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Case Western Reserve Law Review

Volume 41 | Issue 2

1991

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Recommended Citation

Christopher T. Wonnell, *The Structure of a General Theory of Nondisclosure*, 41 Case W. Res. L. Rev. 329 (1991)
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Case Western Reserve Law Review

Volume 41 | 1991 | Number 2

THE STRUCTURE OF A GENERAL THEORY OF NONDISCLOSURE

*Christopher T Wonnell**

Nondisclosure cases have often turned on two factual distinctions: the distinction between nondisclosure by a buyer and a seller and between nondisclosure of intrinsic and extrinsic facts. The author critically examines these distinctions in order to derive a general framework for the resolution of nondisclosure cases. The author then applies his nondisclosure framework to the problem of foreseeability in contract damages and, more generally, to other default rules.

I. INTRODUCTION: THE OPEN-ENDED LAW OF NONDISCLOSURE

DIFFICULT PROBLEMS OF law and policy arise from a common factual phenomenon: a party to a contract who is in possession of information pertinent to the contractual exchange elects not to reveal that information to the other party Several legal responses to such nondisclosure[1] are possible: condemnation of nondisclosure as tantamount to fraud, approval of nondisclosure as

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1. Nondisclosure is defined as "[a] failure to reveal facts, which may exist when there is no 'concealment.' " BLACK'S LAW DICTIONARY 1053 (6th ed. 1990). Concealment is "[a] withholding of something which one knows and which one, in duty, is bound to reveal." *Id.* at 289.

the just reward for entrepreneurial discovery of information, or tolerance for nondisclosure as an inevitable by-product of a human predisposition against affirmatively aiding others. Predictably, perhaps, the legal response to nondisclosure has consisted of a confused mixture of all three reactions.

There has been ample opportunity to develop a coherent response to the phenomenon of nondisclosure, since it arises in a wide range of settings. Nondisclosure is specifically treated in the *Restatements of Agency*,[2] *Contracts*,[3] *Restitution*,[4] *Torts*,[5] and *Trusts*.[6] Under the label of insider trading, nondisclosure has been a major preoccupation of statutes and regulations governing the sale of securities.[7] In addition, federal labor laws address the issue of nondisclosure of material facts by the parties to a collective bargaining agreement.[8]

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2. *See* RESTATEMENT (SECOND) OF AGENCY § 390 (1958) (An agent acting as an adverse party with the principal's consent "has a duty to deal fairly with the principal and to disclose to him all facts which the agent knows or should know would reasonably affect the principal's judgment . . . .").

3. *See* RESTATEMENT (SECOND) OF CONTRACTS § 161 (1979) (listing situations in which nondisclosure is equivalent to an assertion).

4. *See* RESTATEMENT OF RESTITUTION § 8 (1936) (including in the definition of fraud "non-disclosure, where it is not privileged, by any person intending or expecting thereby to cause a mistake by another to exist or to continue, in order to induce the latter to enter into or refrain from entering into a transaction").

5. *See* RESTATEMENT (SECOND) OF TORTS § 551 (1977) (The section entitled "Liability for Nondisclosure" defines nondisclosure as the failure to disclose "a fact that [one] knows may justifiably induce the other to act or refrain from acting in a business transaction . . . [if one] is under a duty to the other to exercise reasonable care to disclose the matter in question.").

6. *See* RESTATEMENT (SECOND) OF TRUSTS § 170 (1959) (A trustee owes a duty to a beneficiary "to communicate to him all material facts in connection with the transaction which the trustee knows or should know.").

7. Many states require that owners of more than 10% of a domestic stock file with the commissioner a statement that specifies their ownership interests; these individuals are also required to update these statements as their interests change. *See, e.g.*, ALASKA STAT. § 21.40.010 (1990); ARIZ. REV. STAT. ANN. § 20-726-01 (1989); ARK. STAT. ANN. § 23-69-122 (1990); DEL. CODE ANN. tit. 18, § 5103 (1990); GA. CODE ANN. § 33-14-91 (1990); IOWA CODE § 523.7 (1989); *see also* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968) (concluding that "anyone in possession of material inside information must either disclose it to the investing public, or . . . must abstain from trading in or recommending the securities concerned while such inside information remains undisclosed."), *cert. denied*, 394 U.S. 976 (1969).

8. *See* National Labor Relations Act, 29 U.S.C § 158(a)(5) (1988) (holding it an unfair labor practice for an employer to refuse to bargain collectively with his employees' representatives); *Id.* § 158(d) (requiring employer to bargain in good faith); *see also, e.g.*, Curtiss-Wright Corp. v. NLRB, 347 F.2d 61, 68 (3d Cir. 1965) ("[I]f the requested data is relevant and, [sic] therefore reasonably necessary, to a union's role as bargaining agent in the administration of a collective bargaining agreement, it is an unfair labor practice

A few specific prohibitions of nondisclosure have emerged from this body of judicial decisions and legislative enactments. Nondisclosure by a fiduciary is generally prohibited,[9] although the question of when fiduciary relationships exist remains troubling.[10] In addition, a party who makes a disclosure is under an obligation not to omit facts where such an omission would render the disclosure misleading.[11] Similarly, a party who chooses to speak regarding a subject during negotiations may have an affirmative duty to update statements which were true when originally made but which have subsequently become false.[12]

Outside of these specific prohibitions, the law of nondisclosure lapses into statements so vague that they can assume any meaning. The *Restatement (Second) of Contracts* considers nondisclosure tantamount to fraud when the nondisclosure "amounts to a failure to act in good faith and in accordance with reasonable standards of fair dealing."[13] One commentator concluded that his review of the "countless decisions" concerning vendor-purchaser nondisclosure left only the question-begging theorem that

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for an employer to refuse to furnish the requested data.").

9. *See, e.g.*, Jordan v. Duff & Phelps, Inc., 815 F.2d 429, 435 (7th Cir. 1987) ("close corporations buying their own stock, like knowledgeable insiders of closely held firms buying from outsiders, have a fiduciary duty to disclose material facts."), *cert. dismissed*, 485 U.S. 901 (1988).

10. *See generally* DeMott, *Beyond Metaphor: An Analysis of Fiduciary Obligation*, 1988 DUKE L.J. 879 ("Fiduciary obligation is one of the most elusive concepts in Anglo-American law ").

11. *See* RESTATEMENT (SECOND) OF TORTS § 551(2)(b) (1977) (A party to a business transaction must exercise reasonable care to disclose "matters known to him to be necessary to prevent his partial or ambiguous statement of the facts from being misleading "); 17 C.F.R. 240.10b-5(b)(1990) (In interstate securities transactions, it is unlawful "[t]o make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading ").

12. *See* RESTATEMENT (SECOND) OF TORTS § 551(2)(c) ("One party to a business transaction is under a duty to exercise reasonable care to disclose to the other before the transaction is consummated subsequently acquired information that he knows will make untrue or misleading a previous representation that when made was true or believed to be so ").

13. *See* RESTATEMENT (SECOND) OF CONTRACTS § 161(b) (1979). According to the *Restatement*:

> A person's non-disclosure of a fact known to him is equivalent to an assertion that the fact does not exist in the following cases only: (b) 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.

Id.

"[s]ilence or nondisclosure does not constitute an actionable wrong, unless the defendant is under a duty to speak and disclose."[14]

An examination of three cases provides an example of the continuing difficulty in reconciling the case law in this area. In *Thacker v. Tyree*,[15] the court held that the seller of a house has a duty to disclose to the buyer that the house had been built on filled ground causing structural problems.[16] In *Holly Hill Lumber Co. v. McCoy*,[17] the court held that a buyer of land has no duty to disclose to the seller the existence of a valuable lime deposit on the land.[18] In *Laidlaw v. Organ*,[19] the Supreme Court of the United States held that a purchaser of tobacco was under no duty to disclose to the seller that a peace treaty had just been signed, ending the war of 1812 and the naval blockade that had been holding down the price of tobacco.[20]

These cases suggest two distinctions that a general theory of nondisclosure should explain. The first is the distinction between buyer and seller nondisclosure, with the law being much stricter with respect to sellers.[21] The second is the distinction between the failure to disclose intrinsic facts pertaining to the commodity at hand and the failure to disclose extrinsic facts pertaining to the general environment affecting the economic value of that commodity. Several commentators have noted a tendency for the law to take a stricter position regarding the nondisclosure of intrinsic facts.[22]

Professor Keeton has listed the following as factors that courts consider in nondisclosure cases:

(1) The difference in the levels of the parties' sophistication regarding the subject matter of the contract;

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14. Goldfarb, *Fraud and Nondisclosure in the Vendor-Purchaser Relation*, 8 W. RES. L. REV. 5, 7 (1956).

15. 297 S.E.2d 885 (W. Va. 1982).

16. *Id.* at 886-88.

17. 201 S.C. 427, 23 S.E.2d 372 (1942).

18. *Id.* at 443, 23 S.E.2d at 379.

19. 15 U.S. (2 Wheat.) 178 (1817).

20. *Id.* at 195.

21. *See, e.g.*, Zaschak v. Traverse Corp., 123 Mich. App. 126, 333 N.W.2d 191 (1983) (Michigan law places no duty upon a prospective purchaser to disclose facts or possible opportunities within his or her knowledge that materially affect the value of the property).

22. *See, e.g.*, Lawson, *The Ethics of Insider Trading*, 11 HARV. J.L. & PUB. POL'Y 727, 740 (1988) (citing numerous historical commentators who draw a distinction between intrinsic and extrinsic facts).

(2) The relationship between the parties;
(3) The manner in which the information is acquired. Information may be acquired by chance, by effort, or by an illegal act;
(4) The nature of the undisclosed fact. In contracts of sale of real property, if the vendor conceals an intrinsic defect not discoverable by reasonable care, the court will be more prone to find a duty to disclose than it would be to find a duty to disclose an extrinsic fact;
(5) The contracting position of the parties relative to each other. It is more likely that a seller will be required to disclose information than a purchaser;
(6) The nature of the contract. All material facts generally must be disclosed in releases and contracts of insurance;
(7) The importance of the nondisclosed fact to the parties;
(8) The active concealment of any material fact.[23]

The literature has not attempted to bring these factors together into a general theory of nondisclosure. Only with the help of a general theory can these and other factors be assigned their proper weight, allowing the court to decide cases where the individual factors militate toward opposite conclusions. The purpose of this article is to formulate the basic structure for such a general theory

A few preliminary words about the methodology of such a general inquiry are in order. In recent years, the literature on the nondisclosure problem has been animated by a concern for economic efficiency, or the maximization of societal wealth.[24] This article follows that tradition for two reasons. First, efficiency can be a proxy for utility across a relatively broad range of legal issues.[25] Second, efficiency often yields results compatible with individualist moral intuitions about behavior.[26]

Nevertheless, because efficiency is not an end in itself, it will be necessary to reconsider the normative case for particular rules

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23. W. KEETON, D. DOBBS, R. KEETON & D. OWEN, PROSSER & KEETON ON TORTS § 106 (5th ed. 1984) (discussing and summarizing factors set forth in Keeton, *Fraud, Concealment and Non-disclosure*, 15 TEX. L. REV. 1 (1936)).

24. *See, e.g.*, R. POSNER, ECONOMIC ANALYSIS OF LAW 97-99 (3d. ed. 1986) (discussing societal concerns regarding disclosure in consumer cases and the economic implications of disclosure for monopolistic industries).

25. *See* Wonnell, *The Abstract Character of Contract Law*, 22 CONN. L. REV. 437, 461-62 (1990) (describing utilitarian linkage with economic "value").

26. *See* R. POSNER, *supra* note 24, at 238-39 ("[O]n balance it would seem that adherence to generally accepted moral principles increases the wealth of society more than it reduces it ").

that are indicated by an efficiency calculus. Accordingly, when it appears that the efficiency analysis strains either a conception of social utility or notions of ethical behavior, the compatibility issue will be readdressed in that context.[27]

The efficiency analysis draws on previous developments in the law in its justification for the general framework of nondisclosure. This article argues that the law in the nondisclosure area makes many economically justifiable distinctions. Indeed, the sharp dichotomy between positive and normative analysis of law is not wholly appropriate. While the law as it has evolved must not be viewed uncritically, there is reason to believe that, in certain cases, the law embodies a degree of unarticulated normative wisdom.[28] Accordingly, one can view the compatibility of the efficiency analysis with the existing judicial wisdom as another, highly fallible, test of the normative validity of its conclusions.

Section II begins with a discussion of the competing contract principles of mutually beneficial trade and security of promissory transactions. Section III explores and justifies the nondisclosure distinction between buyer and seller. Section IV addresses the distinction between the nondisclosure of extrinsic and intrinsic information. Section V identifies some implications of the nondisclosure analysis for the issues of foreseeability in contract damages and default rules more generally Section VI describes the structure of a general theory of nondisclosure and summarizes some tentative rules of nondisclosure.

II. A Preliminary Organizing Principle: Mutually Beneficial Trade Versus the Security of Promissory Transactions

In searching for a unifying principle in the nondisclosure area, it is useful to return to basic principles of contract law Contract law defines and nurtures two social institutions: promise and exchange.[29] Generally speaking, both are necessary for contractual obligations to arise. A promise without an exchange may be

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27. *See infra* text accompanying notes 80-81, 155-57 & 163-66.

28. *See* Barnett, *Foreword: Of Chickens and Eggs — The Compatibility of Moral Rights and Consequentialist Analyses*, 12 HARV. J.L. & PUB. POL'Y 611, 620-30 (1989) (discussing the inability of philosophical, economic, and natural rights analyses to explain legal norms).

29. *See* E. FARNSWORTH, CONTRACTS § 1.1 (2d ed. 1990) (contract law is confined to exchanges resulting from promise).

unenforceable for lack of consideration, while an exchange without a promise is merely an instantaneous or simultaneous transaction for which most contract rules are inapplicable.[30]

Both exchange and promise generate important efficiencies, but they do so in different ways. Exchange allows the mutually beneficial movement of resources to their highest and best use.[31] Promise protects reliance expenditures and ensures that property titles will remain stable over time so that valuable resources will not be spent on ownership disputes at each stage of a transaction.[32]

In the nondisclosure context, the exchange-based and promise-based values can be in tension with each other. When a buyer discovers that the newly purchased house is infested with termites, the transaction may no longer constitute a mutually beneficial movement of the house to its highest and best user.[33] However, allowing the buyer to rescind the contract and move out of the house would entail significant transaction costs in the form of litigation and duplicative moving expenses.

In this sense, the nondisclosure problem is a subset of the more general question in contract law of why people would voluntarily choose to enter into a contract but then refuse to abide by it. Essentially, there are two reasons for such conduct. First, a party may be engaging in opportunistic behavior[34] by, for example, refusing to perform their half of the bargain after the other party has performed. Second, circumstances — tastes, economic position, or alternatives — may change subsequent to the time of the promise.

