to sell its information to the landowners, Texas Gulf Sulphur would have encountered two difficulties. It would first have had to convince the landowners of the value of the information without actually disclosing it. Second, it would have had to persuade all of the landowners involved to purchase the information jointly—since, in all likelihood, no single owner could pay a price that would compensate the corporation for the costs it had incurred in obtaining it. A multi-party transaction of this sort would involve obvious free-rider problems, and would be made especially difficult by the fact that disclosure of the information to one party would make it nearly impossible to conceal it from the others. If one owner obtains the information and begins mining, this will tip the others off and they will have no reason to buy the information themselves. Since it is reasonable to assume that the only effective way in which Texas Gulf Sulphur could profit from its information was by purchasing the rights to the property itself, a disclosure rule would have frustrated its only real hope of recovering the costs incurred in acquiring the information in the first place.

⁵⁸ See, for example, *Burt v. Mason*, 97 Mich. 127, 56 N.W. 365 (1893), and *Furman v. Brown*, 227 Mich. 629, 199 N.W. 703 (1924). See also 12 Williston, *supra* note 2, at § 1498 n.6.

⁵⁹ *Guaranty Safe Deposit and Trust Co. v. Liebold*, 207 Pa. 399, 56 A. 951 (1904).

Suppose Reiber had known definitely that the plant was to be established in Butler, and Liebold had been ignorant of this, was it the duty of the former to disclose such information to the latter, and can it be that, without such disclosure, his contract with Liebold is not enforceable in equity? In this commercial age, options are daily procured by those in possession of information from which they expect to profit, simply because those from whom the options are sought are ignorant of it. When the prospective seller knows as much as the prospective buyer, options can rarely, if ever, be procured, and the rule that counsel for appellant would have us apply would practically abolish them.⁶⁰

Courts frequently have stated that in the absence of a confidential or fiduciary relation between buyer and seller, "a purchaser [of real estate], though having superior judgment of values, does not commit fraud merely by purchasing without disclosing his knowledge of value."⁶¹ A rule of this sort makes economic sense where the buyer's judgment is based upon his prediction of the likelihood of various future uses to which the property might be put. Although a buyer's "knowledge of value" is not always based upon deliberately acquired information, the number of entrepreneurs involved in professional real estate speculation makes it plausible to assume that such knowledge is often (if not typically) acquired in a deliberate manner. (Real estate speculators, by matching buyers and sellers, facilitate the movement of real property to its most efficient use. The information on which their predictions of future use are based should therefore be regarded as a social asset.)

A third line of cases permitting nondisclosure appears, at first glance, to be inconsistent with the thesis argued here. These cases involve the sale of property which is *patently* defective in some way; courts regularly have found that the seller of such property has no duty to bring the defect to the buyer's attention.⁶²

In *Gutelius v. Sisemore*,⁶³ for example, the plaintiff bought a house and subsequently discovered that rain water accumulated under the floors causing the residence "to become permeated with noxious and offensive odors." The buyer asserted that the tendency of water to accumulate was a latent defect, and that the defendant-seller had a duty to warn him of its existence. In finding for the defendant, the court said that an inspection of the premises (which the plaintiff had in fact made) should have acquainted the plaintiff with the conditions responsible for the accumulation of water. (The conditions cited included the placement of air vents, the slope of the ground surrounding the house, and the composition of soil in the yard.) "Where the means of knowledge are at hand and equally available to both parties," the

⁶⁰ *Id.* at 405, 56 A., at 953.

⁶¹ *Pratt Land & Improvement Co. v. McClain*, 135 Ala. 452, 33 So. 185 (1902).

⁶² See 37 Am. Jur. 2d § 157, and cases cited there.

⁶³ *Gutelius v. Sisemore*, 365 P.2d 732 (Okla. 1961).

court concluded, “and the subject of purchase is alike open to their inspection, if the purchaser does not avail himself of these means and opportunities, he will not be heard to say that he had been deceived by the vendor’s misrepresentations.”

