1-1-2010

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Recommended Citation

Jeffrey L. Harrison, *Rethinking Mistake and Nondisclosure in Contract Law*, 17 Geo. Mason L. Rev. 335 (2010), available at <http://scholarship.law.ufl.edu/facultypub/80>

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RETHINKING MISTAKE AND NONDISCLOSURE IN CONTRACT LAW

*Jeffrey L. Harrison**

INTRODUCTION

In contract law, the issues of when there has been a unilateral mistake and whether one party has an obligation to disclose information are frequently two sides of the same coin. When one party claims there has been a unilateral mistake, the claim is often made that the other party knew of the misperception and could have spoken up but elected not to. This eventuality gives rise to the oft-discussed question of when a party must disclose information that will likely alter the terms of an exchange or prevent it from occurring at all.¹ On one hand, the answer to this question is easy. Both logic and economic theory support the view that individuals and firms are more likely to make mutually beneficial decisions as the level of information increases.² This suggests a default rule of requiring full disclosure of any relevant information.

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¹ The problem of unilateral mistake is addressed by section 153 of the *Restatement (Second) of Contracts*. RESTATEMENT (SECOND) OF CONTRACTS § 153 (1981). The critical question under section 153 is whether the party claiming unilateral mistake assumed the risk of the mistake as defined under section 154 of the *Restatement*. *Id.* § 153; *see also id.* § 154. These matters are closely related to section 161, which concerns the question of when nondisclosure will be regarded as a misrepresentation. In general, nondisclosure will be a misrepresentation when one party is responsible for a misunderstanding by the other party and does not correct it or one party has a reasonable expectation that the opposite party will disclose certain information. *Id.* § 161; *see also* RESTATEMENT (SECOND) OF TORTS § 551 (1977) (describing liability for nondisclosure of information and reflecting the same theme as found in the *Restatement (Second) of Contracts*).

² Two concepts of efficiency come into play here. The condition of perfect competition—rarely, if ever, achieved—requires perfect or complete information. *See* ROBERT COOTER & THOMAS ULEN, *LAW & ECONOMICS* 301 (5th ed. 2008); *see also id.* at 293 (“Efficiency requires uniting knowledge and control over resources at least cost . . .” (emphasis omitted)). When there are information imbalances, the buyer or seller may possess market power. *See id.* at 301. Market power results in resources not being allocated to their most valued uses. *See id.*; *see also* ABA SECTION OF ANTITRUST LAW, *MARKET POWER HANDBOOK: COMPETITION LAW AND ECONOMIC FOUNDATIONS* 1 (2005). Economics calls this “allocative inefficiency.” *See* COOTER & ULEN, *supra*, at 301; JEFFREY L. HARRISON & JULES THEEUWES, *LAW & ECONOMICS* 22-23 (2008); Joseph F. Brodley, *The Economic Goals of Antitrust: Efficiency, Consumer Welfare, and Technological Progress*, 62 N.Y.U. L. REV. 1020, 1025, 1027 (1987) (“Allocative efficiency is achieved when the existing stock of goods and productive output are allocated through the price system to those buyers who value them most, in terms of willingness to pay or willingness to forego other consumption.”).

On the other hand, a disclosure requirement—say, a golden rule of disclosure requiring parties to disclose information they would want to hear if they were on the other side of the bargain—means that the possessor of valuable information will lose whatever gain can be attributed to the superior information. This outcome would seem unimportant unless the information were the product of a deliberate and perhaps expensive effort. In these cases, an inability to profit from the information or internalize benefits of the information-producing effort will discourage the production of information. This type of investment is particularly important when it involves the discovery of goods, products, or services that are undervalued and which have more productive uses. As a simple example, there would be little motivation to identify and purchase oil-producing land if buyers were required to disclose the true value of the land to sellers.

The disclosure problem was explained in elegant terms over thirty years ago by Professor Anthony Kronman in his classic article, *Mistake, Disclosure, Information, and the Law of Contracts*.³ In that article, Professor Kronman fashioned a compromise that seemed to balance these two interests and that he maintained was recognized by the common law.⁴ According to Professor Kronman, the economically sensible solution to the

In addition, “Pareto superiority” refers to a resource reallocation—like a contract—that leaves at least one party better off while leaving no one worse off. COOTER & ULEN, *supra*, at 47; Jeffrey L. Harrison, *Piercing Pareto Superiority: Real People and the Obligations of Legal Theory*, 39 ARIZ. L. REV. 1, 2 (1997); see also DAVID D. FRIEDMAN, *LAW’S ORDER* 24 (2000); HARRISON & THEEUWES, *supra*, at 26. This outcome is more likely to occur when parties have complete information. There are complexities here, however, that will not be addressed in this Article. For example, what does “better off” mean? Is it how one feels or how one actually is? Is it that one anticipates being better off by virtue of the contract or that one turns out to be better off? See generally Harrison, *supra*, at 14 (discussing Pareto superiority and concluding that “[t]he issue, though, is one of determining what sorts of things go into the sense of being ‘better off.’”).

³ Anthony T. Kronman, *Mistake, Disclosure, Information, and the Law of Contracts*, 7 J. LEGAL STUD. 1, 2 (1978) (arguing that deliberately acquired information should enjoy a right to nondisclosure in contract law). Professor Kronman’s work has been cited repeatedly by legal scholars. A recent Westlaw search revealed 262 citations. Interestingly, the article is cited, as determined by a Westlaw search, only nine times by courts at any level. Six of these citations were by Judge Richard Posner and two by Judge Frank Easterbrook. See, e.g., *Teamsters Local 282 Pension Trust Fund v. Angelos*, 762 F.2d 522, 528 (7th Cir. 1985) (containing a citation to Kronman’s article by Judge Easterbrook). Typically the Seventh Circuit citations are not related to the holdings of the cases.

It is important to note, as suggested above, that the issues involved may arise under contract and tort theories. See *supra* note 1. The cases themselves, however, arise in the context of contracts.

⁴ For a discussion of Professor Kronman’s theory see KIM LANE SCHEPPELE, *LEGAL SECRETS: EQUALITY AND EFFICIENCY IN THE COMMON LAW* 32-35, 111-26 (1988); Christopher T. Wonnell, *The Structure of a General Theory of Nondisclosure*, 41 CASE W. RES. L. REV. 329, 340-42 (1991). See also Alex M. Johnson, Jr., *An Economic Analysis of the Duty to Disclose Information: Lessons Learned from the Caveat Emptor Doctrine*, 45 SAN DIEGO L. REV. 79, 86-100 (2008) (reviewing three theories that pertain to disclosure and nondisclosure in the context of real estate transactions). See also Steven Shavell, *Acquisition and Disclosure of Information Prior to Sale*, 25 RAND J. ECON. 20 (1994) (distinguishing buyers and seller with respect to impact of disclosure requirements).

problem is to distinguish between information that is deliberately acquired and that which is casually acquired.⁵ He defines deliberately acquired information as 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.”⁶ Casually acquired information, according to Professor Kronman, may also be the result of incurring costs, but the costs in question would have been incurred even if the information had not been acquired.⁷ It may be more appropriate to view this as *incidentally* acquired information.⁸

According to Professor Kronman, the law generally does not require parties to disclose deliberately acquired information.⁹ Whether or not the theory actually explains the law is, of course, a different matter. Nevertheless, the basic idea is that the common law generally permits the party who has invested in developing or gathering information to internalize the gains those efforts make available.¹⁰ Intellectual property law is similar in this respect. Inventive and creative people are given property rights in order to allow them to profit from their efforts as a means of promoting these efforts. On the other hand, when inventions and creative works are the result of accidents, at least in a system designed with efficiency in mind, there is no need for a property right.¹¹

This Article reconsiders this analysis of the disclosure/nondisclosure issue. Its thesis is that Professor Kronman’s analysis, referred to here as the

⁵ Kronman, *supra* note 3, at 2, 13.

⁶ *Id.* at 13.

⁷ *Id.*

⁸ The principal characteristic of casually acquired information is that it would be obtained whether or not there was an anticipated return. *See id.* The examples offered by Professor Kronman range from an overheard conversation, *id.*, to information that is deliberately acquired and information that was not obtained in hopes of a future profit, *id.* at 25. For example, one may do research about one’s home or automobile in order to properly maintain it. *See id.*

⁹ Professor Kronman’s efficiency-producing nondisclosurer is not necessarily an admirable character as one is reminded by Roald Dahl’s Mr. Cyril Boggis, who cruised the English countryside looking for undervalued antiques. In the short story “Parson’s Pleasure,” Mr. Boggis, sometimes disguised as a clergyman, was a masterful negotiator who was able to “become grave and charming for the aged, obsequious for the rich, sober for the godly, masterful for the weak, mischievous for the widow, arch and saucy for the spinster.” ROALD DAHL, *Parson’s Pleasure*, in *TALES OF THE UNEXPECTED* 236, 237-38 (1990).

¹⁰ Professor Scheppele, in particular, disagrees on whether the common law can be explained by the deliberate/casual distinction. SCHELPELE, *supra* note 4, at 124. Instead, she maintains that a “contractarian theory” is more in accord with the law. *Id.* Under that theory, information must be disclosed when the possessor had an advantage in acquiring the information. *Id.* When the parties have an equal opportunity, disclosure is not required. *Id.*

¹¹ When inventions are accidental, the need for internalization and private property is less important. *See* Jeffrey L. Harrison, *Rationalizing the Allocative/Distributive Relationship in Copyright*, 32 *HOFSTRA L. REV.* 853, 854 (2004) (explaining that in copyright, given the very low level of creativity required and the protection of alcatary art, it appears that unnecessary property rights are extended).

default rule, stops short of a complete analysis in four important ways. When all these factors are considered, it puts into question the default position and suggests that a more nuanced approach is both preferable and possible. First, in many instances the availability of the information and *when* it is available can be intertwined. The deliberate investment may be designed to enable the provider of the information simply to be first. Yet, very often being first has little economic impact even though the effort may be expensive. Awarding the first provider of the information the full benefit of the information advantage is often unnecessary from an economic point of view and may encourage relatively wasteful efforts. More precisely, a winner-take-all approach may encourage races in which there is either over- or underinvestment in information-discovering efforts.¹²

Second, the foundation of the default rule is that deliberately acquired information is connected to economic efficiency. In the standard formulation, deliberately acquired information—like the discovery of oil deposits on farmland or a lost masterpiece at a yard sale—leads to bringing resources into more valued uses.¹³ In fact, investments in information have both allocative and distributive implications.¹⁴ A policy of not requiring disclosure of information, even deliberately and expensively acquired information, if its use has exclusively or predominately distributive effects, has no socially beneficial consequences.¹⁵ In fact, the converse is true: the social costs of efforts to acquire information when the purpose is primarily to have a distributive impact are comparable to those which scholars have associated with theft¹⁶ and monopoly.¹⁷

Third, the default position as generally understood seems to stress only one type of information. The usual scenario is one in which one person has

¹² See *infra* Part II.D.

¹³ The economic theory which seems to underlie Professor Kronman's theory uses wealth maximization as its standard. The wealth maximization, or Kaldor-Hicks standard, as opposed to a utilitarian standard, seeks to allocate resources to those who value them the most as measured by their willingness and ability to pay. See HARRISON & THEEUWES, *supra* note 2, at 28-31.

¹⁴ As a general matter "allocative" refers to the eventual use of a resource. Harrison, *supra* note 11, at 855; see also HARRISON & THEEUWES, *supra* note 2, at 22-23. Distributive issues concern how a set amount of profit or benefit will be divided. Harrison, *supra* note 11, at 855.

¹⁵ See COOTER & ULEN, *supra* note 2, at 295. Although this idea is advanced by Cooter and Ulen, it is not clear what is regarded as "information." Part of the thesis of this Article is that the concept of information extends to all unilateral efforts that have a perception-affecting effect which, if understood by the party affected, would influence the terms of the exchange or whether it would be made at all.

¹⁶ See *infra* text accompanying notes 111-14. For the classic article on the social costs of theft, see Gordon Tullock, *The Welfare Costs of Tariffs, Monopolies, and Theft*, 5 W. ECON. J. 224 (1967). For a follow-up article describing rent-seeking as a method for understanding social cost and wealth transfers, see Gordon Tullock, *The Origin Rent-Seeking Concept*, 2 INT'L J. BUS. & ECON. 1, 1 (2003).

¹⁷ See Richard A. Posner, *The Social Costs of Monopoly and Regulation*, 83 J. POL. ECON. 807 (1975) (estimating the social costs of monopoly in the United States based on the assumption that monopoly profits are converted into social costs through the competition to gain a monopoly and the monopoly-inducing regulations in the United States).

invested in information the import of which is that something is more valuable than it is thought to be by his or her counterpart. The idea is that the item has been *undervalued* and the buyer's investment leads to a proper valuation and a more efficient use of the resource. There is, however, no reason a priori to assume that research is predominately directed to the discovery of undervalued items. In fact, "prospect theory," as described by Daniel Kahneman and Amos Tversky,¹⁸ suggests just the opposite. According to Kahneman and Tversky, "[t]he aggravation that one experiences in losing a sum of money appears to be greater than the pleasure associated with gaining the same amount."¹⁹ If acquiring something only to find out later that it is worth less than expected is viewed as a loss, people are likely to invest more to avoid losses. This is not to say that this information is not potentially important. The discovery of overvaluation can, like undervaluation, have important allocative implications. In the instances of overvaluation, however, buyers are anxious to disclose the information to sellers. Disclosure is assured. The new owner, however, has no motivation to reveal the information to a subsequent buyer. Consequently, whatever social benefit results from research may be quickly lost or not materialize at all, and the outcome can ultimately be viewed as having produced distributive, as opposed to allocative, effects.