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30. *See id.* at § 1.2 (distinguishing barters from contracts).

31. *See* Kronman & Posner, *Introduction: Economic Theory and Contract Law*, in THE ECONOMICS OF CONTRACT LAW 1, 1-2 (A. Kronman & R. Posner eds. 1989) ("[I]f voluntary exchanges are permitted resources will gravitate toward their most valuable uses.")

32. *See* Barnett, *A Consent Theory of Contract*, 86 COLUM. L. REV. 269, 320-21 (1986) (consent theory of contractual obligation protects the promisee's reliance on the promisor's consent).

33. *See* Obde v. Schlemeyer, 56 Wash. 2d 449, 453, 353 P.2d 672, 675 (1960) (holding that "[a] termite infestation of a frame building is manifestly a serious and dangerous condition ," that " 'justice, equity, and fair dealing' demand[] that [owners] inform[] prospective purchasers of the condition," and that failure to do so is sufficient grounds for liability).

34. *See generally* Muris, *Opportunistic Behavior and the Law of Contracts*, 65 MINN. L. REV. 521 (1981) (defining opportunistic behavior as behavior by the performing party that is inconsistent with the other party's understanding of the contract but not inconsistent with the terms of the contract).

In the first instance, permitting the opportunistic breach would undo the prospects of a mutually beneficial exchange. The law strongly condemns such breaches, and there may be a trend toward expanding the penalties for such opportunistic breaches even further.[35] In the second instance, one of the parties to the contract has lost the anticipated benefit of the bargain. Here, the law may excuse performance entirely under the doctrine of mistake[36] or impracticability.[37] In other circumstances, some commentators have suggested compensatory damages as the appropriate sanction for nonperformance resulting from an efficient breach.[38] Even when the law chooses to substantially penalize offending parties in "changed circumstance" breaches, it does so with reservation, recognizing that to preserve the security of a promissory transaction it is occasionally necessary to sacrifice the goal of attaining an exchange which is beneficial to all parties.[39]

Many of the factors that Professor Keeton has identified are best understood when viewed through a lens that contrasts mutually beneficial exchange and the security of promises. Consider the emphasis on the importance of the nondisclosed fact.[40] If the fact not disclosed is relatively insignificant, the exchange may still be mutually beneficial, or only slightly to the detriment of one party.[41] The nondisclosure of immaterial facts, on the other hand,

35. *See, e.g.*, Seaman's Direct Buying Service, Inc. v. Standard Oil Co., 36 Cal. 3d 752, 769, 686 P.2d 1158, 1167, 206 Cal. Rptr. 354, 363 (1984) (holding that a party who breaches a commercial contract and denies in bad faith that a contract exists may also be subject to tort liability).

36. *See, e.g.*, RESTATEMENT (SECOND) OF CONTRACTS § 153 (1979) (a mistake as to a basic assumption made by a party when entering into the contract may render the contract voidable).

37. *See, e.g.*, *id.* § 261 (impracticability of performance may discharge a party from the duty to perform).

38. *See, e.g.*, R. POSNER, *supra* note 24, at 105-07 (in order to isolate "efficient breaches," the breaching party should be compelled to pay the other party the profits lost because of the breach).

39. *See, e.g.*, Triple A Contractors v. Rural Water Dist., 226 Kan. 626, 629, 603 P.2d 184, 186 (1979) (holding "that in the absence of fraud, a unilateral mistake does not excuse the non-performance of a [bid] contract . . . ." because "to hold otherwise . . . would materially weaken the purpose of the bidding procedure," which is to bind the parties so that they may rely on the bids).

40. *See* W. KEETON, D. DOBBS, R. KEETON & D. OWEN, *supra* note 23, § 106, at 739.

41. In other words, the transaction is efficient in a Kaldor-Hicks sense; that is, the transaction yields benefits to one party in excess of any loss incurred by the other. R. POSNER, *supra* note 24, at 12-13 (Kaldor-Hicks is a "less austere concept of efficiency" than Pareto efficiency).

is presumably such a common occurrence that prohibiting those nondisclosures would seriously threaten the security of promissory transactions.[42]

As a second example, consider Keeton's emphasis on the difference in the degree of sophistication of the parties as well as the extent to which the defect was not discoverable by reasonable care.[43] If the party from whom information is withheld has easy and well-established access to information about the subject matter of the contract, then that party may well be the "cheaper cost avoider."[44] Barring the cheaper cost avoider from rescinding will give that party an incentive to discover the information, thereby avoiding substantial degradation of the value of mutually beneficial exchange.

The party with independent access to the information may not be the cheaper cost avoider in all circumstances. One could argue that it is virtually costless for a person who already has certain information to disclose it to the other party.[45] On this theory, efforts by the sophisticated party to arrive at the same information that the less sophisticated party already possesses would be duplicative and socially wasteful.[46] On the other hand, full disclosure of every defect in one's products may be sufficiently contrary to human nature that the more realistic cost avoider remains the party with independent access to the information.[47]

An important question is whether the attempt to balance the policy of promoting mutually beneficial trade against the policy of ensuring the security of promissory transactions explains the two

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42. *See* Keeton, *Fraud, Concealment and Nondisclosure*, 15 TEX. L. REV. 1, 32-33 (1936) (arguing that the reasonable person standard reflects "what the man of ordinary moral sensibilities would have done" and that nondisclosure of certain types of material information is to be expected and therefore is reasonable).

43. *See* W. KEETON, D. DOBBS, R. KEETON & D. OWEN, *supra* note 23, § 106 at 739.

44. *See* R. POSNER, *supra* note 24, at 99 ("The question of liability for nondisclosure should turn on which of the parties to the transaction, seller or consumer, can produce or obtain information at lower cost.").

45. *See* Teamsters Local 282 Pension Trust Fund v. Angelos, 762 F.2d 522, 528 (7th Cir. 1985) ("Once the duty to disclose exists, and lying or nondisclosure is condemned as an intentional tort, it no longer matters whether the buyer conducts an investigation well or at all.").

46. *Id.* ("The buyer's investigation of things already known to the seller is a wasteful duplication of effort.").

47. *See, e.g.*, Goodwin v. Agassiz, 283 Mass. 358, 363, 186 N.E. 659, 661 (1933) (president and director of a corporation failed to disclose material information to a shareholder from whom they purchased stock, yet the court refused to impose a duty to disclose).

distinctions noted in section I. Specifically, does the tension between these policies explain the tendency to punish nondisclosure by sellers more severely than nondisclosure by buyers and the tendency to punish nondisclosure of intrinsic information more severely than the nondisclosure of extrinsic information?[48]

Professor Farnsworth has argued that the buyer-seller distinction is a subset of the general problem of access to information: "A court is more likely to expect a party to disclose if that party has special knowledge or a special means of knowledge not generally available to those in the position of the other party This may explain why the burden is more often imposed on sellers than on buyers."[49] If the seller has better access to information about the property offered for sale, then a rule allowing seller nondisclosure will frustrate many mutually beneficial exchanges, while a rule allowing buyer nondisclosure will merely force sellers to discover the information to which they have access.[50]

The distinction between intrinsic and extrinsic information can also be explained in terms of the exchange-promise dichotomy Intrinsic information about the very commodity being sold may be peculiarly salient to the parties, so that a disclosure duty backed by sufficient sanctions would prevent exchanges that are not mutually beneficial. By contrast, a general duty to disclose all extrinsic information, that is, information pertaining to the general environment in which the contract was formed[51] might fail to generate much disclosure, leaving considerable uncertainty in the property titles generated by promissory transactions.

The tension between mutually beneficial exchange and the security of promissory transactions also explains a historical development. It is often said that business ethics have matured from an earlier era of caveat emptor and "every man for himself" individualism.[52] Courts have noted this trend in decisions that increas-

48. *See supra* text accompanying note 28.

49. E. FARNSWORTH, *supra* note 29, § 4.11, at 256 (citation omitted).

50. *See* 3 J. POMEROY, A TREATISE ON EQUITY JURISPRUDENCE § 903 (5th ed. 1941) (The decisions in this area recognize a difference in the information a buyer can obtain as opposed to a seller because "the seller has better opportunities than anyone else to know all the material facts concerning his own property, and is thus able under all ordinary circumstances to protect his own interests.").

51. *See supra* text accompanying note 23.

52. *See* Hamilton, *The Ancient Maxim Caveat Emptor*, 40 YALE L.J. 1133, 1186 (1931) (jurisprudence has recognized a close relationship between imposing caveat emptor and the development of individualism in this society).

ingly sanction parties for nondisclosure.[53] If contracting parties feel some ethical duty to disclose information, then it is more likely that a legal duty to disclose will successfully ensure full disclosure. Full disclosure furthers both mutually beneficial exchange and promissory security to the extent that it is actually practiced.[54] By contrast, if the law were too distant from the moral code of the era of caveat emptor, it might generate only a partial compliance, which would leave too many transactions subject to subsequent litigation.

The duty to disclose in fiduciary relationships might be similarly understood.[55] For example, codes of ethics and marketplace realities both require attorneys to perform considerable disclosure of material facts to their clients.[56] In this ethical milieu, a legal duty to disclose would arguably ensure that sufficient disclosure occurs so that few attorney-client contracts would require scrutiny for fraud. In terms of the exchange-promise dichotomy, the fiduciary settings might be seen as an area where the benefit of mutually beneficial trade from additional disclosure can be obtained at little cost in terms of the number of transactions that would be set aside.

Section I of this article noted that the law could take any of three positions on nondisclosure: condemnation, approval, or tolerance.[57] The exchange-promise framework involves only the first and third of these reactions. Full disclosure in all transactions is the ideal: if it occurs, mutually beneficial transactions need not be set aside. Nondisclosure is tolerated only as a concession to human frailty that might render a duty to disclose ineffective, thereby producing uncertainty in the property titles arising from

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53. *See* Note, Reed v. King: *Fraudulent Nondisclosure of a Multiple Murder in a Real Estate Transaction*, 45 U. PITT. L. REV. 877, 882 (1984) ("For whatever reason, economics, expectations, or morality, some courts began to hold vendors to a higher standard of honesty . . . .").

54. *See supra* text accompanying notes 31-32.

55. For an argument that fiduciary relationships arise from the voluntary assumption of a position in which one is to further the interests of another, see Scott, *The Fiduciary Principle*, 37 CALIF. L. REV. 539, 540 (1949).

56. "A lawyer should exert his best efforts to insure that decisions of his client are made only after the client has been informed of relevant considerations." MODEL CODE OF PROFESSIONAL RESPONSIBILITY EC 7-8 (1990). The disciplinary rules establish that "[a] lawyer shall not enter into a business transaction with a client if they have differing interests therein and if the client expects the lawyer to exercise his professional judgment therein for the protection of the client, unless the client has consented after full disclosure." *Id.* DR 5-104(A).

57. *See supra* text accompanying note 1.

contracts.[58]

The current framework for the debate of the nondisclosure issue has offered little support for this practice. At best, nondisclosure is regarded as an evil that must be tolerated because the costs associated with full disclosure and its enforcement are too great. In such a framework, it might be that less and less nondisclosure will be tolerated as business ethics improve. Some observers argue that the ambit of materiality has been broadened and should be broadened still further.[59] Furthermore, the proposition that there is no duty to disclose where the uninformed party had an opportunity to discover the withheld information has fallen into disfavor.[60] Similarly, the range of relationships recognized as fiduciary in character has steadily broadened.[61]

Against this backdrop, Anthony Kronman introduced the ground-breaking argument that nondisclosure of information in certain circumstances might be a positive measure to which courts should approvingly defer.[62] Kronman's highly influential article changed the nature of the debate regarding the economic utility of nondisclosure. The next section of this article examines, extends, and critiques Kronman's conclusions in the context of the distinction between buyer and seller nondisclosure.

III. The Asymmetry of Buyer and Seller Nondisclosure

In essence, Kronman's theory is that the right to trade without disclosure provides an incentive to acquire valuable information.[63] In other words, individuals will not incur the cost of obtaining information if they must subsequently disclose that information without compensation to potential trading partners who have not incurred such costs. Kronman notes that informa-

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58. *See* Litvinoff, *Vices of Consent, Error Fraud, Duress and an Epilogue on Lesion*, 50 LA. L. REV 1, 62, 63 (1989) (examining the duty of full disclosure and concluding that the standard should not be idealistically set).

59. *See, e.g.*, Shell, *Substituting Ethical Standards for Common Law Rules in Commercial Cases: An Emerging Statutory Trend*, 82 NW. U.L. REV. 1198, 1232 (1988) (discussing the relaxed standards that plaintiffs must meet to show a misrepresentation of a material fact).

60. *See supra* text accompanying notes 45-46.

61. *See* Shell, *supra* note 59, at 1207-08 ("In the past, the label 'fiduciary' was reserved for specific, highly dependent relationships In recent years, the concept of fiduciary duty has begun to appear in cases involving conventional business dealings.").

62. Kronman, *Mistake, Disclosure, Information, and the Law of Contracts*, 7 J. LEGAL STUD. 1, 9 (1978).

63. *See id.*

tion may also be acquired casually, without significant effort or cost.[64] In Kronman's view, individuals should be required to disclose such information. Since acquiring the information required little or no effort, a legal duty of disclosure will not deter its acquisition.[65]

Significantly, Kronman's theory suggests that information serves a dual function in the market. First, information is a commodity. Requiring its distribution without compensation is likely to deter its production, just as a duty to share any other commodity would deter production.[66] Second, adequate information is a prerequisite to the rational and efficient exchange of other commodities. Most of the controversies surrounding nondisclosure stem from this dual role that information plays in a market economy.[67]

Richard Posner has argued that Kronman's theory explains the distinction between buyer and seller nondisclosure. For example, where the seller is aware that the house is infested with termites, that seller probably "has not invested (much) in discovering that the house has termites, but acquired the information just as a byproduct of living there."[68] On the other hand, where the buyer undertakes the effort and expense of discovering that there is oil under the seller's land, a duty to disclose would deter such investigations.[69]

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64. *See id.* at 13-18.

65. *Id.* at 13-14.

66. This "property in information" view of the nondisclosure phenomenon is defended explicitly in Lawson, *The Ethics of Insider Trading*, 11 HARV. J.L. & PUB. POL'Y 727, 761-66 (1988).

67. *See generally* Carlton, *The Law and Economics of Rights in Valuable Information: A Comment*, 9 J. LEGAL STUD. 725 (1980) (discussing the use of information in making business enterprises productive and markets more efficient); Kitch, *The Law and Economics of Rights in Valuable Information*, 9 J. LEGAL STUD. 683 (1980) (describing and analyzing the welfare consequences of the law governing the ownership of information).