If we assume that the seller in the *Gutelius* case knew or had reason to know that the buyer was unaware of the defect (despite the fact that the buyer had inspected the premises), he would be in much the same position as the recipient of a palpably mistaken bid, and if his knowledge of the buyer’s error were not the fruit of a deliberate search, it would be reasonable to assume that the seller was the cheaper mistake-preventer—at least at the time of contracting. For reasons that will be considered in a moment, it is implausible to think that a seller’s knowledge of defects in his own property is typically the result of a deliberate search in which he would not have invested had he known he would be required to disclose the existence of the defects in question. This being the case, on the assumption that the seller in *Gutelius* had reason to know of his buyer’s error, it would seem to make sense, from an economic point of view, to require the seller to eliminate the error by bringing the defect to the buyer’s attention. This is so despite the fact that both parties initially had an equal opportunity to discover the defect themselves—just as it is efficient to impose the risk of a mistaken bid on the party receiving it where he has reason to know of the mistake, despite the fact that the bidder was the party best able to prevent occurrence of the mistake in the first place.

But if a seller has no reason to know that his buyer is mistaken, it would be uneconomical to require him to notify the buyer of patent defects, since in all likelihood he would only be telling the buyer what the buyer already knows. Communications of this sort needlessly increase transaction costs. The critical issue in a case like *Gutelius*, therefore, is not whether knowledge of the defect was “equally available to the parties” at some previous moment in time, but whether the seller, at the time the contract is executed, actually knows or has reason to know that the buyer is mistaken. The rule that a seller of real property has no duty to disclose patent defects makes economic sense where—as is often the case—the seller has no reason to know that the buyer is mistaken. These cases (of which *Gutelius* is an example) appear to conflict with the interpretation offered here only because of their failure to explicitly discuss this key issue, focusing instead on the parties’ initial parity of access to information concerning the defect.

With regard to *latent* defects, the older authorities are equivocal. Some cases state that a seller who is aware of such a defect must disclose it to his buyer or forgo the bargain.⁶⁴ Others state that the seller is privileged to

⁶⁴ See generally, William W. Story, *supra* note 27, at 444-45; James Kent, 2 Commentaries § 482 n.1 (12th ed. 1873).

remain silent if he wishes.⁶⁵ In the last twenty-five years, however, there has been a marked expansion of the duty to disclose latent defects.⁶⁶ One particularly dramatic illustration involves the sale of a home infested with termites. A seller of a house in Massachusetts in 1942 was held to have no legal duty to disclose the existence of a termite infestation of which the buyer was ignorant.⁶⁷ If it were to impose such a duty, the Massachusetts Supreme Court declared, it would make every seller liable "who fails to disclose any nonapparent defect known to him in the subject of the sale which materially reduces its value and which the buyer fails to discover." Similarly, the court went on to say, "it would seem that every buyer would be liable who fails to disclose any nonapparent virtue known to him in the subject of the purchase which materially enhances its value and of which the seller is ignorant."

Eighteen years later, in *Obde v. Schlemeyer*,⁶⁸ a Washington seller was held to have a duty to disclose under identical circumstances. The Washington court concluded that the seller had a duty to speak up, "regardless of the [buyer's] failure to ask any questions relative to the possibility of termites," since the condition was "clearly latent—not readily observable upon reasonable inspection." The court bolstered its argument with a long quotation from an article by Professor Keeton:

It is of course apparent that the content of the maxim "caveat emptor", used in its broader meaning of imposing risks on both parties to a transaction, has been greatly limited since its origin. When Lord Cairns stated in *Peek v. Gurney* that there was no duty to disclose facts, however morally censurable their non-disclosure may be, he was stating the law as shaped by an individualistic philosophy based upon freedom of contract. It was not concerned with morals. In the present state of the law, the decisions show a drawing away from this idea, and there can be seen an attempt by many courts to reach a just result in so far as possible, but yet maintaining the degree of certainty which the law must have. The statement may often be found that if either party to a contract of sale conceals or suppresses a material fact which he is in good faith bound to disclose then his silence is fraudulent.