Finally, although the casual/deliberate distinction has appeal to it,²⁰ the theory has not been extended to the point of allowing all potential benefits. The default rule seems to begin with the notion that a "mistake" has occurred and then proceeds to ask, using the casual/deliberate analysis, whether the disadvantaged party should be permitted to rescind if the other party had control of information that would have corrected the mistake. This first step—whether there was mistake—is somewhat artificial. Indeed, terms like "mistake" and "unilateral mistake"²¹ are terms of art typically invoked once a decision has been made. For the casual/deliberate distinction to realize its full economic potential, the appropriate initial question should be whether one party has withheld any perception-affecting information that would substantially change the terms under which another party

¹⁸ See Daniel Kahneman & Amos Tversky, *Prospect Theory: An Analysis of Decision Under Risk*, 47 *ECONOMETRICA* 263, 274 (1979). See generally Chris Guthrie, *Prospect Theory, Risk Preference, and the Law*, 97 *NW. U. L. REV.* 1115, 1116-17 (2003) (explaining prospect theory, analyzing its use in the legal field, and concluding that the theory is a valuable tool in analyzing legal issues); John A. List, *Neoclassical Theory Versus Prospect Theory: Evidence from the Marketplace*, 72 *ECONOMETRICA* 615, 616 (2004) (examining prospect theory and the endowment effect through a field experiment and reaching the conclusion that prospect theory is consistent with the behavior of inexperienced consumers).

¹⁹ Kahneman & Tversky, *supra* note 18, at 279.

²⁰ This is particularly true when "casual" is defined, as Professor Kronman does, to include incidentally acquired information. See Kronman, *supra* note 3, at 13.

²¹ "Defect," "patent," and "latent" are terms of art as well.

would agree to enter into a bargain.²² Arguably, if the answer is yes, it is at that point the casual/deliberate distinction comes into play. One could rephrase this by saying: when should nondisclosure of *any* information be viewed as leading to an excusable mistake by the other party?²³ This would be more consistent with the compromise Professor Kronman seems to have sought in proposing the default position. When that approach is used, however, the range of permissible nondisclosure shrinks relative to the range of required disclosure to the extent that the benefits of the default rule itself may be outweighed by its social costs.

The sum of these factors is that the default rule and its allowance of nondisclosure create a set of incentives that are the source of social costs. In addition, it permits nondisclosure in instances where there is no welfare-increasing rationale. Part I of this Article elaborates on the basic model and some of the complexities of identifying the actual impact of nondisclosure. Part II details the social costs of the default nondisclosure rule. In this context, the costs are largely one of overinvestment. In other words, the nondisclosure rule creates a set of investment incentives that are inconsistent with efficient outcomes. In Part III, a case is made that concepts like “mistake” and “defect,” both “patent” and “latent,” unnecessarily retard allocative efficiency by limiting what must be disclosed. In Part IV, alternatives to the default nondisclosure rule are examined in the context of several cases, some of which have been used to illustrate the virtues of the default rule. These alternatives are two versions of a Golden Rule of disclosure. Under a full-disclosure rule, no information may be concealed that would be relevant to the decision-making of the opposite party. Under a “cost-minimizing” approach, nondisclosure would be permitted but only when social benefits are advanced.²⁴

I. THE BASIC MODEL

The basic nondisclosure issue can be illustrated with two examples involving yard sale transactions. In the first, a party studies older audio

²² This includes, of course, the possibility that disclosure would mean there are no terms under which the contract would be made.

²³ See discussion *infra* Part III. For example, an airline might regard it as ill-advised to disclose the age of its fleet. This would likely not be regarded as a mistake and thus not reach the casual/deliberate analysis. Still, the information is likely to be perception-affecting and casually acquired. See *infra* notes 134-36 and accompanying text.

²⁴ The two alternatives also are consistent with different approaches to risk. They mirror to some extent the debate about the preferences of individuals behind the Rawlsian veil of ignorance. Ultimately, the decision depends on how risk averse the parties are. The “cost minimizing” approach is similar to Rawls’ “difference principle.” See JOHN RAWLS, A THEORY OF JUSTICE 75-78 (1971) (explaining the difference principle as the idea that “the social order is not to establish and secure the more attractive prospects of those better off unless doing so is to the advantage of those less fortunate”).

equipment that is still favored by audiophiles. She then makes a Saturday morning tour of yard sales looking for specific models of audio equipment. She buys the components for yard sale prices and resells at much higher prices. The profit is a return to the investment made in learning about stereo equipment. If disclosure were required, the likelihood that the information will be gathered decreases, and the chances that valued stereo equipment will find its way to a landfill or to someone who does not appreciate its quality increases. Put in slightly more technical terms, the system promotes allocative efficiency in that components are more likely to find their way to people who value them the most.²⁵ In effect, the research has resulted in a market correction. The seller of the equipment will, of course, claim that a mistake has occurred, but the social cost of responding to that claim is that various resources will remain misallocated.

An example of this type of reasoning is *Neill v. Shamburg*,²⁶ in which one co-tenant purchased the rights to land of another co-tenant.²⁷ The land had undergone limited development and included one marginally productive oil well.²⁸ Wells on neighboring land were found to be significantly productive.²⁹ The buying co-tenant knew this and instructed those who had contact with the selling co-tenant not to reveal the information to her.³⁰ In ruling that the buyer had no obligation to disclose, the court noted that the defendant had invested substantial sums and reasoned that, “[w]e 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.”³¹

²⁵ By implication this is an application of Kaldor-Hicks efficiency. See *supra* note 13. For the original articles establishing the Kaldor-Hicks efficiency theory, see J.R. Hicks, *The Foundations of Welfare Economics*, 49 *ECON. J.* 696, 711 (1939); Nicholas Kaldor, *Welfare Propositions of Economics and Interpersonal Comparisons of Utility*, 49 *ECON. J.* 549, 550 (1939).

²⁶ 27 A. 992 (Pa. 1893).

²⁷ *Id.* at 993.

²⁸ See *id.* at 992.

²⁹ *Id.*

³⁰ *Id.* at 993.

³¹ *Id.* Professor Kronman uses *Neill v. Shamburg* as an example of the right not to disclose deliberately acquired information. Kronman, *supra* note 3, at 19-20. According to Professor Kronman and as implied by the opinion, Shamburg appears to have owned the neighboring land that included the producing well. Kronman, *supra* note 3, at 19; see also *Shamburg*, 27 A. at 992. If this is the case, it is not clear that the case fits Professor Kronman's deliberate/casual distinction. Whatever research conducted about the oil-producing potential of the land seems to have been called forth by his interest in the land he already owned. Whatever information it produced about the neighboring land of which he was a co-tenant seems to be casually or incidentally obtained. Put differently, there is no evidence that Shamburg invested more on developing his tract of land because he was a co-tenant of the neighboring tract. Even if the case does fit Professor Kronman's theory, it is not clear that the deliberate/casual distinction is the only factor playing a role. The language of the case is difficult to understand but one interpretation is that the price for the land included a provision for payments depending on whether oil was produced on the land. See *Shamburg*, 27 A. at 993 (stating that the parties' agreement had a clause "stipulating a

In the second example, the yard sale shopper knows very little about stereos. Just before going shopping, however, he stops at a friend's house where the friend has music playing. The friend says, "I just bought that 1972 Nakamichi 890 tube receiver for only \$500 on eBay."³² A few minutes later, while looking for fishing equipment, the shopper spots the same receiver at a yard sale for \$20 and buys it. Under the deliberate/casual distinction, the buyer would have to disclose this information to the seller. This has no impact on the gathering of information in the future because it was acquired without the sort of effort for which one expects to be compensated. Note also that disclosing the information, once it has been acquired, has no impact on the eventual use of the stereo. If the information is disclosed, the seller realizes that the component should be spared from the trash heap just as if the buyer had purchased it.³³ Here, according to Professor Kronman, the common law is likely to view the mistake as significant enough to warrant rescission.³⁴

The distinction made by Professor Kronman makes sense as a first take on the matter but leaves out a great deal. The incompleteness can be understood in the context of the case most frequently used to illustrate the nondisclosure problem, *Laidlaw v. Organ*.³⁵ The case involved the purchase of tobacco at the end of the War of 1812.³⁶ The end of the war meant the end of a blockade and thus, an increase in the price of tobacco.³⁷ Organ received the news earlier than others and bought tobacco from Laidlaw at an especially favorable price.³⁸ The news was evidently distributed more

'further consideration of one hundred dollars when a well is found on said lease producing six barrels per day''"). In other words, the seller evidently understood that oil production was possible but just did not understand the proximity of successful production.

³² The example is hypothetical. Your author is not an audiophile, but Nakamichi sounds familiar. For the Nakamichi home page, see <http://www.nakamichi.com/home.html>.

³³ This is not to say there should be no reward for the process of buying and reselling, but that is a different matter from an investment in information. Moreover, as Professor Kronman notes, the deliberately/casually acquired distinction is more of a continuum than a dichotomy. Kronman, *supra* note 3, at 14.

³⁴ Although Professor Kronman uses the overheard conversation as one example of casually acquired information, *id.* at 13, the more likely occasions are those in which the information is deliberately acquired but not with an eye toward future exploitation, *see id.* at 25.

³⁵ 15 U.S. (2 Wheat.) 178 (1817).

³⁶ *See id.* at 178, 182-83. For other discussions of *Laidlaw v. Organ*, see COOTER & ULEN, *supra* note 2, at 294; Kronman, *supra* note 3, at 10.

³⁷ *See Laidlaw*, 15 U.S. (2 Wheat.) at 182-83; *see also* Kronman, *supra* note 3, at 10.

³⁸ *See Laidlaw*, 15 U.S. (2 Wheat.) at 183 (explaining that upon the news being disseminated "the value of said article had risen from 30 to 50 per cent"). Interestingly, the representative making the sale "asked if there was any news which was calculated to enhance the price or value of the article about to be purchased." *Id.* Perhaps pre-dawn Sunday tobacco purchases in 1815 were a bit unusual and the odd nature of this sale may have been enough to put the representative on notice. *See infra* text accompanying notes 49-50.

broadly the same day.³⁹ The Supreme Court held that there was no duty for Organ to inform Laidlaw of the news.⁴⁰

From an economic perspective, the outcome can be defended as consistent with the timely dissemination of information. In very basic terms, if the price of tobacco goes up it means it is a more valued commodity. In order to meet this demand and presumably to enhance the utility of tobacco users, it is important that the increased value be communicated to the market more generally and specifically to tobacco growers. This promotes allocative efficiency. As Professor Kronman notes, "[i]nformation revealing a change in circumstances which alters the relative value of a particular commodity will always have some (perhaps unmeasurable) allocative impact."⁴¹ Requiring disclosure, so the argument goes, would remove the incentive to bring information to the market. In short, the nondisclosure rule rests on the assumption that the potential provider of the information must be permitted to internalize the benefit of the information.

The history of *Laidlaw v. Organ* evidently does not reveal how Organ came to be in possession of the news from which he was eventually to profit.⁴² Nevertheless, the fact pattern illustrates more than Professor Kronman originally suggested. For example, in the context of the case, Organ beat the public dissemination by a very short period of time.⁴³ In effect, in terms of allocative effects, the one hour or so jump he had on others made virtually no difference with respect to tobacco crops and allocative efficiency. This illustrates the possibility that in some instances the notion of deliberate effort is more connected with speed than with the information itself. Unless an award for being first is warranted by the allocative consequences, the deliberate/casual distinction loses its appeal as an indicator of what sorts of efforts should be rewarded.

For example, the effort may simply duplicate the efforts of others. In addition, the first disseminator of the information may not be the lowest cost provider of the information; other providers may experience economies of scale in gathering information or disseminate it to a broader audience. Or, the second provider may be someone who comes across the information casually. Finally, at least from an allocative perspective, rewarding the information provider any amount in excess of the minimum necessary to

³⁹ See *Laidlaw*, 15 U.S. (2 Wheat.) at 183.

⁴⁰ *Id.* at 195.

⁴¹ Kronman, *supra* note 3, at 12.

⁴² *Id.* at 15 ("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 . . ."). The opinion tells us that, on the night before the purchase, three men brought news of the peace treaty from the British fleet. *Laidlaw*, 15 U.S. (2 Wheat.) at 182-83. Although difficult to decipher, it seems that the brother of one of the three men was entitled to one-third of the profits from the purchase, and this was the connection through which Organ received the information. *Id.* at 183.

⁴³ *Laidlaw*, 15 U.S. (2 Wheat.) at 183 (stating that the information was made public in a handbill on Sunday morning at 8:00, but the purchase was made "soon after sunrise" that morning).

make the investment worthwhile is unnecessary. As *Laidlaw v. Organ* seems to illustrate, there is nothing automatically magical, as an economic matter, about the first provider, and an efficient approach to the disclosure/nondisclosure dilemma requires a more nuanced examination of the social value of the effort and the information provided.

Perhaps more important in examining the default model are the uses to which deliberately acquired information may be put. There is no reason to think deliberately acquired information is any more likely to promote allocative ends than to promote distributive ones. Suppose in *Laidlaw v. Organ*, Organ had invested significant resources into tracking the course of the war knowing that various commodities would demand a higher price once the war ended. He also knew that the news would be quickly disseminated to New Orleans merchants who would raise their prices just as Laidlaw undoubtedly would have as soon as he saw or heard about the handbill that was to come shortly. It is hard to see Organ's investment as being designed to do anything more than to redistribute wealth from Laidlaw to himself.⁴⁴ Put differently, even if acquired deliberately, Organ's information likely had no allocative importance.