68. R. POSNER, *supra* note 24, at 97.

69. The following cases establish some circumstances under which a prospective purchaser who knows that land contains valuable resources is under no duty to disclose this information to the seller: Storthz v. Arnold, 74 Ark. 68, 84 S.W. 1036 (1905) (purchaser of land from two "ignorant girls" not obligated to disclose the presence of valuable bauxite deposits); Zaschak v. Traverse Corp., 123 Mich. App. 126, 333 N.W.2d 191 (1983) (denial of motion for summary judgment by plaintiff affirmed because plaintiff failed to support the assertion that the defendant had a duty to disclose the potential presence of oil and gas on the property); Crowley v. C.N. Nelson Lumber Co., 66 Minn. 400, 69 N.W. 321 (1896) (lumber company was not required to tell seller of the presence of valuable iron ore on land used to grow timber); Caples v. Steel, 4 Or. 491 (1879) (purchaser did not have a duty to

Kronman has moved the discussion of nondisclosure in the right direction, but in certain respects his theory is unsatisfactory Suppose, for example, that the owner of a house decided to do a termite inspection in order to sell it before the condition becomes obvious to purchasers. Would the fact that the seller deliberately sought this information constitute sufficient ground to permit the sale of the house without disclosure?

Alternatively, suppose that an art history professor attending a garage sale noticed a painting that she recognized as an original work of art, while the seller believed the painting was only a print.[70] As an original work of art, the painting would be worth tens of thousands of dollars, far beyond the ability of the purchaser to pay Should the law require that the professor refrain from purchasing the painting without disclosure of this information on the theory that it was acquired casually?

The risk is that a legal duty to disclose or refrain from trading would lead the professor to refrain rather than disclose. Unless the professor is altruistic, which is not typically assumed in either economic or legal analysis, she would have no incentive to disclose the information.[71] She could try to sell the information by saying "I have information that will make you thousands of dollars and I will reveal it to you if you agree to give me half of the money I make for you." The problem with this strategy is that it is difficult to sell the information without divulging it.[72] The seller might conclude that the paintings must be valuable after all and refuse to sell them. Alternatively, the seller might conclude that the buyer is not serious or is attempting to take some of the profit that the seller would have received at a later time, and decline the offer

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disclose the presence of a valuable coal mine on the seller's property).

70. For an analysis of civil law cases raising this fact pattern, see Litvinoff, *supra* note 58, at 65-66. Of course, the professor had to deliberately acquire her own training, but this investment would still be a case of casually acquired information in Kronman's terminology if the training was acquired in order to pursue a teaching career rather than make trading gains.

71. I have discussed the assumption of self-interest as a part of Thomas Sowell's "constrained vision" elsewhere. *See* Wonnell, *Causal and Normative Underpinnings of Legal Controversies: The Constrained Vision of Thomas Sowell*, 21 U.C. DAVIS L. REV. 1009, 1018 (1988).

72. This problem, as well as possible market adaptations to it, is discussed in Kitch, *supra* note 67, at 707 (suggesting that "[t]here are contractual solutions to [the] problem[]. The negotiating parties can enter into a contract specifying the information to be disclosed and what can and cannot be done with it, even if no deal is made.").

As the hypothetical suggests, it is not sufficient for the buyer to acquire information about resources that are being used inefficiently It is equally important that the buyer act on the information by entering into a contract of purchase rather than idly withhold the information. A duty to disclose has the undesirable tendency to discourage the actual use of the information she has acquired, especially where such use entails significant cost.

If the buyer does not acquire the painting, the resource will remain in the hands of a person who does not know important facts about it. The ramifications for efficient resource use are evident. A party who does not know that a painting is an original work of art may not care for it properly, secure it, or use it properly —for example, by showing it privately or donating it to a museum.[73] In general, a party who is unaware of the material properties of a resource will not be motivated to make proper use of that resource or to acquire appropriate complementary resources.

The gain in efficiency comes about from the merger of the resource and the information. Physical resources are valuable only when coupled with information. The hypothetical art buyer unites information and the physical resource; indeed, this is the source of her profit. By contrast, a seller who parts with a termite-infested house profits from the temporary severance of the resource and the information. Furthermore, because the buyer will not know to take remedial action until the infestation becomes obvious, the lack of information will likely result in even greater social costs, which are borne by the buyer.

This difference between profiting from the merger of information and resources and profiting from their severance is the fundamental distinction between buyer and seller nondisclosure. On the other hand, it is important to note that in many contracts the buyer also acts as a "seller" of its own creditworthiness, or the ability to pay when the obligation becomes due. A buyer who fails to disclose material facts pertaining the buyer's own solvency is in this respect analogous to the seller who fails to disclose material

73. On the importance of information to ensuring that efficient decisions pertaining to property are undertaken, see Shavell, *Strict Liability Versus Negligence*, 9 J. LEGAL STUD. 1, 4 (1980); Note, *Imposing Tort Liability on Real Estate Brokers Selling Defective Housing*, 99 HARV. L. REV. 1861, 1867-71 (1986) (suggesting that a broker is best suited to provide information that will lead to efficient real estate transactions).

facts about defects in the product being offered.[74] Thus, disclosure confers efficiency benefits where one seeks to profit from the severance of information and resources, regardless of that individual's status as buyer or seller.

It is important to relate this account of buyer nondisclosure to the factors that Professor Keeton enumerated. Many of these factors do not make sense in buyer nondisclosure cases and should not be employed.

For example, Keeton emphasizes the importance of the nondisclosed fact.[75] But, in the case of buyer nondisclosure, the more material the information, the greater the inefficiency resulting from the failure to merge the information and the resource. For example, consider a French case in which a purchaser acquired a painting by a great master from a seller who was unaware of the painting's value.[76] Subsequent to the sale, the buyer discovered the value of the painting and resold it to the Louvre.[77] The French court refused to grant the rescission sought by the seller on the grounds of his error because the painting had been resold. Instead, the court granted the seller considerable damages equal to the difference between the buyer's purchase price and the price obtained from the museum.[78] Unfortunately, the court ignored the fact that the materiality of the new information merely highlights the materiality of the prior inefficiency of resource use.

Since the relevant distinction is between merger and severance of information and resources, it is inappropriate to focus on factors such as "the difference in the degree of intelligence of the parties" or the extent to which the information was "not discoverable by reasonable care."[79] An owner of land may not realize that it is oil bearing, or may lack access to the information that would yield this knowledge. Nevertheless, the absence of this information causes the resource to be inefficiently underused; considerable social utility gains could result from the purchase of the land by one who knows it is oil-bearing.

This result may not fit comfortably with individualist moral

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74. *See, e.g.*, Manly v. Ohio Shoe Co., 25 F.2d 384 (4th Cir. 1928) (seller may rescind sales contract where buyer concealed its insolvency).

75. *See* W KEETON, D. DOBBS, R. KEETON & D. OWEN, *supra* note 23, § 106, at 739.

76. *See* Litvinoff, *supra* note 58, at 42-43.

77. *See id.*

78. *See id.*

79. W KEETON, D. DOBBS, R. KEETON & D. OWENS, *supra* note 23, § 106, at 739.

intuitions.[80] However, the value of property is a function of the creative insights that human beings bring to the physical objects they control.[81] The owner of the land was paid a fair price for every use to which the owner was able to put the land. There is no compelling normative reason that entitles the owner to the profits derived from the creative insights of the buyer regarding additional uses for the parcel of land.

Section II of this article generally defended Professor Keeton's list of factors on the theory of balancing the exchange-based and the promise-based factors in contract law.[82] Those factors do not fit the buyer nondisclosure problem because the same trade-off between these values is not involved. Buyer nondisclosure assists the process of moving the resource to its highest and best use, which is the social justification for the system of exchange. Therefore, denying rescission for nondisclosure to sellers promotes both the exchange-based and the security of transactions values.

This theory, which generally treats buyer nondisclosure as privileged, comports more closely with the existing law than Professor Keeton's factors — despite the fact that one of Professor Keeton's factors is whether the buyer or the seller is the nondisclosing party. While there are exceptions, the courts have generally been tolerant of buyer nondisclosure even in cases where the other factors point toward requiring disclosure.[83] Again, this is because buyer nondisclosure is not simply one factor among many, but neutralizes or reverses the significance of other factors in the calculus.

This article has, thus far, discussed three bases for distinguishing between buyer and seller nondisclosure. Section II tried

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80. At least one court has refused to grant specific performance to a purchaser of oil-bearing land who failed to disclose that fact to an apparently unsophisticated seller. *See* Schlegel v. Moorhead, 170 Mont. 391, 553 P.2d 1009 (1976).

81. Thomas Sowell has criticized the "physical fallacy," which he defines as the belief that a particular physical entity possesses a constant value independent of the uses to which humans put it. *See* T. SOWELL, KNOWLEDGE AND DECISIONS 67-72 (1980).

82. *See supra* text accompanying notes 29-61.

83. *See generally* Furman v. Brown, 227 Mich. 629, 199 N.W. 703 (1924) (disagreement as to the value of land during negotiations is not evidence of fraudulent inducement); Stuart v. Dorow, 216 Mich. 591, 185 N.W. 662 (1921) (no duty to disclose the purpose for which land was being purchased); Zaschak v. Traverse Corp., 123 Mich. App. 126, 129, 333 N.W.2d 191, 193 (1983) ("Michigan courts have not yet recognized a duty on the part of a vendee to disclose facts relevant to the value of the real estate in question even when specifically asked."); Annotation, *Duty of Purchaser of Real Property to Disclose to the Vendor Facts or Prospects Affecting the Value of the Property*, 56 A.L.R. 429 (1928).

to fit that distinction into the exchange-promise framework, arguing that sellers generally have better access to information than buyers.[84] Kronman and Posner assert that sellers generally acquire their information casually while buyers generally acquire their information deliberately.[85] This section has argued that sellers profit from the socially destructive severance of the resource and the information, while buyers profit from their socially constructive merger.

The choice among these three theories of buyer nondisclosure has considerable ramifications. In cases where the buyer has easier access to information, the "access to information" theory would presumably call for mandatory disclosure.[86] Moreover, access to information could presumably be outweighed by the other factors in the exchange - promise calculus. The "deliberate discovery" theory requires buyers to disclose information that they discover casually, resulting in a perverse incentive for the buyer to refrain from making use of the information. Since these ideas have tempted the courts,[87] it is essential to recognize that the case for buyer nondisclosure is not dependent upon such empirical regularities.

IV. NONDISCLOSURE OF EXTRINSIC INFORMATION

A. Capturing the External Benefits of Activities

Insider trading in securities is a particular type of contractual nondisclosure that illustrates the problem of capturing the external benefits of activities. While the common law generally permitted insider trading, federal securities laws have been interpreted to impose upon corporate insiders a duty to either disclose material facts or refrain from trading their corporation's shares.[88]

Professor Henry Manne has argued that insider trading in securities serves valuable social functions and should be permit-

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84. *See supra* text accompanying notes 49-50.

85. *See supra* text accompanying notes 66-69.

86. *See* E. FARNSWORTH, *supra* note 29, § 4.11, at 241. ("[A] court is more likely to expect a party to disclose if he has special knowledge or a special means of knowledge not generally available to those in the position of the other party."); *supra* text accompanying notes 49-50 (discussing situations where the seller has better access to information.).

87. *See supra* text accompanying notes 76-78.

88. *See, e.g.*, Speed v. Transamerica Corp., 99 F. Supp. 808, 828-32 (D. Del. 1951) (interpreting the Securities Exchange Act of 1934, 15 U.S.C. § 78 (1988)); *supra* text accompanying note 7 (discussing insider trading as a focus of statutes governing the sale of securities).

ted.[89] One of these functions is that insider trading can be a method for inducing corporate managers to engage in entrepreneurial activity, since insiders will be able to buy shares before they engage in the activity and sell at a profit afterwards.[90]

One criticism of Manne's argument is that insider trading would allow insiders to profit by selling on bad news, which would give them a perverse incentive to operate the corporation so as to generate bad news.[91] This argument presupposes that the law must take the same attitude toward purchasing and selling on the basis of inside information. However, the original federal securities laws regulated only the seller of securities, and the Rule 10b-5[92] prohibition on purchasers was added later under pressure from the staff of the SEC.[93] If selling on inside information is undesirable because it gives insiders an incentive to take corporate actions that reduce shareholder value, it is difficult to oppose the argument that insider purchases, in fact, create the opposite incentive.

It is also argued that insider trading would give corporate insiders an incentive to delay the disclosure of materially favorable information.[94] If Manne's thesis is correct it is difficult to see this

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89. *See* H. MANNE, INSIDER TRADING AND THE STOCK MARKETS at v (1966) ("The present work largely defend[s] insider trading.").

90. *See* Manne, *Insider Trading and the Law Professors*, 23 VAND. L. REV. 547, 578-79 (1970).

91. *See* Seligman, *The Reformulation of Federal Securities Law Concerning Nonpublic Information*, 73 GEO. L.J. 1083, 1095 (1985) (emphasizing a manager's interest in volatile stock prices and potential manipulation of media releases to accentuate volatility); *see also* Schotland, *Unsafe at any Price: A Reply to Manne, Insider Trading and the Stock Market*, 53 VA. L. REV. 1425, 1453 (1967) (arguing that even if insider trading profits would not "induce affirmative creation of failures," anything that dilutes the incentive to avoid failure should be eliminated).

92. 17 C.F.R. § 240.10b-5 (1990) (adopted 13 Fed. Reg. 8,183 (1948)).

93. *See* Freeman, *General Discussion*, 22 BUS. LAW. 914, 922 (1967) (drafter of Rule 10b-5 commenting that the rule was added to the federal securities laws following the suggestion of SEC officials); Scott, *Insider Trading: Rule 10b-5, Disclosure and Corporate Privacy*, 9 J. LEGAL STUD. 801, 801-02 (1980) (the rule was developed when the SEC staff heard reports of a company president buying the company's stock after telling the shareholders that the company was in financial trouble).

94. *See* Levmore, *In Defense of the Regulation of Insider Trading*, 11 HARV. J.L. & PUB. POL'Y 101, 103 (1988) (insiders will preserve the advantage of superior knowledge as long as possible to exploit the market). A related argument is that insider trading might delay the transmission of information from one person to another within an organization. *See* Haft, *The Effect of Insider Trading Rules on the Internal Efficiency of the Large Corporation*, 80 MICH. L. REV. 1051, 1054-55 (1982) (arguing that the recipient of good or bad news would delay reporting the news until the recipient exercised the opportunity to buy or sell company stock).

as a serious reason for prohibiting insider trading. The discovery of a new production process, a new product line or technological development, or a new possibility for profitable mergers or spin-offs, surely constitutes a net benefit for shareholders even if the disclosure of that benefit is delayed for the short time it would take to make trading profits.

Other criticisms of allowing insider trading have been made[95] and answered[96] elsewhere. Rather than pursuing these lines of inquiry solely in the context of insider trading of securities, it is important to examine the general type of argument which Manne is making, in order to see whether it might have more general applications to other types of contractual nondisclosure.