The attitude of the courts toward non-disclosure is undergoing a change and contrary to Lord Cairns' famous remark it would seem that the object of the law in

⁶⁵ *Swinton v. Whitinsville Sav. Bank*, 311 Mass. 677, 42 N.E.2d 808 (1942). See also *Perin v. Mardine Realty Co.*, 5 App. Div. 2d 685, 168 N.Y.S. 2d 647 (1957).

⁶⁶ William B. Goldfarb, *Fraud and Nondisclosure in the Vendor-Purchaser Relation*, 8 W. Res. L. Rev. 5 (1956); Leo Bearman, Jr., *Caveat Emptor in Sales of Realty—Recent Assaults Upon the Rule*, 14 Vand. L. Rev. 541 (1961). Two illustrative cases are *Kaze v. Compton*, 283 S.W.2d 204 (Ky. 1955), and *Cohen v. Vivian*, 141 Colo. 443, 349 P.2d 366 (1960).

⁶⁷ *Swinton v. Whitinsville Sav. Bank*, 311 Mass. 677, 42 N.E.2d 808 (1942). See also *Perin v. Mardine Realty Co.*, 5 App. Div. 2d 685, 168 N.Y.S.2d 647 (1957).

⁶⁸ *Obde v. Schlemeyer*, 56 Wash. 2d 449, 353 P.2d 672 (1960). See also *Williams v. Benson*, 3 Mich. App. 9, 141 N.W.2d 650 (1966); *Cohen v. Blessing*, 259 S.C. 400, 192 S.E.2d 204 (1972), Annot., 22 A.L.R.3d 972.

these cases should be to impose on parties to the transaction a duty to speak whenever justice, equity, and fair dealing demand it.⁶⁹

However one feels about Professor Keeton's moral claim, requiring the disclosure of latent defects makes good sense from the more limited perspective offered here. In the first place, it is likely to be expensive for the buyer to discover such defects; the discovery of a latent defect will almost always require something more than an ordinary search. Even where neither party has knowledge of the defect, it may be efficient to allocate to the seller the risk of a mistaken belief that no defect exists, on the grounds that of the two parties he is likely to be the cheapest mistake-preventer.⁷⁰

Where the seller actually knows of the defect, and the buyer does not, the seller is clearly the party best able to avoid the buyer's mistake at least cost—unless the seller has made a deliberate investment in acquiring his knowledge which he would not have made had he known he would be required to disclose to purchasers of the property any defects he discovered. A seller, of course, may make a substantial investment in acquiring information concerning a particular defect: for example, he may hire exterminators to check his property for termites. But even so, it is unlikely that his principal aim in acquiring such information is to obtain an advantage over potential purchasers. Typically, homeowners conduct investigations of this sort in order to protect their own investments. In most cases, a homeowner will have an adequate incentive to check for termites even if the law requires him to disclose what he discovers;⁷¹ furthermore, many termite infestations are discovered by simply living in the house—something the owner will do in any event. A disclosure requirement is unlikely to have a substantial effect on the level of investment by homeowners in the detection of termites: the point is not that information regarding termites is costless (it isn't), but that a disclosure requirement would not be likely to reduce the production of such information. This represents an important distinction between cases like *Obde*, on the one hand, and those like *Laidlaw*, *Shamburg*, and *Guaranty Safe*, on the other.

A seller of goods might argue that a rule requiring him to disclose latent defects will discourage him from developing (socially useful) expertise regarding the qualities or attributes of the goods he is selling: if he cannot enjoy its fruits by selling without disclosure, what incentive will he have to acquire

⁶⁹ Keeton, *supra* note 29, at 31.

⁷⁰ Because of his superior access to the relevant information. See Posner, *supra* note 2, at 74-75.

⁷¹ This will not be true in every case. It may not be true, for example, if the homeowner plans to sell his home in the immediate future.

such expertise in the first place? This argument is rather unconvincing. A seller benefits in many different ways from his knowledge of the various attributes which his goods possess. For example, expertise of this sort enables him to be more efficient in purchasing materials, and reduces the likelihood that he will fail to identify any special advantage his goods enjoy (and therefore undersell them). Because the benefits which he derives from such knowledge are many and varied, it is unlikely that a duty to disclose latent defects will by itself seriously impair a seller's incentive to invest in acquiring knowledge regarding the attributes of what he sells.