One premise of those supporting the default rule must be that without it, investments in acquiring information would fail. This, in itself, is not obvious. There are two points to be considered here. First, a great deal of information resulting from investment is readily revealed because it indicates that something has been overvalued by the seller.⁴⁵ And, as noted earlier, this type of information may be more commonly acquired than information revealing positive outcomes.⁴⁶ Consequently, the default rule plays no role in increasing this type of investment.

The second general point is that any investment is largely contingent on a belief that one has a property right in the information. Just how much is invested in this particular "property right" can be understood by considering copyright and patent law. In those instances, the possessors of the "property" are permitted to keep it.⁴⁷ On the other hand, suppose a copyright or patent holder were required to provide licenses at no cost to all who ask. To be sure, there would be substantially less invested in authorship and innovation. In these instances, one could say that the property right is very "thin."

Thin is an apt way to characterize the common law protection of unilaterally held information. The common law goes no further than to say that

⁴⁴ Professors Cooter and Ulen also question whether the decision in *Laidlaw v. Organ* is consistent with efficiency goals. COOTER & ULEN, *supra* note 2, at 294.

⁴⁵ See *infra* Part II.C.

⁴⁶ See *supra* text accompanying notes 18-19.

⁴⁷ This is subject to various statutory exceptions, the primary one of which relates to "fair use" in the context of copyright law. FRANK H. FOSTER & ROBERT L. SHOOK, PATENTS, COPYRIGHTS & TRADEMARKS 149 (1989).

in some instances there is no duty to disclose. On the other hand, the possessor of the information is, by and large, required to reveal it if asked. For example, the art expert at the yard sale who spots the Picasso may be asked by the seller, “do you know anything about this painting?” The buyer is trapped. If he says “no,” he has engaged in a misrepresentation.⁴⁸ One might advise the buyer to say nothing, but even that is an answer of sorts and is likely to put the seller on notice.⁴⁹ Thus, if asked for the information he either lies, which would make the contract likely avoidable, or he ignores the question, which is likely to make the seller suspicious enough to withdraw the painting from the sale.⁵⁰ No doubt some of the risk of being asked to reveal may be reduced by strategic behavior (e.g., appearing disinterested or offering a very low price that suggests that you know nothing). But the question remains of how much serious investing takes place in a property right to information that is free to anyone who asks for it. To some extent it is more accurate to say that people have a “right,” if it can be called that, simply because of the ignorance of others. It would be tantamount to having an exclusive “right” to the use of one’s land unless someone else asks to use it. Put differently, whatever value the information has to the one possessing it and the level of the investment one might make seem largely contingent on a misunderstanding of the law.

II. THE SOCIAL COSTS OF THE NONDISCLOSURE RULE

This Article suggests that there are categories beyond casual and deliberate and that recognizing them and responding appropriately can reduce social costs. First, however, it is useful to take a quick look at casually acquired information. While it may not make sense to reward instances of nondisclosure of casually acquired information, this gives rise to another question: why require disclosure of casually acquired information?⁵¹ If it is true that disclosure often does not result in any allocative losses, why not treat the information as a windfall and let the gains and losses fall where

⁴⁸ See RESTATEMENT (SECOND) OF CONTRACTS § 161 (1981) (“A person’s non-disclosure of a fact known to him is equivalent to an assertion that the fact does not exist . . . where he knows that disclosure of the fact would correct a mistake of the other party as to a basic assumption on which that party is making the contract and if non-disclosure of the fact amounts to a failure to act in good faith and in accordance with reasonable standards of fair dealing.”).

⁴⁹ Professor Kronman notes that even a refusal to answer could amount to fraud. Kronman, *supra* note 3, at 10 n.27 (stating that “in light of Laidlaw’s direct question,” Organ’s silence may have been fraudulent).

⁵⁰ Interestingly, there may be a market solution to this quandary. Sellers could compete on the basis of how few questions they ask prospective buyers.

⁵¹ The question becomes more interesting when one considers that information is likely to be, as Professor Kronman points out, somewhere on a continuum between casually and deliberately acquired. Kronman, *supra* note 3, at 14.

they may? The problem is that actions based on incorrect or incomplete information—often labeled mistakes—do result in misallocations. The belief, for example, that one is buying a defect-free house only to find that it is termite-ridden means that the same money could have been allocated to achieve greater satisfaction elsewhere.⁵² Perhaps more importantly, one of the attractive features of contracting is that it has the potential to make both parties better off. Unless one or more individuals are made worse off, these exchanges are Pareto superior moves and welfare increasing.⁵³ On the other hand, if the exchange is based on a false or mistaken impression, the outcome is not Pareto superior and may or may not increase overall welfare.⁵⁴ If mistake and consequent losses can be avoided at a small cost, it makes sense to require disclosure.

With this aside, it is time to focus on deliberately acquired information. There are a number of reasons why the nondisclosure rule is less attractive and more costly than it may initially seem. To understand why, it is important to adopt a purely functional view of Professor Kronman's distinction. The function is to permit nondisclosure when it is socially beneficial. Taking this function seriously means asking a number of additional questions. First, the general question should be framed not in terms of deliberately or casually acquired, but in terms of whether required disclosure of information—however acquired—would actually generate less allocatively relevant information in the future. A second question is whether the party acquiring the information is either the only provider of the information or at least the lowest cost provider. Finally, was the information acquired for the use to which it was actually applied?⁵⁵ As the following suggests, there are a number of instances in which nondisclosure, even of deliberately acquired information, imposes significant social costs and makes little economic sense.

A. *Proximate Cause*

A functional approach to the disclosure/nondisclosure problem is one that permits nondisclosure when there is a connection between the nondis-

⁵² Professor Kronman seems to offer a slightly different rationale for avoiding mistakes. A risk of mistake, he writes, "is a cost to the contracting parties themselves and to 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-valued users." *Id.* at 2-3.

⁵³ An outcome is Pareto superior if the result is that at least one party is better off and no one is made worse off. *See supra* note 2.

⁵⁴ An outcome that is not Pareto superior may still increase overall welfare if those benefiting receive more than those made worse off lose. COOTER & ULEN, *supra* note 2, at 47.

⁵⁵ As will be explained, unless there is some cognitive connection between acquisition of the information and the profit, allowing possessors of the information to retain the profit has no functional effect. *See infra* Part II.A.

closure and future benefits. Proximate cause, special damages, and foreseeability, terms usually associated with losses in the context of a tort or a breach of contract, are all applicable in this context. A logical approach to the proximity issue is to ask the question: will holding the party liable have any impact on future conduct? This theme can be perceived in law school standards ranging from *Hadley v. Baxendale*⁵⁶ to *Transatlantic Financing Corp. v. United States*.⁵⁷ Another way to state the question is whether the chain of events—say, in a torts case—or the type of damages suffered in a contracts case are so improbable that, even if a party knew of the possible liability, there would be no impact on conduct.⁵⁸

There is very little reason not to apply the same analysis to gains. Gains to a party that are not proximately caused by prior decisions⁵⁹ are sufficiently disconnected that awarding them will not affect conduct. Consequently, in the context of information, it makes little sense to reward one for the acquisition of information if the process of acquisition was not motivated, at least at some level, by the promise of the reward.

One can understand this disconnectedness by thinking about a college art major who discovers a misplaced masterpiece at a yard sale. The deliberately acquired information does lead to the discovery, but the possibility of finding yard sale masterpieces hardly led to the decision to acquire the information—a degree in art—possibly years earlier. In short, the gain is not proximately related to the deliberate acquisition of information. Not only is the gain unanticipated, but, even if it is, the present value of the gain at the time of making the investment decision could be tiny.⁶⁰ More importantly, it is unlikely the number of people studying art will decline if the occasional yard sale finding is not rewarded.⁶¹ What this means is that the casual/deliberate division does not capture the distinction between efficient and inefficient nondisclosure. In fact, it would be more efficient to treat some deliberately acquired information as though it were casually acquired. Otherwise, the social cost of a mistake is incurred without any offsetting gain.

⁵⁶ 9 Ex. 341, 156 Eng. Rep. 145 (1854).

⁵⁷ 363 F.2d 312 (D.C. Cir. 1966).

⁵⁸ Obviously, in the case in which the possibility of liability is unknown, there will be no impact on conduct.

⁵⁹ In this context, proximately caused means that the party planned on or anticipated the gain at the time the decision was made to incur the costs associated with gathering the relevant information.

⁶⁰ In the context of copyright, this point can be understood by asking if an extra ten years added to the current copyright term of life plus seventy years is likely to encourage more creative efforts. See *infra* notes 63-68 and accompanying text.

⁶¹ The outcome would be and should be different if a person set out to study art in the belief that there were misplaced treasures. This would be more akin to those who search for buried treasure.

B. *Information and Sunk Gains*

The reasoning with respect to proximate cause is related to that applied to sunk gains. To help understand this relation, first think about sunk costs. A sunk cost is a cost that, for purposes of rational decision-making, is irrelevant.⁶² A common example is the person who reasons he must go to a concert, football game, or a weekend trip, because the tickets are already purchased. The problem is that nothing about the decision means recovering those costs—in this case, the price of the tickets. The relevant factors are those at the margin, meaning the future costs and benefits affected by the decision.

The notion of sunk gains refers to the same type of irrelevancy. Take, for example, the idea of playing poker with “house money.” The existence of house money does not alter the probability of winning or losing on the next hand. For example, in the context of blackjack, one does not take a “hit” while sitting on twenty because he or she won the prior hand.

A relatively recent copyright case illustrates the sunk gains issue. *Eldred v. Ashcroft*⁶³ was a review of the Copyright Term Extension Act of 1998, which extended the copyright term for most works from life plus fifty years to life plus seventy years.⁶⁴ The extension was retroactive.⁶⁵ One argument for not permitting the retroactive extension (couched in constitutional terms) was that the extension could not “promote the Progress of Science,”⁶⁶ at least with respect to work already in existence. The Court rejected this argument by envisioning a bargain-like relationship between authors and the public under which authors assumed, when producing works, even fifty years ago or more, that they would have the benefits of any future term extensions.⁶⁷

The notion that an author in, say 1930, was, even at the margin, motivated by some future lengthening of the copyright term seems farfetched. The gains some time far in the future would have to be discounted both to present value and discounted further for the possibility they may never occur.⁶⁸ It would be like saying that an author today is more productive be-

⁶² RICHARD A. IPPOLITO, *ECONOMICS FOR LAWYERS* 115-16 (2005).

⁶³ 537 U.S. 186 (2003).

⁶⁴ *Id.* at 193. The Copyright Term Extension Act amended 17 U.S.C. §§ 302, 304, enlarging the term by twenty years. *Id.*

⁶⁵ *Eldred*, 537 U.S. at 193 (“Congress provided for application of the enlarged terms to existing and future copyrights alike.”).

⁶⁶ U.S. CONST. art. I, § 8, cl. 8 (giving Congress the power “[t]o promote the Progress of Science and useful Arts, by securing for limited Times to Authors and Inventors the exclusive Right to their respective Writings and Discoveries”).

⁶⁷ *Eldred*, 537 U.S. at 214-15.

⁶⁸ Justice Breyer’s opinion in dissent outlines the economic objections to the extension. *See id.* at 248-53 (Breyer, J., dissenting).

cause of the likelihood, likely to be unknown to the author, that in 2060 the copyright term may be extended from life plus seventy years to life plus ninety years. Whatever social benefits result from past creativity can be seen as sunk gains. Allowing the copyright holder to internalize those gains quite literally cannot affect decision-making that has already occurred.

Copyright and patent law both deal with information that is deliberately acquired. Whatever works were created under prior copyright terms are now sunk gains. Disclosure in the case of patents or free access in the case of copyright are not required for a limited period of time in order to encourage not past, but future efforts. In fact, putting constitutional issues aside, a decision today that all pre-1950 works are in the public domain would only be relevant to the extent it affects future works. Works in existence are, in effect, house money.

The same is true with respect to whatever allocative gains may flow from previously acquired information. In this regard, it is important to note that every case that reaches a court in which disclosure is an issue is ultimately a battle between two parties over sunk gains. The research to acquire the information deliberately has already taken place. Consequently, any decision a current court makes, while hugely important to the parties involved, has no positive implication unless it affects future efficient information gathering efforts.⁶⁹ For example, again recalling the case of the art major who uncovers the masterpiece,⁷⁰ the gains from that person's investment and others similarly situated are sunk. No decision today can increase or decrease those gains, and, insofar as the two parties, the decision has only distributive consequences.

An obvious question is how to separate cases in which only sunk gains and distributive issues are involved from those that have future-looking implications. As already suggested, perhaps the best example of instances in which information and the positive allocative consequences should be treated as sunk gains are those in which proximate cause is weak.⁷¹ It is important to note that the question is not whether a person's actions have socially beneficial results but whether a decision to reward current actions will increase the likelihood of socially beneficial actions in the future. Consequently, one can combine the idea of proximate cause and sunk gains and narrow the scope of permitted nondisclosure to those cases in which the information was deliberately gathered *and* the use to which it was put was foreseeable by the party not disclosing it.

⁶⁹ Deliberately acquired information can be acquired inefficiently, so the question to be considered is whether these efforts should be encouraged. *See infra* Part II.D.

⁷⁰ *See supra* text accompanying notes 59-61.

⁷¹ *See supra* note 59 and accompanying text.