Essentially, Manne's point is that corporate managers have the power to take actions which confer benefits on others — the shareholders. This includes discovering some potentially profitable activity as well as acting on that discovery to bring it to fruition. Shareholders should, therefore, be willing to compensate managers for this activity However, it is often difficult after the fact for shareholders or their agents to identify precisely which manager played what role in bringing any particular entrepreneurial benefit to the company Unlike stock benefit plans or bonuses, insider trading is self-regulating: an insider who was in a position to contribute would be able to take advantage of the opportunity by buying shares.[97]

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95. It is argued, for example, that with bonuses and other compensation devices, insider trading is an unnecessary method of compensating entrepreneurs. *See* Mendelson, *The Economics of Insider Trading Reconsidered*, 117 U. PA. L. REV. 470, 489 (1969) (those employees most likely to be in a position to profit from insider trading would also be likely to get offers to work for competitors); Seligman, *supra* note 91, at 1095 (insider trading may reward an entrepreneur who did not contribute to the value of the enterprise).

96. It is argued that many people other than the original entrepreneur will have access to the information and will be able to benefit from insider trading. *See* Easterbrook, *Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information*, 1981 SUP. CT. REV. 309, 333 (noting the expense firms incur to protect information from outside "snoopers"). The argument that non-entrepreneurs will derive benefits, which can in principle be controlled by contract, confronts the fact that "empirical evidence suggests that trading profits are positively correlated with position in the firms — the more important the position, the greater the trading profits." Carlton & Fischel, *The Regulation of Insider Trading*, 35 STAN. L. REV. 857, 878 (1983). On the inadequacy of alternative compensation schemes, see *id.* at 870-71 ("The unique advantage of insider trading is that it allows a manager to alter his compensation package in light of new knowledge, thereby avoiding continual renegotiation. The manager, in effect, 'renegotiates' each time he trades.").

97. *See* Carlton & Fischel, *supra* note 96, at 878 (arguing that insider trading is less inefficient than other compensation schemes).

Manne's argument can be given a more general structure. One individual, A, is in a position to discover information and subsequently take an action which would, at least in part, inure to the benefit of another individual, B. Because of the externality involved, A may not be willing to undertake the action unless compensation can be obtained.[98] However, A perceives that high transaction costs would preclude B from making such a payment if the contemplated activity were disclosed. Moreover, A fears that disclosure to B might cause B to raise the selling price of B's own position in the hope that A will undertake the activity without B's help. Accordingly, A does not disclose the opportunity but purchases B's position. A can then internalize the benefits of the contemplated activity and will be willing to undertake the necessary efforts to bring it to fruition.[99]

The formal structure of Manne's argument arises in many settings other than insider trading in securities. Consider, for example, the facts of a leading real estate nondisclosure case, *Standard Steel Car Co. v Stamm.*[100] Standard Steel intended to purchase land abutting the defendant's property in order to erect a factory In conjunction with the factory construction, a railway line was to be extended out to the two properties; this line was a critical element since the rail provided the most cost effective means of transporation in 1905. Standard Steel purchased the defendant's land without disclosing its intention of building a factory on the adjoining land. After building the factory, the market value of the land purchased from the defendant increased by 100%[101] The seller sued to rescind the contract of sale on the grounds of nondisclosure, but the court held for the buyer.

Manne's theory can help to explain this result. Standard Steel was contemplating an activity which would confer an external benefit on Stamm's property Standard might have disclosed its intention to Stamm in the hope of obtaining a payment from Stamm, but doing so would have entailed significant risks. For in-

98. *See* Macey, *From Fairness to Contract: The New Direction of the Rules Against Insider Trading*, 13 HOFSTRA L. REV. 9, 19 (1984) (suggesting the existence of externalities in the insider trading area).

99. The use of property rights to internalize externalities is discussed in Demsetz, *Toward a Theory of Property Rights*, 57 AM. ECON. REV. 347, 348 (1967).

100. 207 Pa. 419, 56 A. 954 (1904).

101. *Id.* at 420-21, 56 A. at 954 (although the railroad would capture in fees a part of the benefit conferred on neighboring landowners, the fact that land prices increased suggests that much of the benefit was not internalized through those fees.)

stance, as a result of disclosure, Stamm probably would have refused to pay Standard Steel for the construction of a factory It is likely that the owners of several other properties would benefit from the construction of the new factory and rail line, and Stamm might have tried to "free ride" on the contributions of others. Alternatively, Stamm could have concluded that Standard Steel was bluffing and would build the factory whether Stamm paid or not. He then would be in a position to receive the benefits while bearing no cost. Another risk inherent in disclosure is that Stamm would refuse to commit to a fee arrangement unless Standard Steel demonstrated its commitment to the construction of the factory by investing time and capital in construction plans. With knowledge of such plans, Stamm could have offered a modest payment, capitalizing on the fixed cost of Standard's prior planning. Finally, had the intended construction of the factory been disclosed to Stamm, he would have raised the price of his land since he could have logically concluded that there was a high probability that the factory would be built either with Standard's own money or with that of others in the community Thus, a decision to inform Stamm in the hopes of securing his payment would jeopardize Standard's goal of internalizing the benefits of the activity

The previous two sections considered ideal types in that each was analyzed under a distinct factual characterization. Section III examined nondisclosure in the context of the seller's underutilization of property [102] Section IV has analyzed the problem of externalities generated by the buyer's activities and the effect of nondisclosure on encouraging those activities.[103] Situations arise, however, in which both fact patterns and their characteristic problems are present to some degree.

As examples of such "hybrid" fact situations, consider *Burt v Mason*[104] and *Boyd v Leith*.[105] In both cases the buyers, as agents for the railroad, actively sought to induce the construction of a railroad line. Both buyers purchased property near the intended site of the line, which subsequently appreciated in value when the railroad was built. The sellers sought to rescind the contracts of sale on nondisclosure grounds, but the courts refused to

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102. *See supra* text accompanying notes 63-87.
103. *See supra* text accompanying notes 88-101.
104. 97 Mich. 127, 56 N.W 365 (1893).
105. 50 S.W 618 (Tex. App. 1899).

grant rescission.[106]

If one discounts the role of the buyers in bringing about the construction of a railroad line, the economics of these cases become complicated. The sellers, unaware of the planned railroad, might make inappropriate reliance decisions pertaining to the land. However, the sellers presumably would acquire the information at some point in the foreseeable future. Consequently, these situations are distinguishable from those in which the seller will probably remain uninformed for an extended period, such as when the seller did not know the land contained oil. These considerations indicate that the buyer may not be a higher-value user of the land located near the site of a potential railroad when compared to the seller.

If the buyers play an important role in bringing about the construction of a railroad line, the analysis is different. Construction of a railroad creates external benefits for adjoining properties. The railroad corporation may have wanted to purchase those properties itself, in which case the agents who purchase might be guilty of usurpation of corporate opportunities.[107] But if there is no indication that the corporation had intended to purchase such lands, the shareholders of the corporation could benefit from having their agents buy those lands in lieu of the full salary they would otherwise demand to work at the firm. As a result of this benefit, the right to trade without disclosure becomes an incentive to construct enterprises, such as railroads, that confer external benefits.

B. Nondisclosure of Information Affecting Supply or Demand

An important nondisclosure problem concerns the duty to disclose extrinsic facts that influence the supply or demand, and thus the price, of a particular commodity The leading case addressing this problem is *Laidlaw v Organ*,[108] which involved a tobacco purchaser who was aware that a peace treaty had just been signed, ending the War of 1812 and therefore ending the naval blockade that had been holding down the price of tobacco. The Court, in an

106. *See Boyd*, 50 S.W at 619-20; *Burt*, 97 Mich. at 128-29, 56 N.W at 365.

107. *See* Brophy v. Cities Serv. Co., 31 Del. Ch. 241, 70 A.2d 5 (1949) (an officer of a corporation is in a fiduciary position with respect to that corporation and consequently has a duty to refrain from using confidential information acquired as a result of that relationship for personal profit).

108. 15 U.S. (2 Wheat.) 178 (1817).

opinion by Chief Justice Marshall, stated that nondisclosure by the buyer was not actionable.[109] The Court observed that a duty to disclose would be "difficult to circumscribe within proper limits," since both parties had equal access to the information,[110] but cautioned that "each party must take care not to say or do any thing tending to impose upon the other."[111]

In evaluating the efficiency of the nondisclosure rules pertaining to extrinsic, market-oriented information in a situation like *Laidlaw*, it is useful to observe a basic distinction. The costs associated with being uninformed in an absolute sense are distinct from the costs associated with being less informed than a trading partner. An absolute ignorance of facts affecting supply or demand can be costly in terms of both private and social wealth. A party who is not aware that the war is over and the price of tobacco is about to rise will make improper economic decisions. Such a party would use tobacco when it would be more sensible to store it[112] and plant other crops when it would be more efficient to plant tobacco.

It is tempting to view these private and social costs of ignorance as attending a nondisclosure rule. Arguably, a law backed by substantial sanctions will encourage disclosure, ensuring that both parties would be informed that the war was over Inefficient economic decisions based upon an erroneous assumption that the price of tobacco will remain depressed would be avoided by a full disclosure regime.

This argument against nondisclosure is fundamentally misconceived. When it is necessary for the parties to actively pursue the information about the peace treaty, Kronman's thesis suggests that a disclose-or-refrain rule would prevent the acquisition of that information by either party[113] Moreover, had the information about the peace treaty been acquired casually, a known requirement that a party disclose such information would have caused the contracting party to idly withhold the information

109. *Id.* at 195.

110. *Id.*

111. *Id.*

112. *See* Peck, *The Economic Role of Traditional Commodities Futures Markets*, in FUTURES MARKETS: THEIR ECONOMIC ROLE 1, 40-51 (A. Peck ed. 1985) (discussing the potential effect of storage costs on the price of an agricultural commodity).

113. Kronman, *supra* note 62, at 13-14 (suggesting that the level of investment for obtaining information is directly proportional to the benefit derived from possessing the information).

rather than act on it.[114] In either case, a disclose-or-refrain rule would lead to a decision to refrain from trading, not to disclose.

The argument that nondisclosure is undesirable because of the social costs of market ignorance is false; indeed, just the opposite is true. To avoid erroneous economic decisions, it is not essential that a contracting party be aware that a peace treaty has been signed. It is essential, however, that such a party be aware that the market price of tobacco will increase in the future. Speculative trading raises the price of the goods and thus sends the correct signal to the seller.[115] Because it would deter trading, a rule of full disclosure would deter the transactions necessary to send pricing signals.

The distinction that the law draws between "intrinsic" and "extrinsic" information is an imperfect way of capturing this basic phenomenon. In the case of intrinsic information, such as the fact that a house has termites, a prospective buyer can make economically efficient decisions only when in possession of the actual information; a pricing proxy for that knowledge will not do. The buyer only knows to remedy the termite problem upon independently acquiring access to the information. By contrast, truly extrinsic information is information that is relevant precisely because of its effect on market prices, and thus the pricing effect of trades can substitute for the information itself in encouraging efficient decisions.

It does not follow, however, that there are no economic costs associated with insider trading. It is necessary to distinguish between the costs of ignorance in an absolute sense and the costs of being more ignorant than one's trading partner. The former set of costs is not a disadvantage but an advantage of a nondisclosure regime. The second set of costs may be a disadvantage and should be explored. In *Laidlaw v Organ*,[116] three types of costs could have been attributed to the fact that the buyer was more fully informed of extrinsic facts than the seller. First, the differential knowledge may account for the transaction itself, with attendant transaction costs such as meeting, inspecting the tobacco, entering

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114. *See supra* text accompanying notes 70-73 (discussing this problem in the context of a painting not known to be valuable).

115. *See* R. POSNER, *supra* note 24, at 97 (discussing *Laidlaw* and the effect on prices of revealing some inside information); Seligman, *supra* note 91, at 1092 (arguing that higher prices will lead to increased production).

116. 15 U.S. (2 Wheat.) 178 (1817).

into an agreement, and shipping the tobacco. It is also possible that the seller would have sold to another purchaser had Laidlaw not entered the market, but the possibility cannot be ignored that Laidlaw's favorable price induced a transaction that otherwise would not have taken place.

Second, there are the costs of becoming more informed than one's trading partners. Laidlaw had to spend time and money cultivating a network of contacts to keep him informed about peace negotiation developments.[117] The prospect of being induced to enter into a transaction at a price below that which an informed seller would receive will inspire sellers to become informed as well. Considerable duplication of effort could arise as handlers attempt to become better informed or avoid being less informed than other traders.

Third, because Laidlaw was motivated by a desire for speculative gain, Laidlaw may not have been a more efficient handler of the tobacco than Organ. Like all commodities, "tobacco" is not a wholly generic commodity; each specific holding is likely to have its own quality characteristics, as well as the transportation costs of moving the commodity to local markets that are facing temporary shortages.[118] Laidlaw may not have possessed storage facilities or skills in evaluating specific holdings of tobacco equivalent to Organ's (or the party to whom Organ would otherwise have sold the tobacco). The *Laidlaw* rule causes commodity handlers to be speculators, and speculators to be handlers. Costs of underspecialization arise from a transaction that otherwise might not have taken place. For these reasons, there are costs associated with insider trading beyond the spurious costs associated with an absolute ignorance of market conditions.

Ironically, however, many of these costs can also be seen as a product of too little speculative trading rather than too much, and it is important to explore the reasons. The costs of insider trading stem primarily from relating a speculative motive to the costly handling of commodities. The fact that speculators become owners and handlers of the commodity substantially increases the transaction costs of the trade itself.[119] If speculators must be handlers,

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117. *Id.* at 182-83.

118. *See* F HAYEK, *Socialist Calculation II: The State of the Debate*, in INDIVIDUALISM AND ECONOMIC ORDER 148, 153-54 (1948) (arguing that an efficient economic plan must take into account the individuality of each "batch" of a commodity).

119. Documents of title, such as warehouse receipts, can remove the need for physi-

there will be limits on their ability to specialize in the speculative skill, and duplication of effort will arise as each handler attempts to become a part-time speculator. Finally, the costs of the speculators' mishandling or misuse of nongeneric holdings of commodities are also attributable to the relation between speculation and handling.

The market has a tendency to seek to control costs of underspecialization resulting from the combination of the speculation and handling functions. One of the most important market adaptations has been the development of futures markets for many important commodities.[120] For other commodities, forward markets with characteristics similar to formal futures exchanges have evolved.[121]

No formal futures market has developed for tobacco, in large part because tobacco prices have been heavily controlled through a government program of quotas, price supports, and purchases of surplus crops.[122] While programs of this nature serve as an alternative means of controlling the costs of speculation, they operate at high cost. Surplus stocks of tobacco represent a social waste, as does the tendency to grow crops on inferior land because that is where the governmental quota system permits it.[123] Therefore, the analysis continues with a commodity such as corn where rapid price changes remain a real phenomenon and where futures markets have developed fully.[124]

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cal handling of the commodities. However, the owner of the commodity still bears responsibility for ascertaining the ultimate best use and proper sales price for a nongeneric sample of a particular commodity.