By contrast, the usefulness of market information (as distinct from information regarding the attributes of goods held for sale) is substantially reduced by imposing a duty to disclose on its possessor. It is doubtful whether the benefits of market information which are not eliminated by a disclosure requirement are sufficient by themselves to justify a deliberate investment in its production. Consequently, even if we regard these two kinds of information—market information and product information—as equally useful from a social point of view, a legal rule requiring disclosure is likely to have a different impact upon the production of each. It follows from what I have just said that a rule permitting nondisclosure of market information is sensible whether the party possessing the information is a buyer or a seller.⁷² Thus, if the seller in *Laidlaw* had known the treaty would have a depressing effect on the price of cotton and had sold to the buyer without disclosing this fact, the economic considerations favoring enforcement would be the same as where the buyer had acquired special information. Although economic considerations would appear to support similar treatment for buyers and sellers possessing market information, these same considerations may justify different treatment where product information is involved. It should be clear, from what I have already said, that there is no inconsistency in requiring sellers to disclose latent defects, while not requiring buyers to disclose latent advantages.

The latent defect cases have an interesting analogue in the insurance field. An applicant for a life insurance policy is usually held to have a duty to disclose known "defects" in his own constitution.⁷³ For example, if an appli-

⁷² This point has long been recognized. See William W. Story, *supra* note 27, at 444-45. See also the classic discussion of the problem in Book 3 of Marcus Tullius Cicero's, *De Officiis* (Loeb Classical Library 1975).

⁷³ For a thorough discussion of the duty to disclose in the context of insurance contracts, see Edwin W. Patterson, *Essentials of Insurance Law* 444-73 (1957). At one point in his discussion, Professor Patterson makes an "economic" point similar to the one developed in this paper:

"The doctrine of concealment in relation to insurance contracts is, and long has been, an exceptional rule. In commercial contracts, and in all others between persons dealing at arm's length, A, one party, is not required to *volunteer*, at the time of negotiating the contract, disclosure to the other, B, of A's knowledge of fact X, which he knows that B does not know and which A knows B would deem material to the making of the contract. For example, if A

cant has a history of heart trouble which the insurance company's own medical examination fails to reveal, and he does not disclose the problem himself, the insurance company will usually be permitted to set the contract of insurance aside.⁷⁴ In many cases, of course, an applicant's failure to disclose will constitute actual fraud (this will be so, for example, if a question on the application asks him whether he has a history of heart trouble and he answers that he does not).⁷⁵ But even in the absence of fraud, an applicant is usually held to have a positive duty to speak up even where he has not been asked a specific question.⁷⁶ In this respect, the same disclosure is required of one who purchases an insurance policy as is required of a seller who sells a house with a latent defect (such as a termite infestation). From an economic point of view, these two cases are quite similar and it is therefore understandable that the same disclosure requirement should be applied to each. Because of his intimate familiarity with his own medical history and symptoms, an applicant for an insurance policy will typically be in a better position than the insurance company itself to prevent a mistake by the company regarding some latent defect in the applicant's constitution. More importantly, an applicant will have a strong incentive to acquire information concerning his own health whether or not we impose a disclosure requirement on him.⁷⁷ In this sense, he resembles the homeowner who will have an incentive to protect his home from destruction by termites whether we require him to disclose the existence of a termite infestation or not. Both the homeowner and the insurance applicant have an independent reason for producing information of this sort, and the value to them of the information will in most cases be unimpaired by a disclosure requirement.

offers to sell B a large quantity of coffee beans, knowing, as B does not, that the report of a prospective coffee-crop failure in Brazil was false, B, contracting to buy in ignorance of this fact, cannot avoid the contract on the ground of A's silence. [Citing *Laidlaw v. Organ.*] The policy supporting this rule is based on the economic function of 'the market,' as a process whereby the best-informed traders provide a medium for the selling and buying of property at the 'best' prices obtainable, and for this public service they are rewarded by being allowed to profit by their special knowledge. The bargaining process on a 'free market' would become tedious and unstable if each bargainer had to tell the other all his reasons for the price he asks or bids."