C. *The Nondisclosure of Negative Information*

One version of the nondisclosure issue arises when a party recognizes that an item has been undervalued. Less frequently discussed are instances in which the deliberately acquired information reveals that a seller has overvalued an item. This emphasis is likely to be misplaced if prospect theory is a factor. As explained earlier, a baseline teaching of prospect theory is that people attach more disutility to losses than utility to gains of the same magnitude.⁷² As an example, a wrong decision that results in buying a supposedly valuable painting that is in fact worthless is more likely to be avoided than a wrong decision *not* to buy a painting that turns out to be more valuable than expected. This means that investments are more likely to be made in order to avoid losses than to discover treasures.

A number of implications flow from investments in value-reducing information. As an initial matter, it is important to note that the information does have economic significance. It is as useful economically to reveal a fraud, forgery, or skeletons in the closet as it is to uncover a lost treasure. Both effects are potentially market-correcting.⁷³ Beyond that, however, important differences emerge. First, the idea that it makes sense to incur social costs in order to encourage investments in information has no application here. While the party who discovers the *undervalued* item is reluctant to share the information with the seller, the party who finds information indicating that an item is *overvalued* is all too anxious to share the news with the seller. The market, not the law, takes care of the disclosure issue, at least at this point. This means that any argument that costs and benefits are to be weighed against each other when assessing the nondisclosure rule is irrelevant in the context of negative information. There is no need to offer nondisclosure as a quid pro quo for the information gathering effort since the private benefit of the research exercise hinges on revealing it.

There is, however, another wrinkle in the analysis. The party who discovers the misplaced masterpiece at a yard sale resells it to those who recognize its value. It is by revealing its worth and then selling the masterpiece that the party internalizes the benefits of the investment in information. The pattern is generally nondisclosure in the initial transaction, followed by full disclosure thereafter. Nondisclosure, ironically, does lead to full and permanent disclosure, just not at the time of the initial transaction. The pattern is likely to be reversed when the item is overvalued. The party discloses the information in the initial transaction but has no incentive to do so upon resale. In fact, in this case internalization results from nondisclosure—by buying low while the rest of the world, so to speak, believes in the original

⁷² See *supra* text accompanying notes 18-19.

⁷³ This is not to say that both types of information are used in an equally effective way to actually correct the market.

and mistaken higher value. In the worst case, the information is buried until the research is redone. In effect, private profits are increased by keeping information from becoming known more broadly. This means that not disclosing negative information, whether casually or deliberately acquired, is unlikely to have a socially beneficial, market-correcting effect.⁷⁴

There is some similarity between this idea and that of sunk gains. By adjusting the price of the overvalued item to its proper value, the buyer and possessor of negative information has internalized the benefits of the investment because, without the investment, the price paid would have been higher. In many instances, this investment would have been made whether or not a subsequent resale was anticipated. If profit from the resale were not anticipated, the information represents a sunk gain. If another transaction were anticipated, the gain may not be sunk, but whatever additional private gain results has no connection to a socially beneficial outcome.

To be sure, contract law—both statutory and common—to a limited degree, prevents one from profiting from the nondisclosure of negative information. As Dean Alex Johnson has pointed out, especially in the context of real property, sellers often have a number of disclosure obligations.⁷⁵ In addition, under the *Restatement (Second) of Contracts*, nondisclosure can be treated as a misrepresentation under certain conditions.⁷⁶ To some extent this prohibition on nondisclosure may actually curtail some types of research into negative information since it prevents the investing party from internalizing the gain that is only available if the information remains secret.⁷⁷

D. *Information Races*

Economists, especially those specializing in industrial organization, have written extensively about patent races.⁷⁸ The basic idea is that several

⁷⁴ The use of information for distributive purposes is discussed below. See discussion *infra* Part II.E.

⁷⁵ Johnson, *supra* note 4, at 100-16 (covering the history of the caveat emptor doctrine as it relates to real property sales, including formulation, erosion, and the modern laws creating a lighter version of the doctrine by only requiring certain disclosures when selling a home).

⁷⁶ RESTATEMENT (SECOND) OF CONTRACTS § 161 (1981). The *Restatement* makes no distinction between information that is casually or deliberately obtained. According to Professor Kronman, the illustrations found in the *Restatements* of Contract and Torts can be reconciled with the deliberate/casual distinction. See Kronman, *supra* note 3, at 28-32.

⁷⁷ For example, a homeowner in anticipation of selling his or her house may elect not to have an inspection that would reveal information that would have to be disclosed.

⁷⁸ See, e.g., DENNIS W. CARLTON & JEFFREY M. PERLOFF, MODERN INDUSTRIAL ORGANIZATION 532-40 (3d ed. 2000); JEFFREY CHURCH & ROGER WARE, INDUSTRIAL ORGANIZATION: A STRATEGIC APPROACH 582-88 (2000); Jennifer F. Reinganum, *The Timing of Innovation: Research, Development, and Diffusion*, in 1 HANDBOOK OF INDUSTRIAL ORGANIZATION 849 (Richard Schmalensee & Robert D. Willig eds., 5th ed. 1998); Gideon Parchomovsky, *Publish or Perish*, 98 MICH. L. REV. 926 (2000).

firms may engage in research to acquire a profitable patent. Only one can be successful. The efforts of those who do not prevail are essentially social costs. Put differently, the winner-take-all character of the patent (or any information) race produces social costs.

Patent race theories play out in different ways depending on the information competitors possess and their tolerance of risk. One simple example is that while there may be private benefits to being first due to the winner-take-all element of patents, the social benefits of an invention occurring today versus six months or a year from now may be negligible.⁷⁹ In effect, the parties battle about a particular profit that will not vary much with the timing of the invention. The timing is critical, however, and the rivalry itself results in excessive and duplicative research and development expenditures.⁸⁰

The risk of overinvestment would seem to be decreased if only one firm were selected to do the research. A type of bidding would take place with the winning bidder being the firm that could complete the race first.⁸¹ Of course, each firm estimates the cost of finishing first, and the winning firm may be the firm most willing to invest the most in research and development. In fact, in an extension of this model, it is profitable to spend additional funds to be first up to the total amount of profit that is derived by being first.⁸² Only one firm will invest and there will be no losses associated with the losing firm.⁸³ The problem is that the winning firm will be required to invest an amount equal to the expected profit. Rather than invest at the socially optimal level where the marginal costs of research and development are equal to the marginal benefit, the firm will invest up to all the potential profit in an effort to be first.⁸⁴

The literature on patent races can be quite complicated, but the basic ideas are intuitive. On one hand, patent races create a risk of overinvestment.⁸⁵ Those who lose the race, so the theory goes, have wasted their efforts. On the other hand, firms that are relatively risk averse may assume

⁷⁹ See FRIEDMAN, *supra* note 2, at 135-36.

⁸⁰ See *id.* The social costs here are similar to those found in any case of monopoly. See discussion *infra* Part II.E.4.

⁸¹ CHURCH & WARE, *supra* note 78, at 584.

⁸² See *id.* ("[T]he expenditure on R&D will be bid up . . . to the point at which the winning firm will expect its revenues under the patent to be exactly equal to the costs of doing the research; i.e., the present value of its profits will be zero.").

⁸³ See *id.*

⁸⁴ See *id.* at 585-86. In yet another variation, firms in a race may find themselves in a prisoner's dilemma type situation. *Id.* at 586. Suppose there were two firms engaged in research that will lead to a valuable patent. The project is expected to take two years with one firm or the other claiming that patent. Another approach to the research is that the expected time of completion is two and a half years but includes some probability that it will be complete in only one year. Both firms will be tempted to take the relatively inefficient route even though the expected time of completion is actually longer. See *id.*

⁸⁵ See *id.* at 584.

they are unlikely to win the race and abandon their efforts even though, in fact, they may be the more efficient innovators.⁸⁶ If enough firms do this there can be an underinvestment.

Obviously, the possession of information can be the result of a race. In fact, it is hard to imagine a unilateral mistake case in which there is not a race-like quality—every possessor of information that a counterpart does not have is likely to be concerned that the information may become evident to his or her counterpart if enough time passes. What better case to illustrate this than *Laidlaw v. Organ*?⁸⁷ The information that Organ used was in fact designed to beat the more general dissemination of the same information. In fact, there were at least two sources of information about the war ending, and the possessors of this information may have made significant investments in order to acquire it quickly. The winner-take-all approach in all likelihood meant excessive investment. *Laidlaw v. Organ* is a particularly good case for illustrating this point because it appears that the second possessor of the information was the government, which acquired the information casually in that it made no investment beyond what it was already committed to spend in waging the war.⁸⁸

Similarly, the information race scenario seems to fit the nondisclosure classic *Neill v. Shamburg*.⁸⁹ There, Shamburg instructed employees not to discuss with the seller of the land the fact that a neighboring tract of land had become productive.⁹⁰ In effect, Shamburg had the information first—perhaps as a result of a deliberate effort—and sought to make sure it was not obtained casually by the seller. More importantly, it appears that the information was there for the taking because it was simply that an oil well on a neighboring property was profitable.⁹¹ Timing, again, was the key.

The reference to under- or overinvestment in patent races focuses on duplicative efforts and strategic decisions about whether to continue those efforts. There is, however, another perspective. Suppose two parties race, but the less efficient party wins. That is, the same discovery could have been made with only a slight delay by a researcher that expends far less on the activity. A policy that awards inefficient winners also involves losses.

⁸⁶ See CARLTON & PERLOFF, *supra* note 78, at 540 (“A firm with a relatively short head start can discourage its rivals from entering a patent race. A trailing firm with no chance of catching up should drop out of the race immediately.”); CHURCH & WARE, *supra* note 78, at 585 (“In reality, risk and uncertainty are among the most important features of the innovation activity. History is replete with examples of firms embarking on major research programs and failing in the attempt, or at least failing to be first.”).

⁸⁷ The facts of the case are discussed above. See *supra* notes 35–40, 42–43 and accompanying text.

⁸⁸ “Casual” in this context refers to Professor Kronman’s notion that “casual” refers to instances in which the information was generated as an incidental result of another deliberate effort. See *supra* text accompanying notes 4–8.

⁸⁹ The facts of the case are discussed above. See *supra* text accompanying notes 26–31.

⁹⁰ *Neill v. Shamburg*, 27 A. 992, 993 (Pa. 1893).

⁹¹ *Id.* at 992.

The comparison is like that of allocative and productive efficiency. Patent races can be regarded as allocatively inefficient because too many resources are drawn into the production of a particular innovation.⁹² On the other hand, even in the absence of this loss, if the producer of the innovation is not the lowest cost producer, the outcome is akin to productive inefficiency.⁹³ Again, *Laidlaw v. Organ* comes into play. Whatever investment Organ made in discovering that the war had ended was more than that incurred by the government, which "discovered" the information in what amounted at no cost at all.⁹⁴ Thus, the problem is not simply that there are two investments, but that the less efficient winner may win.

E. *Information Acquired Deliberately for Distributive Purposes*

1. The Theory and the Simple Case

The consideration of deliberately acquiring information primarily to achieve distributive ends is hardly new. As students of contract law and economists know, and as Paul Samuelson pointed out years ago, "rational self-interest . . . does not necessitate that there will emerge . . . a Pareto-optimal solution that maximizes . . . profits, in advance of and without re-

⁹² Allocative efficiency is concerned with allocating resources into their most valuable use. Brodley, *supra* note 2, at 1025, 1027.

⁹³ Productive efficiency, on the other hand, is largely about producing a level of output at the lowest per unit cost. *Id.*

⁹⁴ Again it is instructive to take a close look at *Neill v. Shamburg*. It is Professor Kronman's assertion that the buyer, Shamburg, owned the neighboring tract of land. Kronman, *supra* note 3, at 19. It seems that this is the case, but the opinion does not so state. See *Neill*, 27 A. at 992-93. Again it is useful to look closely at the reasoning of the court:

[U]nless 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, 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."

Id. at 993. Assuming, as Professor Kronman does, that Shamburg owned the land, there is no evidence that he incurred greater expense on his tract of land because he was a co-tenant of neighboring land. As noted earlier, this may render the information casually obtained. See *supra* notes 7-8, 31 and accompanying text.

It seems likely that the plaintiff, Neill, or some subsequent owner would discover oil on the jointly owned tract. The relevant question would be whether that discovery could be made at a lower cost than that incurred by Shamburg. If so, the cost saved on the discovery would have to be compared with the benefit, if any, of the earlier discovery. In short, Shamburg's superior timing may have little to do with ultimately advancing allocative goals.

gard to how that maximized profit is to be divided up.”⁹⁵ In effect, every contract involves a gain from the exchange *and* a subsidiary agreement on how that gain is to be divided. The rationally self-interested person can be interested in both or focus on the subsidiary agreement.⁹⁶ Deliberately obtained information can be profitably devoted to maximizing one’s share of the “gain” whether or not there is any particular allocative advance. Efforts to profit without an accompanying positive impact on efficiency are labeled “rent seeking” by economists.⁹⁷

The logic behind different treatment of information that leads to allocative consequences as opposed to distributive consequences can be understood with a simple example. Suppose the seller of a car is willing to accept no less than \$5,000 for the car and the buyer, after inspecting it closely, decides he would be willing to pay any price less than \$6,000. Two things are important here: first, it is allocatively efficient for the car to be sold—it has more value to the buyer than the seller. Second, any price between \$5,000 and \$6,000 would make both parties better off. In effect, prices between \$5,000 and \$6,000 compose what economists call a contract curve.⁹⁸ The *allocative* question is whether there is a contract curve at all. In other words, is there any way to potentially make at least one party better off without negatively affecting the other party?⁹⁹ Any point on the contract curve serves the allocative end. In fact, it could be picked arbitrarily and the very same level of efficiency would be achieved. The distributive question is the actual price. Any information costs associated with the haggling and bargaining over a specific point on the contract curve can be viewed as a social cost—resources are consumed without an advance in overall wealth. As each party bargains for more than the least he would take and the other bargains for a price lower than the most he would be willing to pay, they are both involved in rent-seeking.¹⁰⁰

⁹⁵ PAUL A. SAMUELSON, *The Monopolistic Competition Revolution*, in 3 THE COLLECTED SCIENTIFIC PAPERS OF PAUL A. SAMUELSON 18, 35 (Robert C. Merton ed., 1972) (emphasis omitted).