120. A futures market is "[a] market in which contracts for the future delivery of commodities are bought and sold . . . . A futures contract is an agreement to deliver or to receive some commodity at a specified price at some specified future time." C. AMMER & D. AMMER, DICTIONARY OF BUSINESS AND ECONOMICS 173 (1977).

121. *See* J. WILLIAMS, THE ECONOMIC FUNCTION OF FUTURES MARKETS 164-66 (1986) ("The actual differences between forward and futures markets are small . . . . Forward markets, not futures markets, are generally the first to standardize the size of lots, the grades allowed for delivery, and the circumstances of delivery such as whether in railcars or in elevators.").

122. *See* Mann, *The Tobacco Franchise for Whom?*, in THE TOBACCO INDUSTRY IN TRANSITION at 37, 37-38 (W. Finger ed. 1981) (discussing the governmental regulation of the tobacco industry).

123. *See id.* There is some flexibility in "selling" one's quota to other lands, but the program generally requires that the subject property be located in the same county as the farmer who had the original quota. *See* 7 U.S.C.A. § 1314b (West 1988 & Supp. 1990).

124. For evidence of the absence of such price changes in tobacco, see Louisville Courier-Journal, Nov. 20, 1988, § E, at 1, col. 4 ("If recent sales history is any indicator, some of the most common grades of burley [tobacco] will bring only $1 to $2 above the

Futures markets unleash the force of speculative insider trading.[125] One who believes the price of corn will increase can acquire a long position in the futures contract.[126] If the price does rise, the speculator realizes a profit by acquiring an offsetting short position in the market. Physical commodities rarely change hands, and there is no need for storage or for speculators to act as handlers. Moreover, futures are traded in homogeneous commodities and, as a result, are remarkably liquid.[127] Because large volumes of trading can be accommodated readily, individuals can afford to become specialists in the market forces affecting the supply or demand of commodities such as corn.[128]

Professor Jeffrey Williams has argued that the function of futures markets is to serve as an implicit market for the "borrowing" of commodities.[129] The common practice of handlers buying a commodity on the spot market while simultaneously taking a short position in the futures market is, in economic reality, borrowing the commodity from the market for the interim period of time.[130] As with any loan, a handler who borrows a commodity in order to satisfy inventory needs incurs a cost. The spread between spot prices and futures prices amounts to an "interest rate" for the borrowing of particular commodities for particular periods of time. Like monetary interest rates, this spread encourages han-

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price support when the annual auctions start tomorrow.").

125. Again, this is insider trading in the economic, not the legal, sense of that term. The information to which commodity speculators have access may be sufficiently public, but the insight into how that information will affect prices is itself a form of information that most people cannot obtain at low cost.

126. A "long" position is a contractual obligation to purchase a particular commodity intended for future delivery. A "short" position is a contractual obligation to deliver a particular commodity, which the person may not currently own, at a set date in the future at a particular price. *See* G. KAUFMAN, THE U.S. FINANCIAL SYSTEM: MONEY, MARKETS, AND INSTITUTIONS 397 (3d ed. 1986). Because the price is fixed, those who have acquired a long position benefit when the price of the commodity increases, while those who have taken a short position benefit from price decreases.

127. *See* Telser, *Why There Are Organized Future Markets*, 24 J. LAW & ECON. 1, 54 (1981) ("An organized futures market is a device for making a futures contract a highly liquid instrument of trade.").

128. *See id.* at 12 (arguing that because the focus is now on the price of a commodity and the forces affecting it, "[f]amiliarity with the properties of the commodity and the preferences of the principal is not necessary").

129. *See* J. WILLIAMS, *supra* note 121, at 236 ("Loan markets, whether for money or for commodities, allocate scarce inventories to the firms whose need for them is greatest at the moment. Through the hurly-burly of futures trading, prices emerge, with remarkable order and allocative sophistication, for interest rates on commodity loans.").

130. *See id.* at 149 ("Firms buy and sell futures contracts as part of more complex transactions that leave them implicitly borrowing commodities.").

dlers to control their inventories and to ration them to those handlers with a need to have such inventories at hand.[131]

It is not entirely accurate to describe the handlers who buy on the spot market and simultaneously sell a futures contract as borrowing the commodity Such handlers are the owners of a nongeneric holding of the commodity As a result, they can benefit from their own expertise regarding the use and sale of specific holdings of corn in specific places. By contrast, the short position in the futures market removes any concern over market developments having an across-the-board effect on holdings of corn.[132] Perhaps it would be more accurate to describe the handlers as borrowing the generic "corn" portion of their concrete holdings of corn.

The development of such futures markets substantially lowers the cost of the amateur speculation evidenced in *Laidlaw* [133] Handlers of the commodities who wish to avoid incurring the costs of becoming expert speculators can do so by hedging their position in the futures markets.[134] Even if such handlers do not hedge, the prices quoted in the spot markets are heavily influenced by the governing futures prices.[135] Consequently, handlers can benefit indirectly from the competition of professional speculators to determine market prices. There will be little or no information left for the Laidlaws of the world to withhold from the Organs that is not processed into market prices. Speculators in the futures markets do not incur costs associated with trying to be handlers or experts in nongeneric holdings of commodities. The transaction costs of speculative trades in the futures markets, as measured by bid-ask spreads, are remarkably low [136]

Ironically, the costs of insider trading can be reduced by le-

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131. *See supra* note 129 and accompanying text.

132. The use of put options to achieve these protections against the price decline of assets one may already hold is discussed in Stoll & Whaley, *The New Option Markets*, in FUTURES MARKETS: THEIR ECONOMIC ROLE, *supra* note 112, at 205-28.

133. 15 U.S. (2 Wheat.) at 188.

134. The utility of financial futures markets for hedging purposes is discussed in Silber, *The Economic Role of Financial Futures*, in FUTURES MARKETS: THEIR ECONOMIC ROLE, *supra* note 112, at 83, 98-107.

135. *See* Peck, *supra* note 112, at 73 ("Futures prices are the referent prices in all transactions, whether they are for immediate or delayed delivery, because they provide a standardized, competitively determined reflection of underlying current and future value.").

136. *See* Telser, *supra* note 127, at 5-6, 12 (discussing transaction costs and comparing speculative and nonspeculative costs as they relate to information gathering).

gitimizing, professionalizing, and expanding the scope of speculation. Costs are not completely eliminated; speculative transactions always generate at least minimal transaction costs. Nevertheless, given the benefit of ensuring that prices reflect impending scarcities, and thereby cause handlers to adjust their inventories, the remaining costs of nondisclosure are reduced to a more acceptable level.

Speculative trading always entails costs. However, it is unclear whether particular categories of speculative transactions should be proscribed. In *Laidlaw*, for example, the Court stressed that the information about the end of the war was equally accessible to both sides.[137] Securities laws attempt to distinguish between "material" nondisclosures, such as a corporate merger, and "immaterial" nondisclosures, such as the economic consequences of a known merger.[138] Do distinctions of this nature make sense given the costs and benefits of speculative trading?

These standards incorrectly portray the circumstances under which prohibitions on speculative trading are desirable.[139] Information not equally available to all parties[140] may still be of considerable use to handlers of the commodities; if so, a ban on such information-based trading would deter the transactions that generate needed pricing signals.[141] Similarly, from the standpoint of price implications, one can make larger and more material errors from incorrectly analyzing the economic effect of a known event than from being unaware of the event's existence.[142]

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137. *Laidlaw*, 15 U.S. (2 Wheat.) at 195; *see* Seligman, *supra* note 91, at 1093 (establishing the values of different types of information in the securities market).

138. *See* Seligman, *supra* note 91, at 1123 (comparing the effect of material and immaterial disclosure on a security analyst's incentive to search for new information).

139. *See* Easterbrook, *supra* note 96, at 330 (discussing optimal use/optimal production problems surrounding insider trading); Lawson, *supra* note 66, at 756 (arguing that rather than focusing on a distinction between lawful and unlawful access, the distinction should be based on an individual's cost of obtaining information).

140. This "access to information" point is stressed in Brudney, *Insiders, Outsiders, and Informational Advantages under the Federal Securities Laws*, 93 HARV. L. REV. 322, 363 (1979).

141. In the context of trading in stocks, it has recently been argued that pricing signals do not serve an important allocative function. *See* Stout, *The Unimportance of Being Efficient: An Economic Analysis of Stock Market Pricing and Securities Regulation*, 87 MICH. L. REV. 613 (1988). Professor Stout's provocative thesis depends, however, on the absence of arbitrage possibilities between the stock and asset markets. If leveraged buy outs and other techniques of arbitrage can exploit gaps between the value of stock and the value of the corresponding assets, the cost of those transactions is an inefficiency of the pricing structure.

142. For a summary of commonly made errors in fundamental analysis, see J.

If speculative trading is prohibited, the prohibition should apply only to information certain to reach the market so quickly that little or no time is available for handlers to make improper economic decisions based upon existing prices.[143] In *Laidlaw*, for example, the end of the war would have quickly commanded the attention of traders or handlers. In such cases, the costs of rushing to make an additional speculative trade might outweigh the benefits of giving better pricing signals for that short period of time. On the other hand, as Professor Grossman noted, the tendency of speculative trades to serve as pricing signals is an externality of such trades.[144] Services that confer external benefits may be underproduced if they are not rewarded sufficiently Therefore, a speculator who follows the development of peace negotiations and brings that information to the market should be entitled to some profit from the knowledge that the peace treaty has been signed.

The market itself may have developed a sensible system to reward speculative trading that also limits those rewards when dramatic information is likely to reach the market very soon. Futures markets generally suspend trading if market prices change by a predetermined amount in a particular day [145] Such suspensions give the market a chance to ascertain and digest ultramaterial developments without entirely removing the speculative gain from their early discovery

It is important to distinguish nondisclosure cases where the principal efficiency advantage is the signalling effect of prices from other extrinsic information cases where the efficiency advantage, if one exists, lies elsewhere. Consider, for example, the series of cases holding that purchasers of land have "no duty to disclose knowledge that railroad or industrial developments, street improvements, or the like, are projected, or apparently even actually under construction, near the land which they are buying."[146]

SCHWAGER, A COMPLETE GUIDE TO THE FUTURES MARKETS 23-32 (1984).

143. *See* Wonnell, *Contract Law and the Austrian School of Economics*, 54 FORDHAM L. REV. 507, 529 (1986) (suggesting that if the information will reach the market very quickly, the encouragement of entrepreneurial skills resulting from allowing speculation is of secondary importance).

144. *See* S. GROSSMAN, THE INFORMATIONAL ROLE OF PRICES 70, 87 (1989).

145. *See* J. SCHWAGER, *supra* note 142, at 713-29 (setting out maximum daily fluctuations for several commodities).

146. Annotation, *supra* note 83, at 440 (citing Pratt Land & Improvement Co. v. McClain, 135 Ala. 452, 456, 33 So. 185, 186 (1902) (improvements in a nearby city); Furman v. Brown, 227 Mich. 629, 637-38, 199 N.W 703, 706 (1924) (development of the city); Stuart v. Dorow, 216 Mich. 591, 593, 185 N.W 662, 663 (1921) (possible construc-

Can this line of cases be justified by the signalling benefits of market prices? It is not apparent that such a justification can be made. Purchases of this character will tend to raise the market price of land in the surrounding area, sending a generally accurate signal to sellers of land to ready additional land for sale. However, a purely price-taking buyer[147] would be misled into concluding that purchasing in this area was now less attractive, because land was more expensive, than it had been before. Although some buyers might be led to inquire into the reason for the price increase, and thereby discover the intended improvements, it is difficult to defend nondisclosure on the basis of a buyer's actual acquisition of knowledge.

If there is an efficiency justification for nondisclosure in this line of cases, it is basically the same as the efficiency justification for buyer nondisclosure of intrinsic information.[148] A seller who is unaware of the planned improvement in the area may be led to make unwise use of the land in reliance on this erroneous view of the facts. This argument is more persuasive to the extent that the intended development will not be public knowledge in the immediate future. If the knowledge is to become public immediately, the only real argument for nondisclosure is the rather humble argument made earlier that there is a need to tolerate human weaknesses in order to avoid jeopardizing the security of transactions.[149]

C. Avoiding Opportunistic Use of Disclosed Information

Professor Saul Levmore has argued persuasively that the nondisclosure problem has much in common with the law of eminent domain or takings.[150] One justification for eminent domain is the

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tion of a "suburban village"); Burt v. Mason, 97 Mich. 127, 134, 56 N.W 365, 367 (1893) (prospect of railroad construction); Whitted v. Fugay, 127 N.C. 68, 72, 37 S.E. 141, 143 (1900) (railroads and other business already completed in the area); Guaranty Safe Deposit & Trust Co. v. Liebold, 207 Pa. 399, 405, 56 A. 951, 953 (1904) (location of a large factory nearby)).

147. A price taking buyer is one whose behavior has such a negligible effect upon price that the buyer acts as if price were independent of his or her buying decision. *See* J. HIRSHLEIFER, PRICE THEORY AND APPLICATIONS 332 (2d ed. 1980).

148. *See supra* text accompanying notes 63-87.

149. *See supra* text accompanying notes 29-62.

150. *See* Levmore, *Securities and Secrets: Insider Trading and the Law of Contracts*, 68 VA. L. REV. 117, 141-44 (1982) ("Both abrogate principles that are basic to our notions of fair dealing Both concepts, however, are more palatable when viewed in their corrective roles").

need to avoid opportunistic behavior by land owners who become aware of government projects.[151] For example, if the government intends to build a highway through a particular area it will incur extensive costs in designing that highway and, perhaps, beginning its construction. Landowners in the path of the highway will know that they have a monopoly because, under these circumstances, they can exploit the high cost of diverting the highway or causing its cancellation by demanding exorbitant prices for their land. The government can avoid this problem by taking the land and paying a "just compensation" that does not include this opportunistic premium.[152]

As Levmore observes, nondisclosure is an alternative means of preventing such opportunism. A railroad, lacking the power of private eminent domain, will attempt to purchase land needed for construction without disclosing its plans to the land owners.[153] Indeed, Levmore goes so far as to contend that if the railroad does not disclose its plans to its agent, the agent, if asked specifically whether the land is being acquired for purposes of building a railroad, should be able to say that no such plans exist.[154] The theory is that the land owner is only seeking information for an improper strategic or monopolistic purpose and has no right to demand the information. Levmore refers to his theory as "optimal dishonesty."[155]

This theory tests one's tolerance for efficiency's demands on morality. Affirmative lying may not be necessary; the railroad could have its attorneys hire agents, who would purchase the land

151. *See* R. POSNER, *supra* note 24, at 49 (suggesting that eminent domain may be necessary to prevent monopolies, which would otherwise lead to inefficient use of resources).