Id. at 446-47.

⁷⁴ See *Equitable Life Assurance Soc'y of United States v. McElroy*, 83 Fed. 631 (8th Cir. 1897) (nondisclosure of an operation for appendicitis in the interim period between signing the application for insurance and completion of the contract); *Stipcich v. Metropolitan Life Ins. Co.*, 277 U.S. 311 (9th Cir. 1928) (dictum).

⁷⁵ Edwin W. Patterson, *Essentials of Insurance Law* 458 (1957).

⁷⁶ Assuming that he has reason to believe the nondisclosed fact is materially relevant to the risk the insurer is assuming. *Id.* at 456.

⁷⁷ This will not be true in every case. If he knows that he must disclose whatever he discovers, an applicant with disturbing symptoms may forgo a medical examination for fear of what it will reveal (just as a disclosure requirement may in some circumstances discourage a homeowner contemplating sale from inspecting for termites).

C. The Duty to Disclose and the Restatements

In addition to generating a substantial case law, the problem of disclosure in bargain transactions has also been addressed by the draftsmen of three different Restatements. It is instructive to compare the treatment which the problem of disclosure has received at the hands of the restaters. The analysis developed in this paper suggests that the different restaters were closer in their thinking about disclosure than might appear to be the case.

Section 472(1)(b) of the Restatement of Contracts (First) provides that "there is no duty of disclosure, by a party who knows that the other party is acting under a mistake as to undisclosed material facts, and the mistake if mutual would render voidable a transaction caused by relying thereon. . ." Like many of the Restatement's black-letter principles, this one is rather shapeless, and acquires content only by the examples which are offered to illustrate its meaning. Two of the five illustrations appended to Section 472 involve situations which appear to be within the contemplated scope of Section 472(1)(b). The two examples are these.

A owns two tracts of land, Blackacre and Whiteacre. B makes a written offer to buy Blackacre for \$10,000. A knows that B is under a mistake as to the names of the tracts and that the more valuable tract, Whiteacre, is the one that B has in mind. A accepts B's offer without disclosing B's mistake to him. Though A is in no way the cause of B's original mistake, the lack of disclosure is fraud.

A learns that the business of C, a corporation, has suffered a serious loss. He knows that B is ignorant of the loss, and without disclosing it to B, contracts to sell to B shares in the corporation. A has no fiduciary relation to B. A's non-disclosure is not fraud. If the mistake had been mutual it would not have made the contract voidable.⁷⁸

In each case, one party is mistaken and the other party knows it. In both cases the party with knowledge is the seller. What distinguishes the two cases is the *kind* of knowledge they involve. Only the knowledge involved in the second case (a species of market information) is likely to be the fruit of a search in which the knowledgeable party has made a deliberate investment. The seller's special knowledge in the first case comes to him—in the most literal sense—by accident. Requiring him to disclose the other party's error will not give the seller in the first case a disincentive to do anything he would not have done anyway; imposing a similar requirement on the seller in the second case may very well have a disincentive effect of this sort. Although today the result in the second case would undoubtedly be affected by our complex securities laws, it does suggest that in framing an appropriate disclosure rule, the draftsmen of the First Restatement of Contracts intuitively

⁷⁸ Restatement of Contracts § 472, Illustrations 2 & 4 (1932).

attached great importance to the distinction drawn here between two different kinds of knowledge or information.