⁹⁶ It does not seem likely that a self-interested party will be motivated solely by allocative ends without regard for distributive outcomes.

⁹⁷ See *Introduction*, in THE ECONOMIC ANALYSIS OF RENT SEEKING xi (Robert D. Tollison & Roger D. Congleton eds., 1995) (“Rent seeking is the socially costly pursuit of transfers.”). See generally DAVID RICARDO, *On the Principles of Political Economy and Taxation*, in 1 THE WORKS AND CORRESPONDENCE OF DAVID RICARDO 67-84 (Piero Sraffa ed., 2004) (explaining that economic rent is the amount paid to a factor of production above the minimum necessary to keep it in its current use).

⁹⁸ See HARRISON & THEEUWES, *supra* note 2, at 185-89 (explaining in more technical terms that economists refer to all the possible points that would increase the welfare of both parties as a lens, and a combination of points within the lens is the contract curve).

⁹⁹ While this would be enough to achieve an allocatively efficient outcome, in the typical contract case both parties advance their welfare.

¹⁰⁰ Rent-seeking behavior involves increasing one’s own wealth without creating additional overall welfare. See THE ECONOMIC ANALYSIS OF RENT SEEKING, *supra* note 97, at xi (“Transfer seeking is at best a zero-sum activity in that it simply shuffles dollars among people and groups, and is probably negative-sum if traditional deadweight costs result as a by-product of such activities Rent seeking

Both *Laidlaw v. Organ* and *Neill v. Shamburg* can be interpreted as exercises in rent-seeking.¹⁰¹ As already noted, Organ's advantage was merely one of time, and the time between the dissemination of his information and a more general dissemination was too short to have any important allocative effects.¹⁰² The fact that Organ sought out Laidlaw in the early hours of the day suggests he knew that whatever advantage he had would be short lived. In all likelihood, even if Laidlaw had demanded a higher price—even a substantially higher price—the exchange would have still taken place, just at a different point on the contract curve. In this instance, any use of resources to gain an edge would be deliberate but ultimately wasteful. Similarly, in *Neill v. Shamburg*, there was likely a range of prices that were acceptable to both the seller and buyer and which would have achieved a desirable allocative end. Shamburg's desire not to disclose information about the productivity of his land was likely driven by a desire to affect the distributive outcome again, without a substantial allocative gain.¹⁰³

2. Exploitation of Decision Biases

Perhaps the greatest problem with implementing, or even describing with some precision, a policy based on the use of information for allocative or distributive purposes is the difficulty of containing the theory. In particular, the use of information to acquire rents occupies a broad range of conduct. Some toe the line of misrepresentation while others focus on efforts to disclose no more than is legally necessary. In all cases, the idea is to affect the perceptions of another party. Once this is understood, it is a simple step to consider sale techniques. For example, as Christine Jolls and Cass Sunstein point out, manufacturers and sellers required to provide product warn-

thus embodies a social cost in terms of foregone product of the resources employed in rent seeking.”). While properly regarded as a type of transaction cost, they are in excess of the minimum necessary to increase social welfare. *See id.*

¹⁰¹ As Robert Cooter and Thomas Ulen note, information gathering efforts are likely to have both allocative and distributive effects, and they argue that in mixed cases, the contracts should be enforced. *See COOTER & ULEN, supra* note 2, at 296. The logic appears to be that refusing to enforce contracts involving mixed effects would reduce allocative efficiency. *See id.* This seems to involve an assumption that the benefits of the allocative effects will generally exceed the social costs of the distributive efforts. The reason for this assumption is not clear, and a better approach may be to assess the relative allocative and distributive effects.

¹⁰² *See supra* notes 38-39, 42-43 and accompanying text.

¹⁰³ Of course, having discovered oil, the cost of not disclosing it to the seller was probably minimal, at least for Shamburg. *See supra* notes 26-31 and accompanying text (discussing the facts of the case). On the other hand, decisions like *Neill v. Shamburg* mean the opposing party would be wise to invest in discovering already known information to achieve a more favorable distributive outcome.

ings are anxious to take advantage of what is called the “optimism bias.”¹⁰⁴ The optimism bias leads to the belief that bad things happen to others and is more likely to affect transactions when warning labels are framed in general terms.¹⁰⁵ In effect, by exploiting the optimism bias, a party does not actually disclose what he or she purports to disclose. Exploiting the optimism bias is clearly not one of those cases in which deliberately acquired information is used for mixed purposes. At *best*, the use of the information is strictly distributive. At *worst*, the tactic may affect perceptions so much that a contract is formed that leaves a party worse off or is not on the contract curve at all.¹⁰⁶

A similar outcome occurs when a seller or buyer becomes knowledgeable about framing effects and prospect theory as a way to make a transaction seem more attractive. Daniel Kahneman and Amos Tversky’s prospect theory suggests that people strive to avoid losses more than they strive to attain gains of the same magnitude.¹⁰⁷ If a proposition can be framed so the choice appears to be one that involves avoiding a loss, it is likely to be more attractive. For example, “use product X and avoid those ugly age lines” is a better sales pitch than “use product X, and you will look young.” Ultimately, however, whether relying on an optimism bias or using a framing technique, there is an investment that leads that is designed to create a specific impression favorable to one party and unfavorable to another.¹⁰⁸ The information deliberately gathered is not connected to an allocative effect.

There is, of course, a difference between the nondisclosure of the unnoticed attribute of a valuable painting found at a yard sale and the use of various sales and advertising strategies in order to make the terms of a transaction more attractive to another party. Ultimately, the difference is more formal than real. Both are intended to affect perceptions, and the success of each depends on the relative ignorance of one of the parties. Requiring disclosure in these cases would deter rent-seeking efforts and actually lower social costs. Nevertheless, extending the policy to cover these types

¹⁰⁴ See Christine Jolls & Cass R. Sunstein, *Debiasing Through Law*, 35 J. LEGAL STUD. 199, 207-08 (2006). “Optimism bias refers to the tendency of people to believe that their own probability of facing a bad outcome is lower than it actually is.” *Id.* at 204.

¹⁰⁵ *Id.* at 204, 212.

¹⁰⁶ In effect, a buyer understanding the true danger might not be willing to purchase even at the seller’s best price.

¹⁰⁷ See *supra* notes 18-19 and accompanying text.

¹⁰⁸ Of course, the Roald Dahl story, “Parson’s Pleasures,” reminds us that the possibility of poetic justice does exist. See *supra* note 9. There, Mr. Cyril Boggis finally convinced the seller of a valuable antique Chippendale Commode that it was relatively valueless and that he was only interested in the legs with the remainder only good for firewood. DAHL, *supra* note 9, at 251-62. After the deal was struck, and believing the sales pitch, the seller delivered four legs and the cabinet, broken into pieces suitable for firewood. *Id.* at 265-66.

of nondisclosure would be hard to articulate in a way that would ensure consistency.¹⁰⁹

3. Nondisclosure of Future Inevitable Development

One line of cases is particularly instructive for illustrating the mistake of equating deliberately acquired information with allocative, as opposed to distributive, ends. Interestingly, Professor Kronman cites the cases as supporting nondisclosure.¹¹⁰ To understand the problem they address, one must distinguish two scenarios. In the first, as already described, a buyer recognizes a painting at a yard sale that he knows is greatly undervalued and buys the painting.¹¹¹ In the second, a buyer expects a railroad to buy a parcel of land, causing the price to increase.¹¹² In the first case, but for the deliberately acquired information, the painting may never find its way to those who appreciate it. In the second case, nothing the buyer does changes the destiny of the land.

The general rule in the second group of cases, as it is in the first group, is that the buyer need not disclose the information to the seller.¹¹³ The typical rationale is that the information was available to either party.¹¹⁴ It is important to note, however, that these cases are not concerned with the possibility that the land will be underdeveloped unless the purchase is legitimized. Instead the only issue is which party will acquire the wealth associated with the eventual resale to another buyer. In a sense, these cases are a bit like the race cases¹¹⁵ in that the intermediate buyer's goal is to beat the ultimate buyer to the purchase and profit from the increased price.¹¹⁶

Even though the information in these cases may be acquired at great expense, the effort is allocatively irrelevant. The land possesses whatever

¹⁰⁹ For the best effort to date, see Jolls & Sunstein, *supra* note 104, at 206-34, discussing disclosure requirements in various legal contexts.

¹¹⁰ See Kronman, *supra* note 3, at 21-22.

¹¹¹ See *supra* text accompanying notes 48-50.

¹¹² See, e.g., *Furman v. Brown*, 199 N.W. 703, 706 (Mich. 1924) (stating that the area near the land plaintiff sold "started towards a boom" including "long prayed for development and growth" accompanied by "soaring prices in realty"); *Burt v. Mason*, 56 N.W. 365, 365 (Mich. 1893) (explaining the allegation that the defendants knew the land was of "great value" before making the purchase because the land was "a prospective terminal point for a railroad on account of the fine natural harbor there located"). These cases are cited by Professor Kronman as examples of deliberately acquired information leading to allocatively efficient outcomes. See Kronman, *supra* note 3, at 21 & n.58.

¹¹³ See Kronman, *supra* note 3, at 21.

¹¹⁴ See *Burt*, 56 N.W. at 367 (stating that the seller "knew the situation as well as" the buyer).

¹¹⁵ See *supra* Part II.D.

¹¹⁶ See e.g., *Guar. Safe Deposit & Trust Co. v. Liebold*, 56 A. 951, 952 (Pa. 1904) (explaining that the buyer secured the option to purchase the property because of the potential of a large company locating a plant in an adjacent borough, and that once the plant's location became certain, the buyer exercised the option). This case is also discussed by Professor Kronman. Kronman, *supra* note 3, at 21-22.

quality it possesses as a site for a railroad, shopping center, or highway. The ultimate use is not altered by the owner of the land or that party's knowledge of the future plans of a potential buyer. The only thing that is determined by the nondisclosure is the party who will acquire the income associated with the discovery by a third party that the land possesses desired characteristics. The investment by the middleman in these transactions is a social cost in that it advances no socially beneficial allocative ends.¹¹⁷

4. Information, Distributive Efforts, and Rent-Seeking

The notion that information is acquired primarily or solely to affect the distributive outcome of a transaction fits nicely within a more general theory of rent-seeking. In this sense, the social costs are similar to those that arise from theft and monopoly. Equating these social costs to those of theft and monopoly may not be intuitively obvious, but the parallel becomes clear when one considers the works of Gordon Tullock and Richard Posner on the origins of social costs. In his classic 1967 article, Tullock noted that the cost of theft does not lie in the transfer of ownership itself.¹¹⁸ In effect, if one party owns a pen or a car and another takes it, there may or may not be a welfare loss. In fact, the new owner may attribute greater utility in which case overall utility increases. Or, the new owner may attribute greater monetary value to the item than the original owner. In either case, aside from other costs, overall efficiency would increase.¹¹⁹ Of course, to avoid theft, people will invest a great deal in security.¹²⁰ And, to achieve a successful theft, others will invest in techniques to avoid those very same security measures.¹²¹ The economic cost, therefore, of theft is not in the transfer itself but in the resources employed to achieve and avoid theft.¹²² These expenditures do not increase wealth; they merely serve to redistribute it or avoid redistribution.¹²³

Tullock notes that the same analysis applies to monopoly. As he put it, "the total costs of monopoly should be measured in terms of the efforts to get a monopoly by the unsuccessful as well as the successful."¹²⁴ This theme was further elaborated by Richard Posner in his equally well-known

¹¹⁷ Notice how the analysis may change if the ultimate purchaser does the research to discover the land is best suited for a highway and thus substitutes higher value use as a highway for a less valuable farm use.

¹¹⁸ Tullock, *The Welfare Costs of Tariffs, Monopoly, and Theft*, *supra* note 16, at 228-31.

¹¹⁹ Utility and wealth maximization would represent different efficiency norms. *See supra* notes 2, 13, 25.

¹²⁰ Tullock, *The Welfare Costs of Tariffs, Monopoly, and Theft*, *supra* note 16, at 229-30.

¹²¹ *See id.* at 230.

¹²² *Id.*

¹²³ *Id.* at 231.

¹²⁴ *Id.* at 232.

article, *The Social Costs of Monopoly and Regulation*.¹²⁵ Typically, monopoly is viewed as having a number of effects as compared to competition. Prices increase, output declines, and welfare is both decreased and redistributed.¹²⁶ In terms of social costs, the welfare effects are more relevant. A pure loss or welfare loss is a result of the decrease in production of output that buyers value more than the cost of production.¹²⁷ In addition, some output continues to be sold but at a higher price.¹²⁸ In the case of this output, the issue is not whether there will be production, but who will enjoy the profit from the monopoly power that allows the price to be raised. Herein lies the cost of monopoly to which Tullock and Posner refer. It is the cost of the efforts to become a monopolist, or to avoid detection, or to protect one's position as a monopolist.¹²⁹ It is important to remember that these are pure losses—nothing new is produced.¹³⁰

The concerns described by Tullock and Posner when it comes to rent-seeking behavior are equally applicable to efforts to increase one's share of the gains from an exchange. In fact, the monopoly comparison is particularly appropriate. In that case, investments are made to gain, continue, or exploit market power resulting in the payment of a price in excess of the competitive price.¹³¹ It is not the price itself that is the loss—that is a distributive matter. It is the investment made to create a more favorable price that is the social loss. A similar loss occurs with deliberately obtained information resulting in a more favorable exchange. The higher price paid or lower price accepted by the disfavored party is a distributive matter. The deliberately acquired information that leads to that outcome is a social cost. It is only a minor simplification to say that in all three cases, costs are expended on how to divide up already existing or potential wealth.