152. *See* Levmore, *supra* note 150, at 141-42 (explaining that the "just compensation ignores the increase in the property's value that results from the government's project"); *see also* United States v. Cors, 337 U.S. 325, 334 (1949) (concluding that the federal government need not pay the fair market value of a tug boat required for war efforts but may deduct from the price the increase in value attributable to the government's activities in the war era market).

153. *See* Levmore, *supra* note 150, at 140 ("[N]ondisclosure ... will prevent free riding and encourage the socially-beneficial quest for information.").

154. *See id.* However, it should be noted that Levmore believes that this approach "creates unnecessary transaction costs and does not protect the buyer" from a seller who inquires into the identity of the actual purchaser of the land. *Id.* Levmore also expresses a preference for a private eminent domain concept over this optimal dishonesty where the former is feasible. *See id.* at 159.

155. *Id.* at 140.

on behalf of an undisclosed principal.[156] Levmore, however, may well be correct in asserting that false answers which only neutralize questions which should not be asked are not immoral.[157]

Case law has rarely confronted the optimal dishonesty question in the stark form of an unquestionable lie regarding the fundamental purpose in acquiring the land. However, many "nondisclosure" cases raise the issue of whether there truly was no disclosure, or whether the statements made tend toward affirmative deceit.[158] The purpose that courts attribute to nondisclosure will influence their decisions about when to characterize the ambiguous statements of a party in such a manner as to remove the case from the realm of nondisclosure. If nondisclosure were tolerated only out of the recognition that humans are frail and the courts cannot reconsider all transactions, then any statement might be sufficient to cast the case as one of affirmative fraud.[159] However, if nondisclosure in a particular setting promotes a positive good, the courts might demand clear proof of affirmative fraud to remove the case from the nondisclosure category.[160]

Labor law provides an interesting study of a very different approach to essentially the same phenomenon of strategic or opportunistic use of disclosed information. Once a plant is built, it is quite costly to dismantle or move. The union can exploit this fixed cost in much the same way that the landowner can exploit the fixed cost of prior railroad investment and the resulting high cost of changing the route of the railroad.

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156. *See* RESTATEMENT (SECOND) OF AGENCY § 304 reporter's note at 523 (1958) ("[N]on-disclosure is not fatal where the third party is not wholly unwilling to deal with the principal, but where the third party, if he knew who the principal was, would try to exact more onerous terms from him.").

157. *See* Levmore, *supra* note 150, at 142 ("The owner . . . who demands a high price for his property is really the despicable character."). An interesting, if imperfect, analogy may be drawn to asking someone whether they like one's new shoes and having them falsely say that they look fine.

158. *See, e.g.*, Heise v. Pilot Rock Lumber Co., 222 Or. 78, 91, 352 P.2d 1072, 1078 (1960) (holding that a partial and fragmentary disclosure accompanied by willful concealment of material and qualifying facts is not a true statement and is often as much a fraud as an inaccurate presentation); Chandler v. Butler, 284 S.W.2d 388, 395 (Tex. App. 1955) (the premise of information as to a material fact may be fraud when a vendor knows that the purchaser is acting on the supposition that no such material fact exists).

159. *See Chandler*, 284 S.W.2d at 395 ("[A] nod or a wink or a shake of the head, or a smile from the purchaser, might defeat the application of the principle that mere reticence on the part of a purchaser does not in law amount to fraud.").

160. *See* Culton v. Asher, 149 Ky. 659, 149 S.W. 946 (1912) (land buyer's statement to seller that land was worth only $1.75 per acre was dismissed as opinion despite the fact that it was evident that the land was worth much more).

However, it is not in the union's interest to make wage demands that result in the closure of the plant, just as it behooves the landowner to avoid demanding a price that forces the railroad to divert the line. Therefore, in order to take opportunistic advantage of the employer's fixed cost investment, the union requires accurate information about the level of wages that would cause the firm to lose enough money to force it to close. Again, this is analogous to the landowner's desire to obtain information on exactly how costly it would be for the railroad to alter the path of its tracks in the middle of its construction plans. The employer and the railroad naturally would be disinclined to provide this information.

In the case of labor law, however, the employer must provide this information. Generally, employers are required to disclose to the union information relevant to the union's discharge of its function as bargaining representative.[161] Disclosure of the facts that substantiate a position of inability to pay is required by the duty to bargain in good faith.[162]

A labor law exception to the general rules of contractual nondisclosure might be justified on the theory that efficiency is a poor proxy for utility in this setting.[163] If workers derive greater marginal utility from the additional dollars they make as a result of the disclosure duty than managers or shareholders lose, there may be reason to accept opportunistic use of the disclosed information.

However, this argument takes as its premise the view that workers can obtain higher wages as a result of the duty to disclose than they could otherwise. This is yet another area in which ex post reasoning tends to obstruct long run ex ante policy.[164] Once

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161. *See, e.g.*, NLRB v. Truitt Mfg. Co., 351 U.S. 149, 152-53 (1956) ("Good-faith bargaining necessarily requires that claims made by either bargainer should be honest claims .... If such an argument is important enough to present in ... bargaining, it is important enough to require some sort of proof of its accuracy."); Curtiss-Wright Corp. v. NLRB, 347 F.2d 61, 71 (3d Cir. 1965) (rejecting employer's argument that classifications of some employees need not be disclosed because the employer considered the information confidential); R. GORMAN, BASIC TEXT ON LABOR LAW, UNIONIZATION AND COLLECTIVE BARGAINING 409-18 (1976) (if the employer is in possession of information that is necessary or relevant to the union in discharging its function as bargaining representative, the employer will normally be required to turn over that information upon request of the union).

162. *See Truitt*, 351 U.S. at 153; R. GORMAN, *supra* note 161, at 409.

163. *See* Coleman, *Efficiency, Utility, and Wealth Maximization*, 8 HOFSTRA L. REV. 509, 526-48 (1980) (arguing that since wealth is not intrinsically valuable, any valid theory must also take utility into account).

164. *Cf.* Wonnell, *supra* note 143, at 535-42 (discussing the detrimental ex ante ef-

the plant is built, the union can secure more money for the workers if it has access to the information. However, ex ante, prospective employers will foresee this situation and be disinclined to construct plants that allows the unions to take advantage of their fixed cost investments.[165]

Still, there is no reason to believe the unions violate their fiduciary duty to represent their current work force fairly by demanding and making use of information on how difficult it would be for the firm to remain profitable given particular wage structures. Current workers will benefit from the higher wages that come from opportunism, and most of the workers who would otherwise have had jobs at plants that are not built are not represented by the union at the present time. Ideally, workers would agree at the time the plant is built that they would not later take opportunistic advantage of the plant's fixed cost. Such contractual promises, however, would likely be struck down as analogous to "yellow dog" contracts and contrary to public policy[166]

Professor Farnsworth has argued that it does not make sense to impose the labor law concept of disclosure on ordinary bargains.[167] In fact, one of the least reliable claims made during negotiations is that a particular offer is the "lowest (or highest) we can possibly go." This is often described as the regrettable but inevitable disposition of negotiators to deceive, and there is some degree of truth to this characterization.[168] However, this section

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fects of attempts to address unconscionability problems in contractual settings).

165. *See generally* Epstein, *In Defense of the Contract at Will*, 51 U. CHI. L. REV. 947, 970-72 (1984) (discussing the savings to an employer of operating where the doctrine of contract at will is recognized); Epstein, *A Common Law for Labor Relations: A Critique of the New Deal Labor Legislation*, 92 YALE L.J. 1357, 1385 (1983) [hereinafter Epstein, *A Common Law*] (noting that labor has greater leverage when a firm's resources are fixed in place).

166. *See* Epstein, *A Common Law*, *supra* note 165, at 1370-75 (challenging the contention that the nature of employees' freedom to contract is "illusory" because employers have excessive leverage with which to force employees to compromise their rights); *see also* National Labor Relations Act, 29 U.S.C. § 158(a)(3) (1988) (forbidding contracts in which workers agree not to join a labor union); J. GETMAN & B. POGREBIN, LABOR RELATIONS: THE BASIC PROCESSES, LAW AND PRACTICE 225 (1988) (defining "yellow dog" contracts as "pledges extracted from employees not to join unions.").

167. *See* Farnsworth, *Precontractual Liability and Preliminary Agreements: Fair Dealing and Failed Negotiations*, 87 COLUM. L. REV. 217, 277-79 (1987) (distinguishing the rationale for the labor law approach to disclosure from that of ordinary bargaining contexts).

168. *See* R. FISHER & W URY, GETTING TO YES: NEGOTIATING AGREEMENT WITHOUT GIVING IN 137-40 (1981) (discussing falsification of facts and other deceptive tactics used during negotiations).

has argued that an uncooperative attitude about the facts that determine the worst offer one can possibly accept may also be a necessary method of avoiding the opportunistic exploitation that has such detrimental ex ante consequences.

Contract modification cases present the problem of one party's ability to exploit opportunistically any information that the other party is required to disclose. Given this problem, it is curious that some courts treat non-disclosure by the party who succumbs to a one-sided modification as a factor in favor of enforcing the modified contract. For example, in *United States ex rel. Crane Co. v Progressive Enterprises, Inc.*,[169] the court upheld a modification against a claim of economic duress. In this case, Progressive's nondisclosure took the form of its acceptance of an increase in a bid made by subcontractor Crane without protest and without notifying Crane that it did not intend to pay the higher price. The court noted that this situation is distinguished from those in which notice or protest is given by the buyer; the seller is then charged with knowing that a new contract has not been accepted and the original agreement still exists.[170]

The reasoning of *Progressive Enterprises* is problematic if applied improperly[171] A party should not be required to reveal its desperate position on pain of having waived its rights, for such a revelation will enhance the opportunistic advantage of the other party Moreover, the party with a substantial situational monopoly can use the resulting economic power to ensure that the other party does not make any formal protest or reservation of rights.

On the other hand, failure to disclose an intention not to abide by the modified contract can be a source of inefficiency The other party may detrimentally rely on the completion of the modified contract,[172] and the probability of litigation costs increases. In evaluating whether the justification for the modification is derived from economic duress or a good faith response to changes in cir-

169. 418 F Supp. 662 (E.D. Va. 1976).

170. *Id.* at 664; *see also* Austin Instrument, Inc. v. Loral Corp., 29 N.Y.2d 124, 272 N.E.2d 533, 324 N.Y.S.2d 22 (1971) (party submitted to a modification explaining that it was forced to accept the modification); Rose v. Vulcan Materials Co., 282 N.C. 643, 194 S.E.2d 521 (1973) (succumbing party expressly reserving the right to sue at acceptance).

171. 418 F Supp. at 664 ("If the buyer wishes not to accede to the increased demand, the seller must be dealt with honestly to be able to consider other possibilities.").

172. *See supra* text accompanying note 32 (discussing the efficiencies gained from the promise dimension of contractual transactions).

cumstances,[173] the presence or absence of protests is an appropriate factor to be considered. Significantly, though, in the cases where protests of helplessness were made, they were made ex post, that is, as part of the decision to accept a specific offer for a modification.[174] Ex ante protests that would gratuitously increase the duress that the other party could exert in defining the terms of its modification offer should not be required.

The distinction between ex ante and ex post notice is an important feature of the nondisclosure problem. The next section explores the significance of that distinction in the context of the foreseeability of damages caused by a breach of contract.

V FORESEEABILITY AND OTHER CONTRACTUAL DEFAULT RULES

Under the rule made famous in *Hadley v Baxendale*,[175] consequential damages are recoverable only if the breaching party foresaw or should have foreseen such damages at the time the contract was signed.[176] The rule in *Hadley* has been defended as a method of encouraging parties who are aware of the risks that their contemplated use of resources entails to disclose those risks to the other party [177]

This raises questions as to the relationship between the *Hadley* doctrine and cases of privileged nondisclosure. For example, suppose that the buyer of land was aware, either through deliberate effort[178] or casual discovery, that the seller's land contained valuable minerals. Alternatively, suppose that the buyer was aware of the existence of another individual who would be willing to buy the land in question for a higher price than was paid. In these cases, if the parties enter into a contract without any ad-

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173. *See* Aivazian, Trebilcock, & Penny, *The Law of Contract Modifications: The Uncertain Quest for a Bench Mark of Enforceability*, 22 OSGOODE HALL L.J. 173 (1984) (surveying the law of duress as it relates to the enforcement of contract modifications).

174. *See, e.g., Rose*, 282 N.C. at 650, 665, 194 S.E.2d at 526, 536 (the buyer notified the seller, who modified their contract while continuing to purchase goods thereunder, of intent to sue).

175. 9 Ex. 341, 156 Eng. Rep. 145 (1854).

176. *Id.* at 346, 156 Eng. Rep. at 147-48.

177. *See* Ayres & Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87, 101 (1989) (the rule is a "purposeful inducement" to the more informed party to reveal information).

178. The problem that *Hadley* might pose in cases of deliberately acquired information is noted in Ayres & Gertner, *supra* note 177, at 107, and R. POSNER, *supra* note 24, at 115.

vanced disclosure, and the seller subsequently breaches that contract, what damages should the buyer be able to recover? Specifically, should damages include the lost value from the buyer's contemplated use or resale of the land, or should such damages be barred by the *Hadley* doctrine as unforeseeable special damages?

Although the law in this area has not been consistent, it has found considerable use for the *Hadley* doctrine in cases of buyer nondisclosure.[179] With respect to real estate transactions, for example, the courts have been reluctant to make adequate damage remedies available to buyers. While buyers of land are generally entitled to specific performance,[180] many states have limited damages for buyers to a restitutionary return of the purchase price.[181] Even courts that allow buyers an "expectation" measure of damages often refuse to allow the buyer to recover the lost profits from either the contemplated resale or the contemplated use of the land.[182] The *Hadley* foreseeability requirement is often cited in these cases denying recovery,[183] although the real estate case law is not uniform in this respect.[184]

The courts have been more willing to allow consequential damages to a buyer who claims to have lost the profits of a contemplated resale of goods when the original seller has breached by failing to deliver.[185] It is generally held that the *Hadley* test is

179. *See* Annotation, *Vendor and Purchaser: Recovery for Loss of Profits from Contemplated Sale or Use of Land, Where Vendor Fails or Refuses to Convey*, 11 A.L.R.3d 719, 722-23 (1967) (the *Hadley* doctrine is the general rule applied to prohibit the buyer from offering the privately contemplated use as part of the damage award).

180. *See, e.g.*, Forman v. Benson, 112 Ill. App. 3d 1070, 1078, 446 N.E.2d 535, 541 (1983) (lower court did not exceed its authority in granting the purchaser specific performance); RESTATEMENT (SECOND) OF CONTRACTS § 360 comment e (1979) (specific performance traditionally awarded to buyers or sellers of real estate).