The treatment of disclosure in the Second Restatement of Torts also accords with the analysis offered here. Section 551(2)(e) states that "one party to a business transaction is under a duty to disclose to the other before the transaction is consummated facts basic to the transaction, if he knows that the other is about to enter into the transaction under a mistake as to such facts, and that the other, because of the relationship between them, the customs in the trade, or other objective circumstances, would reasonably expect a disclosure of such facts."⁷⁹ In an explanatory comment accompanying Section 551, the draftsmen note that

to a considerable extent, fully sanctioned by the customs and mores of the community, superior information and better business acumen are legitimate advantages, which lead to no liability. The defendant may reasonably expect the plaintiff to make his own investigation, draw his own conclusions, and to protect himself; and if the plaintiff is indolent, inexperienced or ignorant, or his judgment is bad, or he does not have access to adequate information, the defendant is under no obligation to make good his deficiencies. This is true in general, where it is the buyer of land or chattels who has the better information and fails to disclose it; somewhat less frequently, it may be true of the seller.⁸⁰

Section 551(2)(e) is illustrated with the following example.

A is a violin expert. He pays a casual visit to B's shop where second-hand musical instruments are sold. He finds a violin which, by reason of his expert knowledge and experience, he immediately recognizes as a genuine Stradivarius, in good condition, and worth at least \$50,000. The violin is priced for sale at \$100. Without disclosing his information or his identity, A buys the violin from B for \$100. A is not liable to B.⁸¹

Although A's visit to B's shop is described as "casual," A has certainly incurred costs in building up his knowledge of musical instruments and one of his anticipated benefits may have been the discovery of an undervalued masterpiece. (Whether this is true will depend, in part, upon what it means to be a "violin expert." Is a "violin expert" someone who plays the instrument, or who collects them? If the latter, then the discovery of an unrecognized Stradivarius is more likely to be one of the important benefits which the expert anticipates from his special knowledge.) Regardless of A's particular motives for becoming an expert, it is plausible to think that many discoveries of the sort described in the example are the result of a deliberate search in the sense defined above.

⁷⁹ Restatement (Second) of Torts § 551(2)(e) (Tent. Draft No. 11, 1965).

⁸⁰ *Id.* Comment e, at 50.

⁸¹ *Id.*

Locating valuable instruments which have been incorrectly identified by their owners serves a useful social purpose: after the Stradivarius has been discovered, it will undoubtedly find its way into the hands of a higher-valuing user (for example, a concert violinist or a university with a collection of rare instruments). An undiscovered Stradivarius is almost certainly misallocated. By bringing it to light, a bargain-hunting expert in musical instruments promotes the efficiency with which society's scarce resources are allocated. If he has incurred costs in doing so (and the development of expertise is one—perhaps the most important—of these costs), the bargain hunter will be discouraged from future searching if he is not given a property right in whatever information he acquires (in the form of a privilege to deal without disclosing).

By the same token, since it enables him to benefit (costlessly) from the other party's special information and eliminates the risk that he will be unable to recover an undervalued masterpiece which he sells by mistake, a disclosure requirement also reduces the owner's incentive to search (that is, to correctly identify the attributes of his own property). Because it reduces the incentive of both the owner and the bargain-hunter to undertake a deliberate search, a disclosure requirement increases the likelihood that the instrument will remain undiscovered and therefore misallocated.

The draftsmen of the Second Restatement of Torts offer four examples to illustrate the circumstances in which Section 551(2)(e) would require a party with special information to disclose what he knows. In the first case, a seller sells a house "without disclosing the fact that the drain tile under the house is so constructed that at periodic intervals it accumulates water under the house"; in the second case, the owner of a business sells it to someone without disclosing that he has been ordered by the United States Government to discontinue his principal activity; in the third case, the owner of an amusement center sells it "without disclosing the fact that it has just been raided by the police, and that [the seller] is being prosecuted for maintaining prostitution and the sale of marijuana on the premises"; and in the last case, one party sells a summer resort to another without disclosing that a substantial portion of the resort encroaches on a public highway. The special knowledge involved in each of these four examples is unlikely to be the intended product of a deliberate search for information in which the knowing party has made an investment he would not otherwise have made. They may all be distinguished, in this regard, from the violin hypothetical. The line which the draftsmen of the Second Restatement of Torts draw between the duty to disclose and the privilege to remain silent is drawn where the analysis developed in this paper would suggest it should be.