There is one difference between deliberately acquired information and the rent-seeking expenses in the case of theft and monopoly. The costs of theft and monopoly can hardly be viewed as transaction costs. They are not

¹²⁵ Posner, *supra* note 17, at 807.

¹²⁶ See E. THOMAS SULLIVAN & JEFFREY L. HARRISON, UNDERSTANDING ANTITRUST AND ITS ECONOMIC IMPLICATIONS 20-22 (5th ed. 2009); Posner, *supra* note 17, at 807.

¹²⁷ More technically, it is some output where buyers would be willing to pay a price in excess of the value of the resources that would be consumed in production. See SULLIVAN & HARRISON, *supra* note 126, at 20-21.

¹²⁸ *Id.* at 20.

¹²⁹ Patent law and copyright law exist in part because free-riding, perhaps informal theft, exists. For example, without patent law those with inventions would invest in keeping secrets while others would invest in attempting to uncover secrets. If social norms precluded taking the works of others, neither patent law nor copyright law and the expenses associated with each would be necessary. Of course, patent law and copyright law involve administrative expenses.

¹³⁰ For a discussion of the social costs associated with copyright law, see generally Harrison, *supra* note 11. In fact, even a cursory examination of the Copyright Statute, Title 17 of the United States Code, reveals that far more of it is designed to resolve distributive questions than to encourage creative efforts. See generally 17 U.S.C. §§ 101-1332 (2006).

¹³¹ See SULLIVAN & HARRISON, *supra* note 126, at 21.

the costs associated with finding and negotiating an exchange. To some extent, efforts to gain a more favorable term of exchange may be viewed as a form of transaction cost. If so, it is important to further note that not every transaction cost is a necessary one. From a social point of view the actual division of the exchange—once it is beneficial to both parties—is irrelevant. It creates no new wealth and is nothing more than a social loss comparable again to the cost of monopoly or theft. It may be a transaction cost, but it is not one that gives rise to an increase in efficiency.

III. A FUNCTIONAL APPROACH TO MISTAKE

This Article so far has shown that the common law and default rule involve a set of incentives that are largely insensitive to the question of whether or not the information produced is consistent with allocative efficiency. In short, the rule itself gives rise to social costs that ideally should be compared to the resulting gains. This Part takes the analysis a step further and examines the potential gains foregone by reliance on the default rule. The narrowing of the benefits of the default rule can be understood by again concentrating on a functional approach to information and disclosure. It is important to recall, as described in the Introduction, that the goal is to balance the costs of incorrect decisions resulting from asymmetries in information with the need to allow some exploitation of asymmetries.

The default rule actually involves two questions. First, has a mistake occurred? Second, was the information possessed by the non-mistaken party deliberately or casually acquired? Suppose the rule was that all perception-affecting information that is casually acquired must be disclosed.¹³² Note that this covers more than “mistakes.” For example, a building contractor will likely know the character of the land upon which a house is built and will inevitably know the quality of the materials in the house. The owner of a house will know any factors affecting the value of a house, at least during the period of ownership. A person having his car serviced may learn from the mechanic that the car has been involved in a collision or repainted. And manufacturers will know the quality of their products and their expected useful life. Much of this information is both relevant to the decision of the party not possessing it and would not be labeled as the source of a “mistake.” When disclosure is required, it is not on the basis of economic relevance but on the basis of a “mistake” having occurred.¹³³ In

¹³² It is important to recall that the definition of casually acquired includes information that was deliberately acquired but for other purposes than the transaction at hand. See *supra* text accompanying notes 6-8.

¹³³ In short, sellers will reveal value-enhancing information, leaving the buyers to make the investment in possible value-decreasing information. Of course, positive features of a product will be eagerly revealed.

fact, sellers may invest to avoid the discovery of value-decreasing information.

What is missing in the analysis is a functional definition of what a mistake is. Or perhaps, more specifically, the definition of mistake has little economic content. For example, the fact that a mistake occurs when a party is wrong about a fact¹³⁴ misses the point that the opposite party may possess information that is highly relevant to the opposite party's decision-making and that the information was acquired casually, even inevitably. In short, if the casual/deliberate distinction is to have the full economic impact it promises to deliver, the "mistake" step is unnecessary. There appears to be no economic downside of requiring disclosure of any information a reasonable person would regard as relevant to a particular transaction whether the concept of mistake is invoked or not. Obviously, it is impossible to have access to all relevant information. Moreover, some information would be more costly to develop than the cost of the mistake itself. In this context, though, the only information that need be disclosed is that which does exist and was casually acquired.

Aside from eliminating the issue of what constitutes a mistake, the full disclosure approach also eliminates the idea that one's duty to disclose may depend on whether there is a defect and whether it is patent or latent.¹³⁵ Like "mistake," the terms "defect," "latent," and "patent" have no substantive economic importance. For example, there is nothing defective about the age of airlines' fleets of planes or the nationality of its pilots, but the information is both casually acquired and can be highly relevant.¹³⁶ Or, in another industry, a seller may have done research on the life expectancy of its product. Again, there are no defects involved, but the information is both relevant and casually—indeed, inevitably—acquired.

Consequently, a more functional approach to the patent/latent issue is one that addresses the information issue directly. If the product characteristic is known casually or inevitably by one party, any rule that disclosure is excused if it was also knowable to the other party makes little economic sense. The information exists, the costs of obtaining it are sunk, and at that point, the party with the information is in the best position (i.e., lowest cost)

¹³⁴ According to the *Restatement (Second) of Contracts*, "[a] mistake is a belief that is not in accord with the facts." RESTATEMENT (SECOND) OF CONTRACTS § 151 (1981).

¹³⁵ See Kronman, *supra* note 3, at 22-26 (explaining the complexity of determining whether a defect is patent or latent); see also Johnson, *supra* note 4, at 96-98 (discussing patent and latent defects in the context of real property). For a case discussing disclosure of latent material defects in the sale of real property, see *Johnson v. Davis*, 480 So. 2d 625, 628-29 (Fla. 1985).

¹³⁶ According to a recent book, the nationality of the pilots may have been the most important factor in many major plane crashes. MALCOLM GLADWELL, *OUTLIERS: THE STORY OF SUCCESS* 202-09 (2008) (explaining that cultural norms related to power and authority account for copilots being unwilling to assert themselves when pilots take improper actions).

to avoid the formation of a contract¹³⁷ that does not increase overall wealth¹³⁸ or utility.¹³⁹ The patent/latent issue then comes down to whether one party already possesses information that would be relevant to a reasonable person and was casually acquired. When the information is possessed, to the extent formalistic labeling is necessary, it should be regarded as a “defect” and “latent.”

While it makes little economic sense for one party to incur costs to discover already known information, a broader duty to disclose has even further-reaching implications. In all of the instances, the impact of a disclosure requirement with respect to negative information will have the impact of lowering demand or making it more elastic. This may mean the product sells for a lower price or that the seller improves product quality. In effect, market corrections are more likely to occur. Thus, like the standard economic formulation,¹⁴⁰ increased information is likely to lead to better decisions and more efficient allocations.

The principal drawback to extended product-quality information is a possible inefficiency associated with the actual dissemination of such information.¹⁴¹ Professor Kronman argues that a requirement that one disclose patent defects raises transaction costs.¹⁴² The idea seems to be that there is even more information for the other party to examine and some of it will duplicate what he or she already knows. No doubt this is true, but it does not fully consider the offsetting gains. For example, issues of what is a defect and then sorting out patent from latent defects also raise costs. A “relevant information to a reasonable person” test seems far simpler. Moreover, current incentives create a bias in favor of nondisclosure by invoking the argument that there was not a defect or, if there was, it was patent. In short, labels like “defect” and “patent” create incentives to underdisclose by shifting the costs to buyers to demonstrate the underdisclosure. Thus, although transaction costs may be raised with respect to truly patent defects, the administrative expenses of distinguishing latent from patent defects would be eliminated. In addition, and although it is an empirical question, the possibility that one may be overloaded with information about obvious defects

¹³⁷ In fact, at this point the possessor of the information has the last clear chance of avoiding what might be regarded as contractual accident.

¹³⁸ This refers to either a utilitarian or Paretian standard. *See supra* note 2.

¹³⁹ This refers to a wealth maximization standard. *See supra* note 13.

¹⁴⁰ The more information available, the more likely resources will be channeled to their most valued uses. *See supra* note 2 and accompanying text.

¹⁴¹ Recall that the existence of the information is a sunk cost. *See supra* Part II.B.

¹⁴² Kronman, *supra* note 3, at 23 (“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.”). This view appears to be endorsed by Professor Johnson. *See Johnson, supra* note 4, at 88-89.

seems unlikely. In fact, it does not seem likely that there would be much litigation with respect to “defects” that are truly “patent.”

This is not to say that there are not possible inefficiencies to be avoided. This stems from the fact that there are two levels of relevant information. Take, for example, a consumer good that can be manufactured with different qualities of steel.¹⁴³ The first level involves what differences may exist between manufacturers with respect to the grade of steel each one uses. The second is what the characteristics of that grade of steel are. In the first instance, the components of the product are manufacturer-specific, and it makes sense to require individualized disclosure. On the other hand, the actual characteristics of the steel will be uniform, and there may be economies of scale associated with public dissemination of the pertinent information.¹⁴⁴ Nevertheless, it is difficult to articulate a reason for not requiring disclosure of all information that is casually or inevitably acquired that may be relevant to the other contracting party. Such a policy does nothing to discourage investment in information, it may decrease the incentive to conceal information, and it makes for contracts that are more likely to be allocatively efficient.

IV. APPROACHES TO NONDISCLOSURE

A. *Some Preliminaries*

To this point, this Article has sought to make two points. First, while the distinction between deliberately and casually acquired information has appeal in terms of economic efficiency, it generates significant social costs ranging from those associated with races to rent-seeking effects. Second, the current rule relies on terms like “mistake,” “defect,” “patent,” and “latent,” which obscure the substantive economic goal of increasing the availability of information.

The proper policy can be viewed as existing along a continuum beginning at one end with complete disclosure of all relevant information and ending at the other with no disclosure requirement. Along this continuum, there are three positions that deserve consideration. The first is, of course, the one Professor Kronman says is consistent with the common law and

¹⁴³ Using another example, the specific information could be the average age of an airline's fleet of planes. *See supra* note 136 and accompanying text. The general information would be the correlation between age and safety.

¹⁴⁴ There are free-rider implications when it comes to this general type of information. For an instance in which the public good character of the information is dealt with through regulation by the Federal Trade Commission, see *Labeling and Advertising of Home Insulation*, 16 C.F.R. pt. 460 (2009). For an explanation of the purpose behind the rules, see *Labeling and Advertising of Home Insulation*, 44 Fed. Reg. 50,218 (Aug. 27, 1979) (codified at 16 C.F.R. pt. 460).

which focuses on the casual/deliberate distinction. A second position is one that accounts for as many of the economic considerations discussed in Parts II and III of this Article as possible. That approach would greatly narrow the area of permissible nondisclosure. For simplicity, it will be called the cost-minimization ("CM") rule. The CM rule achieves or comes much closer to achieving the goals that Professor Kronman attributes to the default rule. In fact, gains associated with the casual/deliberate rule are maintained and increased.

A third possibility would be unconditional full disclosure. Unlike the CM rule, full disclosure does mean sacrificing whatever gains are associated with true market-correcting research.¹⁴⁵ Still, it would be superior to the CM rule if the cost of administering the CM rule exceeds those possible losses. It may also be superior to the default rule if the losses associated with foregone true market-correcting research are offset by the administration costs of the default rule and the social costs discussed in Part II.

All the approaches apply only to information actually possessed by the nondisclosing party that a reasonable person would deem relevant to the decision at hand. This point requires some elaboration. The purpose of the CM rule is just that—to minimize costs. One aspect of this rule is not requiring the nondisclosing party to discover and disclose everything that would be relevant to any specific party. Thus, nondisclosure based on a reasonable belief that the information is irrelevant to the other party is consistent with minimizing costs.¹⁴⁶ Just how much potentially relevant information remains undisclosed is impossible to know. It is possible, however, that the amount that may be legitimately concealed is smaller than one might first imagine. It seems unlikely that assertions that withheld information would have been relevant will frequently surprise those who chose to withhold it.

It is difficult to assess the three policies with any precision. Moreover, the purpose here is a bit more modest—it is to question whether the default rule can be improved upon. In the remainder of this Part, the focus is on the CM rule, particularly with respect to how it may perform relative to the default rule. The unconditional full disclosure rule will not be examined further except for a few observations.¹⁴⁷

¹⁴⁵ As noted, much deliberately acquired information may not be made publicly available. See *supra* Part III.

¹⁴⁶ This would excuse the nondiscloser from disclosing information that should be obvious to the other party.

¹⁴⁷ The workings are fairly obvious—it is essentially a *per se* rule that entitles a party to rescind a contract if any information which the nondiscloser should reasonably believe is relevant is not disclosed. Such a rule may seem impractical or rejected out of hand because of the losses associated with deliberately acquired information. Under this policy, even information associated with a search that may lead to an allocatively efficient outcome would be disclosed. The inability to profit from the investment in the research would presumably limit any further research. For a number of reasons, it is not clear that it should be so easily dismissed. Both the default rule and the CM rule are more expensive to administer.