181. *See* R. CUNNINGHAM, W STOEBUCK & D. WHITMAN, THE LAW OF PROPERTY 642-43 (student ed. 1984) (recovery is generally limited to payments made plus incidential expenses); 8A J. GRIMES, THOMPSON ON REAL PROPERTY § 4478 (1963).

182. *See, e.g.*, Susi v. Simonds, 147 Me. 189, 85 A.2d 178 (1951) (specific damages inappropriate where the defendant had no knowledge of the purchaser's intended use); Merritt v. Adams County Land & Inv. Co., 29 N.D. 496, 151 N.W 11 (1915) (disallowing specific damages where the contemplated use of the land was known only by the buyer).

183. *See Susi*, 85 A.2d at 179, 147 Me. at 190; *Merritt*, 29 N.D. at 506, 151 N.W at 14.

184. Some cases have allowed recovery where the vendor was informed or should have known of the buyer's intent to resell the land. *See, e.g.*, Caughey v. Ames, 315 Mich. 643, 24 N.W.2d 521 (1946).

185. Out of 200 cases decided from 1946 to 1955, plaintiffs recovered lost profits in 75% of the cases where resale was involved and in 50% of the manufacturing use cases. Comment, *Lost Profits as Contract Damages: Problems of Proof and Limitations on Re-*

satisfied if the seller had reason to know that the buyer might intend to resell, even if the seller had no specific information about the resale sufficient to enable a calculation of the probable consequential damages.[186] Recovery of lost profits from a contemplated use of the goods has been allowed over a challenge based on *Hadley*.[187] Still, there are cases denying recovery of "contemplated use" damages due to lack of foreseeability.[188] Given the confused state of the case law in both the sales and real estate areas, it is important to explore the normative case for applying the *Hadley* requirement of ex ante disclosure of consequential damages to buyer nondisclosure cases.

In such cases, nondisclosure by buyers is an affirmatively good thing. A requirement that the buyer of land disclose the existence of minerals or the existence of a sub-purchaser who values the land more would be self-defeating. Since the buyer would know that such disclosure would destroy the prospects of acquiring the land, a rule requiring disclosure could cause such a buyer to refrain from trading, and the land would not be moved to its highest use.[189] Yet if the *Hadley* doctrine were applied, the seller would not be liable for damages due to the loss of these contemplated uses for the land because of the buyer's nondisclosure. The seller would have an incentive to breach the contract upon discov-

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covery, 65 YALE L.J. 992, 1016 n.137 (1956).

186. *See* Sun Maid Raisin Growers v. Victor Packing Co., 146 Cal. App. 3d 787, 793, 194 Cal. Rptr. 612, 616 (1983) ("[A]ppellants had reason to know that their failure to deliver the 610 tons [of raisins] . . . would result in lost profits on resales by Sun Maid."); Harbor Hill Lithographing Corp. v. Dittler Bros., 76 Misc. 2d 145, 147, 348 N.Y.S.2d 920, 923 (1973) ("[W]hile there was no evidence that [the seller] knew the precise extent [of the buyer's] contemplated profits . . . the possibility, if not the probability, of anticipating profit from resale was reasonably within the contemplation of the parties.").

187. *See* Lewis v. Mobil Oil Corp., 438 F.2d 500, 510-11 (8th Cir. 1971) (a seller providing goods to a manufacturer is assumed to know that a disruption of production will cause lost profits and that the manufacturer will be allowed to recover those lost profits); J. WHITE & R. SUMMERS, UNIFORM COMMERCIAL CODE 397 (2d ed. 1980) ("The trend of Code cases to date strongly suggests that the courts will construe this foreseeability requirement [of U.C.C. § 2-715(2) (1989)] to the plaintiff's benefit.").

188. *See* English Whipple Sailyard, Ltd. v. The Yawl Ardent, 459 F. Supp. 866, 877 (W.D. Pa. 1978) (finding that damages for the plaintiff's contemplated use of the boat were too speculative because the defendant had no reason to know of this contemplated use); Gerwin v. Southeastern Cal. Ass'n of Seventh Day Adventists, 14 Cal. App. 3d 209, 92 Cal. Rptr. 111 (1971) (refusing to award damages for anticipated profits where the defendant did not know the contracting party's identity, because the profits were speculative, and the defendant had no reason to foresee the damages).

189. *See supra* text accompanying notes 63-87.

ering a purchaser who would pay more than the contract price (plus incidental damages), preventing the land from reaching the higher use contemplated by the original buyer.

However, if the buyer does not disclose the intended use, the seller will not realize that the breach would generate substantial damages. It is almost axiomatic that a given buyer will not incur substantial unforeseeable damages. The seller will not know to take measures ensuring the ability to perform the contract. Moreover, the seller may breach the contract when a new buyer comes along, and a large money damage award for the original buyer will simply be absorbed by the seller. Litigation costs will consume the contractual surpluses, but the land still fails to achieve its highest and best use.

Evaluating these two arguments requires an inquiry into the economic rationale underlying the *Hadley* doctrine. Why is it desirable to encourage the party who will face special consequential damages from a breach to disclose that information? If Baxendale had known how urgently Hadley needed the crank shaft, what difference would it have made in Baxendale's behavior? One possibility is that Baxendale might have raised his price in response to the disclosed risk, perhaps inspiring Hadley not to use Baxendale's service but to find a more reliable means of getting the factory back in operation. Furthermore, even if Hadley were willing to pay the higher price, the additional disclosure would give Baxendale an incentive to be especially careful not to breach this particular contract.[190] Baxendale would know not to breach this contract deliberately (barring extraordinary alternative opportunities) and would also know to devote resources toward avoiding careless or negligent breaches of the contract.

For present purposes, it is important to separate these two responses to the disclosure of consequential damages. The first response suggests that a Hadley-Baxendale transaction might simply be an inefficient use of Baxendale's resources, a fact revealed to Hadley by Baxendale's high price. The second response suggests that Baxendale might commit an inefficient breach of contract without the information — either a deliberate breach or a deliberate failure to exercise sufficient care to protect against a negligent inability to perform. These two consequences of nondis-

190. *See* Ayres & Gertner, *supra* note 177, at 104 ("*Hadley* penalizes high-damage millers for withholding information that would allow carriers to take efficient precautions.").

closure can be called the "inefficient transaction" and "inefficient breach" problems.[191]

Separating these two problems suggests an important point relating to the timing of disclosure. If the transaction itself would be inefficient, disclosure must occur ex ante, before the parties are locked into a contractual relationship. However, if the problem is inefficient breach, it is theoretically necessary only that disclosure occur before the decision is made that leads to the breach.[192] If the breach is deliberate, the disclosure must occur prior to the breach; if the breach consists of a negligent failure to perform, the disclosure must occur before the degree of care decision is made.

Recall the case of nondisclosure by a buyer where the seller's land contains valuable minerals. Section III argued that this transaction is indeed efficient, moving the resource and the information together.[193] The seller would like to know this information for two reasons. First, knowing the information itself increases the value of the land and, in turn, increases its price. Second, knowing the information informs the seller that the buyer would suffer substantial damages from a breach of contract by the seller. The prospect of additional damages would in turn lead the seller to raise the price as well as devote additional care to prevent breaches of the contract. These two reasons for the seller to want the information will be referred to as the "strategic reason" and the "damage notice reason."

The privilege of nondisclosure is designed to prevent the seller from strategically appropriating the buyer's information. By contrast, the damage notice reason is a legitimate purpose for the seller to seek disclosure — it is the same reason that Baxendale sought notice of Hadley's consequential damages, despite the fact that such knowledge conferred no immediate strategic gain for

191. "Efficient breach" is often thought of as a subset of deliberate or willful breach, but this is not always the case. It may be efficient to devote a limited amount of resources toward ensuring that one will be able to perform, recognizing that in some cases performance will be unfeasible because insufficient resources were expended. For example, it might not have been efficient for Baxendale to use the most reliable employee in the company to carry the crank shaft. *See generally* Macneil, *Efficient Breach of Contract: Circles in the Sky*, 68 VA. L. REV. 947, 951-52 (1982) (defining "efficient breach" and arguing that it is rarely applicable).

192. In some cases, these two ideas will converge. For example, some care decisions are made at the time of contracting, such as what routes will be taken by the carrier. In such instances, failure to give ex ante disclosure would be inefficient, unless full disclosure would produce still larger offsetting inefficiencies.

193. *See supra* text accompanying notes 79-81.

Baxendale. The issue to be explored is whether a failure to give ex ante notice in the mineral case will lead either to inefficient transactions or to inefficient breaches.

There is no reason to believe that a failure to give ex ante notice in a mineral case will lead to inefficient transactions. Disclosure would have led the seller to raise the price because of higher consequential damages manifested through disclosure, even if the seller had not taken strategic advantage of the buyer's disclosure. However, since most contracts are performed, a dramatic price increase is not required. An increase large enough to cover the expected consequential damages multiplied by the probability of breach is sufficient.[194] Since the consequential damages protect a gain to the buyer, the buyer would be willing to pay this small increase in price to secure the full consequential gain. In short, because the buyer remains willing to purchase the land despite the increase in price brought about by notice of consequential damages, the transaction itself is efficient.[195] Of course, one cannot test this theory by requiring actual ex ante disclosure, for then the seller could raise the price dramatically for strategic rather than damage notice reasons.

The question remains whether a failure to disclose the existence of minerals on the land would lead to inefficient breaches, since the seller had no way of knowing how badly the buyer needed the property at the time the seller made its care or breach decisions. There are two points to be made about this rationale for applying the *Hadley* doctrine to the mineral case.

First, one must be careful in asserting that a particular breach of contract is in fact efficient. For example, Posner has viewed an efficient breach as occurring when the seller realizes a greater return by accepting a higher bid than the original buyer had contracted to pay, even after compensating the original buyer for the breach.[196] This is an unusual circumstance because the second buyer could simply purchase the property from the original buyer.[197] If the seller is only tempted to breach for this reason,

194. *Cf.* The T.J. Hooper, 60 F.2d 737, 739-40 (2d Cir. 1932) (to determine the duty owed in a negligence action, the burden which the defendant would have to assume to avoid the harm must be less than the gravity of the potential injury multiplied by the probability that the harm will occur).

195. "Efficiency" is used here in a Kaldor-Hicks sense. For a discussion of Kaldor-Hicks efficiency, see *supra* note 41.

196. *See* R. POSNER, *supra* note 24, at 107-08.

197. *See* Macneil, *supra* note 191, at 951-52 (analyzing efficiencies of breach under

there is no efficiency gain to be protected. Since refusing recovery of unforeseeable consequential damages will not deter breach as effectively as high damages, it would be a step in the wrong direction to apply the *Hadley* doctrine on the theory that nondisclosure misled the seller into thinking that this was a case of efficient breach. Indeed, if there is no possibility for a truly efficient breach, specific performance or punitive damages sufficient to deter breaches should be awarded.

The second point is that even if a seller reasonably believes, because of the nondisclosure, that an efficient breach is possible, the problem can be remedied by ex post rather than ex ante disclosure.[198] The seller must know that the buyer will incur substantial consequential damages but only needs to acquire this information at some time prior to the breach or to making a care decision increasing the likelihood of an unintentional breach. However, the seller does not require ex ante disclosure and should not be entitled to receive it due to the likelihood for strategic misappropriation of any ex ante disclosure.

The purpose of the *Hadley* doctrine, which disallows uncommunicated consequential damages, is to encourage ex ante communication. On the facts of *Hadley*, ex ante communication is necessary to prevent inefficient transactions, while ex post communication is sufficient to prevent inefficient breaches. In the mineral case, the transactions themselves are efficient, and thus there is no need for ex ante communication. Moreover, the problem of strategic use of the information counsels against an ex ante disclosure requirement. If the seller could reasonably believe that an efficient breach is possible, because of the nondisclosure, a requirement of ex post disclosure as a condition for the recovery of consequential damages would be appropriate. If there is no possibility of efficient breach, damages should not be limited by any foreseeability doctrine, but should be augmented sufficiently to deter breaches of contract.

Another rule of sales law clarifies the argument regarding the differential utility of ex ante disclosures in various settings. Unless

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expectation damages and specific performance). "Unusual circumstances" might include situations where sub-buyers could not deal with the original buyer as cheaply as they could with the seller.

198. *See* Sanderlin v. Willis, 94 Ga. 171, 21 S.E. 291 (1894) (suggesting ex post notice of a breach of contract would rebut a general demurrer and would entitle the party to recover damages).

expressly disclaimed, a seller of goods often warrants that the goods are fit for the particular purpose to which the buyer intends to put them.[199] However, such a warranty does not apply unless the seller had ex ante reason to know the particular purpose for the contract.[200]

For example, in *Johnson v Lappo Lumber Co.*,[201] plaintiff was a hog farmer who purchased a fan to provide additional air circulation for the hogs in a barn. The fan failed to provide adequate ventilation, causing the death of a large number of hogs and causing the plaintiff to incur considerable veterinary expenses to save the remainder.[202] Nevertheless, the court held that the seller had not breached the implied warranty of fitness for particular purposes because the buyer had not explained to the seller the conditions in the barn which necessitated a different type of fan.[203]

The high consequential damages incurred in *Johnson* demonstrate that the plaintiff's use of the fan may have been a social waste; the fan should have been used for a more prosaic purpose in which it would have accomplished some positive end. Similarly, in *Hadley*, the high consequential damages suggest that there may have been too much risk to justify using Baxendale's services on behalf of Hadley's mill. The high prices that would have followed ex ante disclosures by the buyers of their particular needs might have led the buyers to forego these particular services, reflecting the private cost-benefit judgments needed to ensure the social utility of transactions. To summarize, the amount of consequential damages in these two cases point to the possibility that the resources in question (Baxendale's carrier service and the farmer's fan) were actually less socially valuable in their contractual usage

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199. *See* U.C.C. § 2-315 (1989) ("[W]here the seller at the time of contracting has reason to know any particular purpose for which the goods are required [t]here is unless excluded or modified an implied warranty that the goods shall be fit for such purpose.").

200. *See* Abraham v. Volkswagen of Am., Inc., 795 F.2d 238, 249 (2d Cir. 1986) (an implied warranty of fitness for a particular purpose arises where the seller knows or has reason to know the particular purpose for which the buyer requires the goods); Price Bros. v. Philadelphia Gear Corp., 649 F.2d 416, 423 (6th Cir. 1981) (an implied warranty of fitness for a particular purpose is contingent on the seller's awareness of the particular purpose at the time of the contract).

201. 25 Mich. App. 217, 181 N.W.2d 316 (1970).

202. *Id.* at 219, 181 N.W.2d at 317-18.

203. *Id.* at 223-24, 181 N.W.2d at 320.

than they would have been in alternative uses.[204]

In general, the same analysis applies to the case of a buyer who does not disclose a resale opportunity.[205] A requirement of ex ante disclosure would allow the seller to deal directly with the sub-buyer, a possibility which would tend to deter the original buyer from acting on knowledge of the resale opportunity. Furthermore, if *Hadley* is held to bar consequential damages resulting from the loss of a resale opportunity when there has been no ex ante communication, the seller would have insufficient incentive to refrain from inefficient breaches.