The Restatement of Restitution treats the problem of disclosure in Section 12: "A person who confers a benefit upon another, manifesting that he does so as an offer of a bargain which the other accepts or as the acceptance of an

offer which the other has made, is not entitled to restitution because of a mistake which the other does not share and the existence of which the other does not know or suspect." In Comment *c* to Section 12 the draftsmen state: "Where the transferee knows or suspects the mistake of the transferor, restitution is granted if, and only if, the fact as to which the mistake is made is one which is at the basis of the transaction unless there is a special relation between the parties." Comment *c* is illustrated by two examples.

A, looking at cheap jewelry in a store which sells both very cheap and expensive jewelry, discovers what he at once recognizes as being a valuable jewel worth not less than \$100 which he correctly believes to have been placed there by mistake. He asks the clerk for the jewel and gives 10¢ for it. The clerk puts the 10¢ in the cash drawer and hands the jewel to A. The shopkeeper is entitled to restitution because the shopkeeper did not, as A knew, intend to bargain except with reference to cheap jewelry.

A enters a second-hand bookstore where, among books offered for sale at one dollar each, he discovers a rare book having, as A knows, a market value of not less than \$50. He hands this to the proprietor with one dollar. The proprietor, reading the name of the book and the price tag, keeps the dollar and hands the book to A. The bookdealer is not entitled to restitution since there was no mistake as to the identity of the book and both parties intended to bargain with reference to the ability of each to value the book.⁸²

The second example closely resembles the violin hypothetical in the Second Restatement of Torts and makes economic sense for the same reasons. The first example is more puzzling. The one important factual difference between the first example and the second one is that while the latter involves a secondhand store, the former involves a store which sells new, high quality merchandise as well as inferior goods. Why should this make a difference so far as the knowledgeable party's duty to disclose is concerned? The restaters distinguish the two situations in terms of the parties' intentions to bargain. This explanation is unsatisfactory, however, since it fails to indicate why their intentions should be different in the two cases. An alternative way of reconciling the two apparently contradictory examples might be the following.

One can easily imagine an expert (in violins or books) browsing in second-hand stores in the hope of finding an undervalued masterpiece. It seems less likely, however, that a bargain hunter would spend time searching the display cases of a fine jewelry store that also sells inferior goods in the hope of finding a gem which has been misclassified.

The owner of a fine jewelry store is almost certain to be an expert in discriminating between valuable jewels and paste. Since he is an expert, and typically takes great care in sorting his own goods, it is unlikely that he will

⁸² Restatement of Restitution § 12, Comment *c*, Illustrations 8 & 9 (1936).

make an error of classification. If similar errors occur more frequently in secondhand bookstores (either because their owners, generally speaking, lack expertise or are careless in sorting), a bargain-hunting expert will be more likely to discover an undervalued item there than he would in a jewelry store which sells both fine gems and junk. Assuming this to be true, one would expect to find more deliberate searches in the one case than in the other. It would follow that a disclosure requirement is more appropriate in the jewelry store setting than in the sale of secondhand books.

This explanation is admittedly a rather tenuous one which rests upon an undemonstrable assumption regarding the incidence of errors of classification in the two cases. If the explanation is unsatisfactory, however, this may itself be a reason for rejecting the view of the restaters or for believing that it does not accurately restate the law.

III. UNILATERAL MISTAKE AND THE DUTY TO DISCLOSE

The rule that a unilaterally mistaken promisor will be excused when his mistake is known or should be known to the other party is typified by the mistaken bid cases and by those in which the mistaken party's error is the result of his having misread a particular document (usually, the proposed contract itself). In both instances, the special knowledge of the non-mistaken party (his knowledge of the other party's error) is unlikely to be the fruit of a deliberate search. Put differently, a rule requiring him to disclose what he knows will not cause him to alter his behavior in such a way that the production of information of this sort will be reduced.