B. *The Cost Minimization Rule*

1. The Rule

The cost minimization rule would strictly adhere to the goal of permitting nondisclosure only when it is consistent with positive allocative ends. Consequently, in a specific transaction, nondisclosure of deliberately acquired information that would be relevant to the opposite party would be permitted when: (1) the profit from the transaction in question was foreseeable when the information was acquired;¹⁴⁸ (2) the use of the information has predominately allocative as opposed to distributive effects; (3) the timing is necessary to achieve positive economic effects because of race characteristics; and (4) the information was unlikely to be casually acquired or acquired at a lower cost by the opposite party.

The list may seem onerous at first and likely to lead to high costs of administration. However, a number of factors offset this. First, the party seeking to rescind the contract need only establish that the withheld information fails any one of these tests. Second, it dispenses with several questions—was there a mistake? was there a defect?—that are themselves the sources of social and administrative costs. Finally, any other approach—which may be no less complex—in one form or another, actually rewards efforts that are misguided.

2. The Cases

With this background it is useful to examine a number of cases in order to understand the social cost of the current approach to the disclosure issue. Some of the cases that follow are relied upon by those attesting to the positive effects of the standard rule. As already noted, it is impossible to assess as an empirical matter just how often courts permit nondisclosures that advance allocative ends and when nondisclosure results in a net social loss. What the general survey undertaken while preparing this Article suggests, but which must be left for future efforts, is that the instances in which individuals discover and withhold deliberately sought information which

The default rule generates significant social costs along with possible gains. In addition, it is not at all clear what the magnitude of investment is in a property right (1) that must be shared if a proper request is made and (2) is truly about upward market corrections as opposed to downward market corrections. This last point requires some elaboration. Any proposal permitting nondisclosure carries with it the assumption that the information actually will be eventually reflected in the market. As explained, in the case of negative information, which this article has argued is the more frequently sought, it may not be in the private interest of those deliberately acquiring information to reveal it. *See supra* Part II.C.

¹⁴⁸ "Foreseeability," in this instance, means that but for this type of anticipated income, the investment would not have been made. *See supra* Part II.A.

result in positive allocative ends are relatively rare. These would be the cases in which an undervalued resource is discovered. Indeed, nondisclosure seems more likely when it means concealing the fact that an already owed asset is less valuable than others think and disclosure would simply lower the wealth of the party opting to remain quiet.

The most appropriate starting place is *Laidlaw v. Organ*,¹⁴⁹ which can be quite easily dispensed with—perhaps easier than it was initially. As soon as Laidlaw was able to demonstrate the information was available more generally only hours after Organ's nondisclosure, contract rescission would have been in order. The information available only a short time later was almost certainly casually acquired.¹⁵⁰ It is difficult to see any positive allocative effects of allowing Organ to prevail. Indeed, the outcome, if anything, encourages similar short-term wasteful efforts.¹⁵¹

Similarly, rescission *may* have been appropriate in *Neill v. Shamburg*¹⁵² under two different ways of interpreting the facts.¹⁵³ Clearly, it appears that Shamburg invested in oil exploration or development.¹⁵⁴ It does not appear that his studies involved the land he eventually purchased. Because the research concerned the land he owned and may have been conducted even if he did not acquire the neighboring land at a depressed price, it can be categorized as casually acquired. Second, if the investment is viewed as deliberate, it is not clear that the possibility of acquiring a full interest in the neighboring property, at a possibly reduced price, was a foreseeable profit when the research was conducted.¹⁵⁵ For that to be the causal link, Shamburg's investment was based not only on the discovery of oil on one parcel of land, but also the belief that the discovery could be kept secret from his co-tenant on the purchased parcel of land.

The CM rule also appears to be superior to the default rule in cases like *Guaranty Safe Deposit & Trust Co. v. Liebold*,¹⁵⁶ discussed by Professor Kronman as an example of an efficient nondisclosure.¹⁵⁷ In that case, an

¹⁴⁹ The facts of the case are discussed above. See *supra* notes 35-40, 42-43 and accompanying text.

¹⁵⁰ Cooter and Ulen express the same view and base it on the likelihood that the information was casually acquired and that it had little useful allocative effect. COOTER & ULEN, *supra* note 2, at 294-95.

¹⁵¹ There is a parallel here to Tullock's theft analysis in that investments will be made in gathering information that is of limited or no allocative importance and in avoiding being taken advantage of by those who have invested in information for that purpose. See Tullock, *The Welfare Costs of Tariffs, Monopolies, and Theft*, *supra* note 16, at 231; see also *supra* Part II.E.4.

¹⁵² The facts of the case are discussed above. See *supra* notes 26-31 and accompanying text.

¹⁵³ The best interpretation from Shamburg's point of view is that he invested in oil exploration and development on his property only because he anticipated the possibility of oil being found under the land of neighbors and that he could purchase that land at a reduced price.

¹⁵⁴ *Neill v. Shamburg*, 27 A. 992, 993 (Pa. 1893).

¹⁵⁵ One could carry the analysis one more step. If Shamburg's research was conducted in hopes of developing the oil on the property he owned, the benefits to the neighboring landowners could be treated as a "sunk gain." See *supra* Part II.B.

¹⁵⁶ 56 A. 951 (Pa. 1904).

¹⁵⁷ See Kronman, *supra* note 3, at 21-22.

option was purchased, but the seller resisted transferring the land when the plaintiff attempted to exercise the option.¹⁵⁸ The land appreciated in value as a result of a belief that a manufacturer was to build a plant in the area.¹⁵⁹ The court held for the plaintiff, reasoning that both parties knew of the possibility of the plant coming to the area and that the price was adjusted accordingly.¹⁶⁰ The court went on to describe its general approach:

Suppose Reiber [the buyer] had known definitely that the plant was to be established in Butler, and Liebold [the seller] 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 [the seller] would have us apply would practically abolish them.¹⁶¹

The court's approach suggests that options are ends as opposed to means to an end of an efficient allocation. Yet, an option may have only distributive effects. In *Liebold*, the buyer's actions were unrelated to quality of the land and whether it eventually would be used as a site for a manufacturing plant or residences or businesses related to the plant. Put differently, nothing the buyer of the option did meant the land would find its way to a more efficient use. *Liebold* has elements of the race problem not necessarily with respect to overinvestment but with respect to being first when nothing rides on it other than private gain.¹⁶²

An early New York case, *Junius Construction Co. v. Cohen*,¹⁶³ illustrates the cost-increasing propensity of the traditional rule that one need not disclose unless a prior statement has led to a misapprehension.¹⁶⁴ There, a seller of property revealed that there were plans to construct streets on each side of the property but not that there was a plan to construct a street that would split the property.¹⁶⁵ In allowing rescission the court reasoned:

We do not say that the seller was under a duty to mention the projected streets at all. That question is not here. What we say is merely this, that having undertaken or professed to men-

¹⁵⁸ *Liebold*, 56 A. at 951-52.

¹⁵⁹ *Id.* at 952.

¹⁶⁰ *Id.* at 953-54.

¹⁶¹ *Id.* at 953.

¹⁶² See *supra* Part II.E.3. Similar in effect is *Burt v. Mason*, 56 N.W. 365 (Mich. 1893), where the court held for a buyer who purchased a nearly valueless property in anticipation of a railroad being built in the area. *Id.* at 367; see also *supra* note 112.

¹⁶³ 178 N.E. 672 (N.Y. 1931).

¹⁶⁴ Today this would call into play section 161 of the *Restatement (Second) of Contracts*. See *supra* note 1.

¹⁶⁵ *Junius*, 178 N.E. at 672.

tion them, he could not fairly stop halfway, listing those that were unimportant and keeping silent as to the other.¹⁶⁶

While the outcome of the case is correct, the policy announced—that had the defendant not revealed any information, rescission would not have been permitted—is likely inconsistent with the default rule and definitely inconsistent with the CM rule. First, it is not clear whether the seller’s information with respect to the planned construction was deliberately or casually acquired, but it seems likely that the seller acquired the information about the streets as a matter incidental to purchasing the property.¹⁶⁷ Nevertheless, even if deliberately acquired, it is hard to equate that research with that which has any particular allocative effect. Instead, the nondisclosure seems purely to promote the distributive ends of the seller. Consequently, the default rule leaves in place an incentive to engage in rent-seeking investment. The CM rule, on the other hand, would eliminate the incentives that lead to these social costs.¹⁶⁸

A more recent case illustrating the distributive as opposed to the allocative implications of nondisclosure is *In re Embers 86th Street, Inc.*,¹⁶⁹ in which the lessees of a New York property for use as a restaurant needed a rear egress from the leased property to be able to operate a portion of their business.¹⁷⁰ On at least two occasions, they asked the lessor if a “legal” egress existed and were assured that one did.¹⁷¹ What was not revealed was that the rear egress was subject to a license that was terminable at will by the landlord of an adjoining building and that the license had been terminated prior to the signing of the contract.¹⁷² Although the court noted that it was not clear that the lessors knew about the license, it observed that “even

¹⁶⁶ *Id.* at 674.

¹⁶⁷ The court does not indicate that such a distinction is relevant. *See id.*

¹⁶⁸ An interesting more recent case that distinguishes *Junius* is *Stambovsky v. Ackley*, 572 N.Y.S.2d 672 (App. Div. 1991), in which a seller did not disclose to a buyer that she had widely publicized that her house was inhabited by ghosts. *Id.* at 674. Evidently, the buyer did not learn of the reputation until after contracting to buy the house. *Id.* The seller had not misled the buyer but, according to the court, owed a duty to the buyer by virtue of publicizing the information to the public. *Id.* at 677. The court repeatedly noted that it was exercising its equitable powers. *Id.* at 674, 675, 677. As Professor Johnson notes, in the context of real property, many states now have mandatory disclosure requirements that pertain to information that is casually acquired and redistributive in nature. *See Johnson, supra* note 4, at 119. For an example, see New York’s law requiring the disclosure of forty-eight different items about the condition of the property. N.Y. REAL PROP. LAW § 462 (McKinney 2006); *see also* *Anderson v. Meador*, 869 N.Y.S.2d 233, 238 (App. Div. 2008) (holding as a matter of law that sellers had committed an affirmative misrepresentation by knowingly answering incorrectly on the statutory disclosure statement).

¹⁶⁹ 184 B.R. 892 (Bankr. S.D.N.Y. 1995).

¹⁷⁰ *Id.* at 895-96.

¹⁷¹ *Id.*

¹⁷² *Id.* Consequently, the fire department barred lessors from operating a portion of the restaurant. *Id.* at 896.

assuming *arguendo* that Vestergom [the lessor] was aware of the License, *Junius* [a prior decision relied on by the lessees and discussed above] does not support debtor's assertion that he was bound to disclose it."¹⁷³ If, in fact, the lessor did know about the terminable-at-will nature of the license, that knowledge could have been obtained through a deliberate effort. This information may have had the market-correcting effect of comparable negative information, but there would be no incentive to use it "efficiently" when nondisclosure is permitted.¹⁷⁴

A recent Missouri case similarly illustrates the cost-raising effect of nondisclosure. In *Richards v. ABN AMRO Mortgage Group, Inc.*,¹⁷⁵ the purchaser of land did not realize that thirty feet of it had recently been sold to a city and that rather than a two lane road in front of his residence, there would be a four lane road.¹⁷⁶ The buyer did not have the land surveyed, evidently assuming instead that a fence around the property was roughly consistent with the property's borders.¹⁷⁷ The seller knew of the prior sale but did not disclose.¹⁷⁸ The court ruled against the disappointed buyer reasoning that ordinary diligence, presumably including a survey, would have revealed the actual property boundaries.¹⁷⁹ In this instance, the information possessed by the nondisclosing party was obviously casually acquired.¹⁸⁰ Because it was negative in nature there was little incentive for the seller to disclose that what appeared to be the borders of the land were, in fact, misleading. One implication of this holding is that a buyer should incur expenses to discover what was already known. Obviously this is costly and inconsistent with a beneficial allocative outcome.

*Walcutt v. Inform Graphics, Inc.*¹⁸¹ concerned the winding up of an estate in which the defendants were indebted to the deceased.¹⁸² The estate representative assumed the amounts involved were small and did not know that the defendants owed \$76,000 to the deceased.¹⁸³ After a generally worded settlement, it came to light that the promissory note existed.¹⁸⁴ Upon that discovery, the estate sought to rescind or reform the release so that it could recover on the note.¹⁸⁵ The defendants had not disclosed the existence

¹⁷³ *Id.* at 899.

¹⁷⁴ *See supra* Part II.C.

¹⁷⁵ 261 S.W.3d 603 (Mo. Ct. App. 2008).

¹⁷⁶ *Id.* at 605.

¹⁷⁷ *See id.* at 605, 610.

¹⁷⁸ *See id.* at 605. The sales contract included an "as is, where is" clause, but this did not seem to be a major factor in the court's reasoning. *See id.* at 611.

¹⁷⁹ *See id.*

¹⁸⁰ *See supra* text accompanying notes 6-8.

¹⁸¹ 817 P.2d 1353 (Or. Ct. App. 1991).

¹⁸² *See id.* at 1354.

¹⁸³ *Id.* at 1354-55.

¹⁸⁴ *See id.* at 1355.

¹⁸⁵ *See id.* at 1353-54.

of the \$76,000 debt, and the court held that disclosure was not required.¹⁸⁶ The court noted that it was not clear that the attorney representing the defendants knew about the promissory note¹⁸⁷ but concluded “as a matter of law, that, even if the facts were as plaintiff posits them to be, she is not entitled to reformation or rescission of the release.”¹⁸⁸ This appears to be a case in which one party knew of the other party’s mistake as a result of information that was casually acquired and that could have been disclosed at no cost. Put in different terms, the defendants knew that what the plaintiff was selling (i.e., a release) was of greater value than the plaintiff assumed. One might analogize this to the misplaced masterpiece hypothetical, except in this case there is no positive allocative outcome.