A contractor receiving a mistaken bid, for example, usually becomes aware of the mistake (if he does at all) by comparing the mistaken bid with others that have been submitted, or by noting an error which is evident on the face of the bid itself. In either case, his knowledge of the mistake arises in the course of a routine examination of the bids which he would undertake in any event. The party receiving the bid has an independent incentive to scrutinize carefully each of the bids which are submitted to him: the profitability of his own enterprise requires that he do so. It is of course true that the recipient's expertise may make it easier for him to identify certain sorts of errors in bids that have been submitted. But the detection of clerical mistakes and errors in calculation is not likely to be one of the principal reasons for his becoming an expert in the first place. A rule requiring the disclosure of mistakes of this kind is almost certain not to discourage investment in developing the sort of general expertise which facilitates the detection of such mistakes.

In the first part of the paper, I argued that a rule requiring disclosure where a unilateral mistake is known or reasonably knowable by the other party makes economic sense because the party with knowledge is—at the

time the contract is executed—the cheaper mistake-preventer. If the party possessing special information has deliberately invested in its production—and if the information is socially useful (so that we regard its production as desirable in the first place)—the costs of his search must be considered in determining whether he is in fact the cheaper mistake-preventer. In the cases which are most often cited to support the proposition that a unilateral mistake will excuse where it is known or reasonably knowable by the other party (*i. e.*, the mistaken bid and misread document cases), it is unlikely that the special information in question is the fruit of a deliberate investment. This being so, the conclusion reached in the first part of the paper is confirmed.

The unilateral mistake cases are indistinguishable, in principle, from the other contract cases, discussed in the second part of the paper, which impose a duty to disclose. These cases are distinguished as a group by the fact that in each of them the social interest in efficiency is best served by allocating the risk of a unilateral mistake to the party with knowledge (since this is unlikely to discourage him from investing in the production of socially useful information). In the cases permitting nondisclosure, a similar allocation of risk would—as I have attempted to show—eliminate the private incentive for producing such information and would therefore work to the disadvantage of society as a whole. When viewed in this way, both the cases requiring disclosure (including the unilateral mistake cases) and those permitting nondisclosure appear to conform to (or at least to be consistent with) the principle of efficiency.

CONCLUSION

In this paper, I have emphasized the way in which one branch of the law of contracts promotes efficiency by encouraging the deliberate search for socially useful information. It does so, I have argued, by giving the possessor of such information the right to deal with others without disclosing what he knows. This right is in essence a property right, and I have tried to show that the law tends to recognize a right of this sort where the information is the result of a deliberate and costly search and not to recognize it where the information has been casually acquired. This basic distinction between two kinds of information (and the theory of property rights which is based upon it) introduces order into the disclosure cases and eliminates the apparent conflict between those cases which permit nondisclosure and the well-established rule that a unilaterally mistaken promisor will be excused if his error is or reasonably should be known by the other party.

Although I have confined my discussion to contract law—indeed, to one rather small part of it—the theoretical approach developed in the second part of the paper may prove to be useful in analyzing related problems in

other areas of the law. For example, to what extent can the disclosure requirements in our securities laws which are aimed at frustrating insider-trading be said to rest upon (and to be justified by) the idea that inside information is more likely to be casually discovered rather than deliberately produced?⁸³ If this is in fact one of the principal assumptions underlying the various disclosure requirements imposed by our securities laws, what conclusions—if any—can be drawn regarding the proper scope of these requirements? For example, how much should a tender offeror have to publicly disclose concerning his plans for the corporation he hopes to acquire? Does the analysis offered in this paper throw any light on the requirement of “non-obviousness” in patent law?⁸⁴ (Is this perhaps a legal device for discriminating between information which is the result of a deliberate search and information which is not?) Do the distinctions suggested here help us to understand the proliferation of disclosure requirements in the consumer products field and to form a more considered judgment as to their desirability? A legal theory which provided a common framework for the analysis of these and other questions would have considerable appeal.

⁸³ Useful discussions of the economics of disclosure requirements in the securities field may be found in Henry G. Manne, *Insider Trading and the Stock Market* (1966), and Eugene F. Fama & Arthur B. Laffer, *Information and Capital Markets*, 44 *J. Bus.* 289, 297-98 (1971).

⁸⁴ See Edmund W. Kitch, *Graham v. John Deere Co: New Standards for Patents*, 1966 *Sup. Ct. Rev.* 293.