The nondisclosure issue also arose in *Jappe v. Mandt*¹⁸⁹ in the context of the sale of a garbage collection business. The plaintiff purchased the rights to a garbage collection route from another collection service, but the city within which the route existed had decided to put a substantial part of the route up for bids.¹⁹⁰ The plaintiff sought damages claiming that the seller should have disclosed that the route purchased was likely to become substantially smaller.¹⁹¹ The court held against the plaintiff, noting that the seller did not “know” that the city was taking action to choose a different service to gather at least some of the garbage.¹⁹² Instead, according to the court, at the time of the sale the possibility was simply “in the wind.”¹⁹³ Aside from the fact that it is difficult to identify a principled basis for a rule that disclosure about a value-decreasing event is not required unless it is certain to occur, the court was insensitive to the casual/deliberate and the

¹⁸⁶ *Id.* at 1355.

¹⁸⁷ *Walcutt*, 817 P.2d at 1355 (“The strongest inference supported by the summary judgment record is that Gleaves [defendant’s attorney] did not know at the time of the negotiations that Kilkenny [estate’s representative] was unaware of the Koski note and that the two lawyers were not talking about the same things at the times that plaintiff suggests that Gleaves’ knowledge was or should have been triggered.”). The court, however, did suggest that the evidence tended to favor the conclusion that the attorney did know. *Id.* (“If it were necessary to decide, we might be obliged to conclude that there was enough evidence—although barely so—to support the contrary inference urged by plaintiff.”).

¹⁸⁸ *Id.* at 1355.

¹⁸⁹ 278 P.2d 940 (Cal. Dist. Ct. App. 1955). The case is cited by Professor Scheppele as part of the thesis that the nondisclosure/disclosure decision typically turns on whether the nondisclosing party possesses inside information. See SCHEPPELE, *supra* note 4, at 117-19.

¹⁹⁰ *Jappe*, 278 P.2d at 941.

¹⁹¹ *Id.*

¹⁹² See *id.* at 942 & n.2, 943. The court distinguished a previous decision, *Dyke v. Zaiser*, 182 P.2d 344 (Cal. Dist. Ct. App. 1947), on the basis that in *Dyke* the contracting party had specific inside information about a transaction that would greatly affect the value of what was sold. See *Jappe*, 278 P.2d at 943 (“[I]n that case the defendant was a city councilman who, by virtue of his position, knew of official action that had already been decided upon which would be definitely executed within 24 hours and which would and did have the effect of greatly depreciating the value of the subject matter of the transaction.”).

¹⁹³ *Jappe*, 278 P.2d at 942.

allocative/distributive issues.¹⁹⁴ As noted earlier, decisions to conceal negative information, even if deliberately acquired, have none of the socially beneficial effects that have been claimed for the default rule.¹⁹⁵

A final and more difficult case is *Toledano v. O'Connor*,¹⁹⁶ which seems to be decided correctly but which also illustrates how a more exacting analysis may change one's perspective. The case arose from the revelation in a *Vanity Fair* article that Mark Felt was the notorious "Deep Throat" from the Nixon era and Watergate scandal.¹⁹⁷ Felt, his son, and O'Connor (the author of the article) were the defendants in a suit by deToledano.¹⁹⁸ DeToledano was the co-author, along with the senior Felt, of a biography of Felt published several years before the "Deep Throat" revelations.¹⁹⁹ In preparation for the article and other possible publications, the defendants agreed to pay royalties to deToledano for use of parts of the earlier book.²⁰⁰ The parties initially negotiated a royalty amount dependent on how much material was used, but ultimately deToledano agreed to sell his portion of the copyright for \$5,000 with a subsequent \$5,000 payment contingent upon publication of the rewritten version of the book if it contained material from the first version.²⁰¹

The contract provided that any disputes were to be resolved by arbitration.²⁰² A disagreement did arise, and the plaintiff sought to rescind the contract based on a number of factors, including the fact that O'Connor, who was also an attorney, had not disclosed the substantial costs of arbitration to deToledano, who was at the time of contracting quite elderly.²⁰³ According to the plaintiff, deToledano "had no inkling whatsoever that arbitration could be a complicated process involving days of hearings, costing the parties hundreds of dollars per hour just for the arbitrator's time."²⁰⁴ The contract, according to the plaintiff, would not have been signed had deToledano known the consequences of the arbitration requirement.²⁰⁵ From the descrip-

¹⁹⁴ See *id.* at 942-43.

¹⁹⁵ See *supra* Part II.C.

¹⁹⁶ 501 F. Supp. 2d 127 (D.D.C. 2007).

¹⁹⁷ *Id.* at 133.

¹⁹⁸ *Id.*

¹⁹⁹ *Id.* For the biography, see W. MARK FELT, *THE FBI PYRAMID FROM THE INSIDE* (1979). The title page listed only Felt as an author, but it was conceded that deToledano was a co-author. See *Toledano*, 501 F. Supp. 2d at 134.

²⁰⁰ See *Toledano*, 501 F. Supp. 2d at 134. Permission was evidently sought in anticipation of the publication of materials about Felt in connection with the "Deep Throat" revelations. See *id.*

²⁰¹ *Id.* at 134-35.

²⁰² *Id.* at 135-36.

²⁰³ See *id.* at 137, 144-45.

²⁰⁴ *Id.* at 144. By this time, deToledano was deceased, and relief was sought by his children. *Id.* at 137; see also Douglas Martin, *Ralph de Toledano, 90, Writer Known as a Nixon Friend*, N.Y. TIMES, Feb. 6, 2007, at D8 (giving a brief account of deToledano's life and writings).

²⁰⁵ *Toledano*, 501 F. Supp. at 144.

tion of the facts, it appears that O'Connor desired the arbitration clause and more or less made an effort to "sell" it to deToledano.²⁰⁶

The court rejected deToledano's argument, reasoning that disclosure was only required if "the facts are known or accessible only to defendant, and defendant knows they are not known or reasonably discoverable by the plaintiff."²⁰⁷ It relied on the first comment to section 161 of the *Restatement (Second) of Contracts*,²⁰⁸ which states: "A Party making a contract is not expected to tell all that he knows to the other party, even if he knows that the other party lacks knowledge on some aspects of the transaction."²⁰⁹ The *Restatement* may reflect the law, but, as described throughout this Article, it hardly represents an approach that would minimize social costs. In fact, with respect to relevant information, it has the influence of requiring both parties to undertake the same research or for one party to invest in research to acquire information that may have already been acquired at no cost to the opposite party.

On its face the decision seems to be the correct one, but it may make sense to frame the case a bit differently in order to understand its relevance to the disclosure issue. In effect, Felt, his son, and O'Connor made a purchase from deToledano. One of the terms of the exchange, and one they preferred, was that disputes would be resolved by arbitration. DeToledano's argument was, in effect, that the payment for his permission to use the earlier book was diminished in value relative to what he had given up.²¹⁰ In a sense, he had "overpaid" as a consequence of a lack of information. In this sense, deToledano's argument was like that of the buyer of land from which thirty feet had been removed or the buyer of a garbage collection business that was soon to be much smaller. In all cases, information that was not disclosed would have had a significant impact on the terms of the exchange or whether the exchange occurred at all.²¹¹ Perhaps most importantly, requiring disclosure would result in no social costs or losses unless the non-

²⁰⁶ See *id.* at 134-35 (showing that O'Connor mentioned the arbitration clause several times explaining that either party could resolve any disagreements through arbitration and that deToledano acknowledged the arbitration provision). DeToledano can be distinguished from cases in which a party claims not to know the contract included an arbitration clause. See, e.g., *Brookwood v. Bank of Am.*, 53 Cal. Rptr. 2d 515, 519 (Ct. App. 1996) (compelling arbitration of plaintiff's wrongful termination suit even though plaintiff was unaware of the arbitration requirement and did not knowingly agree to arbitration).

²⁰⁷ *Toledano*, 501 F. Supp. 2d at 145 (quoting *Warner Constr. Corp. v. City of L.A.*, 466 P.2d 996, 1001 (Cal. 1970)) (internal quotation marks omitted). This policy is similar to that described in Professor Scheppele's book. See SCHEPPELE, *supra* note 4, at 115-19; see also *supra* note 189 and accompanying text.

²⁰⁸ *Toledano*, 501 F. Supp. 2d at 145.

²⁰⁹ RESTATEMENT (SECOND) OF CONTRACTS § 161 cmt. a (1981).

²¹⁰ See *Toledano*, 501 F. Supp. 2d at 144.

²¹¹ Of course, at trial the likely argument will be that the decision was affected by the withheld information. As already noted, this will be a question of whether a reasonable person would have reacted in the same manner.

disclosing party did not have any reason to know that the information was relevant to and unknown by the opposite party.

One interpretation of the case, therefore, is that the defendants "sold" the plaintiff on the idea of arbitration. It would be irrational for them to do so unless they felt arbitration was advantageous to them. For example, they may have had experience with arbitrators and they were almost certainly the types of repeat players whose knowledgeable choices could influence the outcome.²¹² In addition, the experience of the defendants with arbitration may actually lower their costs of participation and increase the cost of prevailing to the plaintiff. Certainly the defendants' nudging toward arbitration and the plaintiff's shock when realizing the costs are consistent with this outcome²¹³ and with the possibility that the defendants sought to raise the plaintiff's conflict resolution costs relative to their own.

In reexamining the case from this perspective, two things are noteworthy. First, to the extent the nudging involved extolling the virtues of arbitration, the defendants may have already become required to tell the rest of the story in order to avoid a misrepresentation. Even if that were not the case, with the one exception noted below, there appears to be no social cost of requiring disclosure. Clearly the defendants possessed relevant information that was unknown to the plaintiff. Second, it is hard to imagine a scenario in which the information was not acquired casually. In fact, regardless of the outcome of this case or, in all likelihood, any other, there is little chance that research into the costs and efficacy of arbitration or any alternative means of dispute resolution would be discouraged. These factors combine to suggest, quite strongly, that the information was withheld strictly for distributive ends.

Still, the outcome of the case may still be correct if imposing disclosure would raise social costs. This exception, as noted above, depends on the costs to the defendants of knowing that the information would be relevant to the plaintiff. Even here though, the defendants' case is weak as an economic matter. Second, at least some of the defendants had prior dealings with the plaintiff and obviously knew that he was elderly, not commercially sophisticated, and not represented by counsel.²¹⁴ In addition, he was evi-

²¹² See, e.g., Lisa B. Bingham, *On Repeat Players, Adhesive Contracts, and the Use of Statistics in Judicial Review of Employment Arbitration Awards*, 29 MCGEORGE L. REV. 223, 238 (1998) ("Employees lose more frequently when the arbitrator is one the employer has used at least once before."); Elizabeth Hill, *Due Process at Low Cost: An Empirical Study of Employment Arbitration Under the Auspices of the American Arbitration Association*, 18 OHIO ST. J. ON DISP. RESOL. 777, 816 (2003) (finding that "the repeat player effect is caused, not by a lack of due process, but by a fair in-house process" in which the "[r]epet player employers isolate and resolve large numbers of meritorious employee claims through in-house dispute resolution programs, leaving only relatively meritless cases for appeal to AAA arbitration").

²¹³ Moreover, in most instances the cost of resolution will affect settlement terms.

²¹⁴ Communications about the contract terms were directly with deToledano. See *Toledano*, 501 F. Supp. 2d at 134-36.

dently concerned about how disagreements would be resolved.²¹⁵ Finally, as in most nondisclosure cases, the defendants relied on the fact that their “property right” in the information only existed by virtue of the fact that deToledano did not ask for it.²¹⁶

CONCLUSION

The common law seems solidly wedded to the idea that disclosure of relevant information is not required unless there is either a duty by one party to another or a prior representation that could be misleading by one party to another.²¹⁷ Professor Kronman and others have explained that the rule, in practice, is actually one that requires disclosure of casually acquired information and permits nondisclosure of deliberately acquired information. As a general matter, so the theory goes, this is consistent with allocative efficiency and social welfare by virtue of allowing gatherers of information to internalize the profit it generates.

The theory involves a number of assumptions and largely ignores the social costs of nondisclosure. Nondisclosure can mean there is a race for information that itself may be inefficient and duplicative. The rule also permits the nondisclosure of and, thus, encourages the investment in information that has strictly distributive and no socially beneficial effects. In addition, it presupposes that nondisclosure will lead to market corrections as undervalued goods are discovered and brought into their more valued uses. In fact, a great deal of deliberate research may be designed to discover when goods are overvalued or to purposely keep information off the market to avoid downward market adjustments.

This Article identifies and discusses the social costs of the nondisclosure rule and generally questions the social benefits of research efforts that are not already protected by intellectual property law. It maintains the casual/deliberate distinction but also asks whether the gain from the information was foreseeable, whether the information has primarily distributive or allocative consequences, whether the information will ultimately be revealed to the market, and whether it is the product of a race in which the winner may not be the most efficient source of market-correcting information. This more nuanced approach to nondisclosure is relatively easy to administer and reduces social costs created by the default rule.

²¹⁵ See *id.* at 134-36, 144.

²¹⁶ See *supra* text accompanying notes 45-50.

²¹⁷ This is more clearly reflected in section 161 of the *Restatement (Second) of Contracts*. See RESTATEMENT (SECOND) OF CONTRACTS § 161 (1981).