The rule of *Hadley v. Baxendale* is a default rule. Subject to constraints such as unconscionability and the penalty rule of liquidated damages,[206] parties can contract around it by agreeing to be liable for special damages.[207] Professors Ayres and Gertner have used the *Hadley* case as an example when discussing default rules in contract law.[208] They argue that default rules should not necessarily be set where contracting parties would want them. Rather, they suggest that in some cases it would be appropriate to set less accommodating default rules as an incentive for one party to come forward with important information in order to avoid the operation of the unfavorable rule.[209]

The thesis of this article suggests that there may be a range over which a reverse Ayres and Gertner rule would be appropri-

204. By contrast, the mineral cases do not represent a situation in which the transaction itself is inefficient. *See supra* text accompanying note 179.

205. On the other hand, there will be situations in which it appears substantially certain that the seller would have discovered the higher price opportunity independently if the buyer had not arrived to place a bid first. For example, in Chandler v. Butler, 284 S.W.2d 388 (Tex. Civ. App. 1955), a purchaser came to the house of an elderly doctor and offered him a price for the latter's stock that was only two-thirds of the price for which the stock was then trading on the over-the-counter market. *Id.* at 390-94. The court held that the purchaser had committed fraud. *Id.* at 398. It is difficult to justify such a transaction on efficiency or fairness grounds.

206. *See* J. CALAMARI & J. PERILLO, THE LAW OF CONTRACTS § 14.5 (3d ed. 1987); Macneil, *Power of Contract and Agreed Remedies*, 47 CORNELL L. REV. 495, 499-513 (1962) (discussing the penalty rule of liquidated damages).

207. *See generally* E. FARNSWORTH, *supra* note 29, § 12.18 (discussing principles and limits of agreed remedies).

208. Ayres & Gertner, *supra* note 177, at 101-04 (characterizing the *Hadley* rule as a "penalty default" because the denial of consequential damages penalized the miller for withholding important information that could have prompted the carrier to act more efficiently).

209. *See id.* at 103-04 ("When relatively informed parties strategically withhold information, courts, to promote information revelation, should choose a default [sic] that the informed party does not want.").

ate; that is, a default rule established for the purpose of encouraging nondisclosure in cases where such nondisclosure brings affirmative efficiency gains. Whether this objective requires default rules that parties themselves would not choose is an important question to be considered later.[210] Consider default rules pertaining to the assignment of contracts. As an example, suppose that A has acquired an option to purchase O's land. Should A be able to assign the right to exercise the option to B? The contract might provide either that assignment of the option was permissible or impermissible, but in many cases assignability will not be expressly addressed, necessitating a default rule. In general, assignment of contracts is permitted in cases where the parties are silent on the question.[211] The major limitation on such assignability arises when the assignment of rights and/or delegation of duties would be prejudicial to the opposing party.[212] For example, B could not exercise the option solely by giving a note in payment without A's credit standing behind B's promise. Where prejudice of this nature is not involved, as when B is willing to pay cash to exercise the option, the law favors assignability.[213]

Significantly, it is generally not a defense that A negotiated the option with the intention to assign the option to B. One possible exception could be that an assignment to a person with whom A knew O was not willing to deal on any terms is improper.[214] Delegation of contractual duties is permissible unless the duties

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210. *See infra* text accompanying notes 218-37.

211. *See, e.g.*, Smithfield Oil Co. v. Furlonge, 257 N.C. 388, 393, 126 S.E.2d 167, 171 (1962) (rights are not dependent on the use of "assign" in the contract but exist absolutely in the absence of contractual or statutory prohibitions).

212. *See* Macke Co. v. Pizza of Gaithersburg, Inc., 259 Md. 479, 482, 270 A.2d 645, 646 (1970) in which the court stated:

> In the absence of a contrary provision — and there was none here — rights and duties under an executory bilateral contract may be assigned and delegated, subject to the exception that duties under a contract to provide personal services may never be delegated, nor rights be assigned under a contract where *delectus personae* was an ingredient of the bargain.

213. *See* Cochran v. Taylor, 273 N.Y. 172, 7 N.E.2d 89 (1937) (right of holder of sealed option to purchase property for cash or for 20 percent cash plus note was assignable where assignee tendered the cash).

214. *Cf.* E. FARNSWORTH, *supra* note 29, § 11.10 n.26 (if one party makes a contract with the undisclosed intention of delegating performance to a person distasteful to the other party, the other party may have a claim of fraud). *But see* H. REUSCHLEIN & W. GREGORY, THE LAW OF AGENCY AND PARTNERSHIP 179 (2d ed. 1990) ("It is generally recognized that one may quite properly contract with another with full intention to assign the contract to one with whom it is known the other would not contract.").

are clearly of a personal nature;[215] the mere fact that the party entering into the contract intended to delegate the duties, with the original delegator remaining liable on the promise, is not a reason to oppose delegation.

These default rules favoring free assignability promote the efficiency gains of nondisclosure. If A knows of someone who is more interested in the contractual rights or more capable of performing the contractual duties, disclosure of these facts is not necessary. Disclosure would merely cause the owner to deal directly with the other person, and the prospect of such a response would deter the use of this information by the original party.

An interesting question is whether the default rule of free assignment and delegation, subject only to the constraint against prejudicial assignments, comports with the rule that the parties would have chosen had they addressed the question. O presumably has some reason for choosing to deal with A, so that compulsory contractual relations with a person that O did not directly deal with almost inevitably involves some cost. Moreover, A's decision to contract and then assign or delegate to B may preclude O from obtaining profits that O might otherwise have received. These arguments suggest that the law imposes an undesirable default rule upon O.

On the other hand, it may be that the default rule encourages competition among those who believe that they know potential sub-parties who value the contractual rights more highly (or who disvalue the contractual duties less). The competitive bidding that results can convert the Kaldor-Hicks efficiencies from nondisclosure into a mutually beneficial exchange. If so, O might choose a default rule that permits nondisclosure of intent to assign as a means of increasing interest in the property. This tendency of competition to convert Kaldor-Hicks efficiencies of nondisclosure into mutual benefits is discussed more fully in the next section.[216]

215. *See* British Wagon Co. v. Lea & Co., 5 Q.B.D. 149 (1880) (assignment of contractual obligations was permitted because personal performance was not the essence of the contract); RESTATEMENT (SECOND) OF CONTRACTS § 318 illustrations 2 and 3 (1979) (examples of instances when delegation and performance of duty is binding).

216. *See infra* text accompanying notes 220-37.

VI. Toward a General Theory

A. Mutual Benefit, Disclaimability, and Commercial Custom

Briefly summarizing conclusions regarding the efficiency implications of contractual nondisclosure, this article began with a paradigm that explains many of the factors courts have considered in nondisclosure cases. This paradigm involved the trade-off between exchange-based and promise-based policies in contract law.[217] Four additional factors were then added to the calculus, factors which primarily affected buyer nondisclosure and the nondisclosure of extrinsic facts. These factors were the efficiency gains from merging information and resources, internalizing the external benefits of entrepreneurial activities, providing advanced pricing signals of impending changes in supply or demand, and avoiding the opportunistic or extortionate use of disclosed information.[218]

It is important to explore the relationship between these four efficiency factors and the idea of mutual benefit central to contract law. All of the efficiency factors point to net wealth gains in a Kaldor-Hicks sense, but such wealth gains might derive from a benefit to one contracting party that exceeds the other party's loss. This contradicts the ordinary assumption that contracts yield transactions that enrich both contracting parties (although nonparties, such as competitors of the parties, may lose, Pareto efficiency has never been a realistic ideal of contract law).[219]

Closely related to the question of mutual benefit is the issue of disclaimability. The rules identified for determining whether to permit nondisclosure may arguably be seen as gap-filling rules that the parties should be able to alter by agreement.[220] Should these nondisclosure rules yield efficiencies at the expense of one party, that party would have an incentive to defeat these social efficiencies by opting out of the background rules on nondisclosure.

Suppose, for example, that one becomes aware that a railroad

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217. *See supra* text accompanying notes 29-61.

218. *See supra* text accompanying notes 74-175.

219. *See* Wonnell, *supra* note 143, at 511-12 (noting that economists since Adam Smith have assumed that contracts will be mutually beneficial to the contracting parties while potentially harming their competitors).

220. Kronman argues that the distinction between deliberate and casual acquisition of information is merely a gap-filling rule to be applied in the absence of an express allocation of risk. *See* Kronman, *supra* note 62, at 114-17.

will come to a particular town in eight months and purchases land from a landowner in the town who is unaware of this information. If the landowner would not discover the railroad's plans immediately, efficiency gains might arise from the purchaser using the land in a manner consistent with the arrival of the new railroad and from preventing the previous owner from making irrevocable decisions about the land which would be inconsistent with the planned railroad. The question, however, is whether these social benefits are obtained at the expense of the existing landowner.[221]

In cases of this type, sellers almost always inquire into the reason for the purchaser's interest in the property. Purchasers typically respond with uninformative answers that sellers later argue constitute affirmative fraud justifying avoidance of these transactions.[222] However, the sellers generally have failed to negotiate a clause stating that the purchaser warrants the absence of material favorable information. Presumably purchasers are unwilling to give such warranties, and sellers who insist upon them do not complete transactions that end in litigation.

Why might a seller fail to insist upon warranties of this character? The seller could lose the opportunity to enter into a contract with a particular buyer, but the seller would know that this buyer possesses material information. With respect to information, such as the plan for the railroad, that the seller would eventually acquire, a transaction with that particular buyer could become a source of regret.

Conversely, the seller may benefit from taking a passive stance that does not insist on a warranty that no material information motivates a purchaser. If one person is aware of particular information, others may also be aware, and the seller could benefit from encouraging competitive bidding for the property. Alternatively, the first individual may well make a bid that is sufficiently lucrative to preempt foreseeable competitors and the seller will not want to lose that bid by insisting on a warranty.

The actual or preempted competitive bidding would have a tendency to convert Kaldor-Hicks efficient transactions into mutu-

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221. Professor Wang argues that a difficult empirical calculation involving the benefit to the landowner of efficient use of the land is required to conclude that nondisclosure is in the long-run interest of all the groups of people affected by such rules. *See* Wang, *Reflections on Contract Law and Distributive Justice: A Reply to Kronman*, 34 HASTINGS L.J. 513, 525 (1982).

222. For example, the seller made such an inquiry in Laidlaw v. Organ, 15 U.S. (2 Wheat.) 178, 183 (1817).

ally beneficial transactions. Prices would tend to rise to the point where the seller would be better off selling than holding on to the land and risk making erroneous decisions about its use. Of course, the market price may subsequently rise above the contract price, giving the seller reason to seek rescission of the contract. It does not follow, however, that it was irrational for the seller to enter into the transaction ex ante when there might have been a greater interest in immediate liquidity

It is not contended that all Kaldor-Hicks efficient nondisclosure transactions are also mutually beneficial. If one individual is in sole possession of particular information and is aware of this fact, no competitive bidding will be anticipated or will occur. This situation presents the normative question of whether to tolerate the private loss in the interest of the net social benefit, or Kaldor-Hicks efficiency[223] Unless the losers are placed in a position where Rawlsian concerns about the least advantaged are triggered, there is no apparent reason to treat these losses differently than the private losses that one competitor suffers when another competitor devises a more socially useful product.[224]

However, the tendency of competitive bidding to transform Kaldor-Hicks gains from nondisclosure into mutually beneficial transactions explains the failure of the nondisclosure problem to self-liquidate.[225] Standard form contracts for the sale of land do not contain clauses in which the purchaser renounces possession of material information. Moreover, there has been an evolution of institutions, such as futures markets, that facilitate speculative trading on the basis of superior information.[226]

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223. *Compare* Kronman, *Contract Law and Distributive Justice*, 89 YALE L.J. 472, 478-87 (1980) (short term gain at the expense of a few is tolerable if the transaction is ultimately to the benefit of all) *with* Wang, *supra* note 221, at 524-25 (criticizing Kronman's approach because of the difficulty in identifying the individual victims, their losses, and the ultimate gain).

224. Rawls's concern is not with individual transactions but with the basic structure of society and the impact of its principal institutions upon particular groups. These institutions define the rights and duties of members of society as well as their future prospects. By virtue of the nature of this relationship, certain "starting positions" are more advantageous than others, leading to "deep inequalities." Rawls's concept of justice focuses on "how fundamental rights and duties are assigned and on the economic opportunities and social conditions in the various sectors of society." *See* J. RAWLS, A THEORY OF JUSTICE 7-11 (1971).

225. It has been argued, for example, that investors are paid a premium to compensate them for the known possibility of insider trading. *See* Scott, *Insider Trading: Rule 10b-5, Disclosure and Corporate Privacy*, 9 J. LEGAL STUD. 801, 807-09 (1980).

226. Such institutions would promote speculative trading through trading rules as

There will often be settings in which one party feels disadvantaged if the other party trades on the basis of inside information.[227] The prohibition of nondisclosure by parties who have undertaken the duties of a fiduciary can be understood in this context. Indeed, the nondisclosure considerations can be useful in determining when it is appropriate to recognize a particular relationship as fiduciary in character. Fiduciary ties are held to arise out of relations of trust and confidence.[228] Transactions with a fiduciary require disclosure because the principal trusts the fiduciary and thus is not apt to exercise the same caution and diligence required by an arm's length transaction.[229] This observation fits easily into the exchange-promise framework developed earlier, with its emphasis on the extent to which a particular nondisclosure was discoverable by the other party One of the efficiencies of dealing with a fiduciary is that it spares the expense of staying

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well as the abstract nature of transactions comprised solely of risk transfer, the purchaser having no intention to take physical possession of a commodity. *See supra* text accompanying notes 120-36.

227. Professor Wang argues that as a result of the "law of conservation of securities," there will always be monetary losers from insider trading. *See* Wang, *Trading on Material Nonpublic Information on Impersonal Stock Markets: Who is Harmed, and Who Can Sue Under SEC Rule 10b-5*, 54 S. CAL. L. REV. 1217, 1234-35 (1981). However, while buyers' gains must equal sellers' losses, investors who neither bought nor sold can benefit from the external effects of these trades. *See* Dau-Schmidt, *An Economic Analysis of the Criminal Law as a Preference-Shaping Policy*, 1990 DUKE L.J. 1, 13 n.62 ("[I]nsider trading may reduce the time it takes for a stock price to reflect relevant information benefiting all market participants."). Finally, a zero-sum monetary game does not translate into a zero-sum utility game given the varying attitudes of investors toward risks and the varying effects of losses on different portfolios.

228. The fiduciary concept has been extended to include commercial franchises. *E.g.*, Arnott v. American Oil Co., 609 F.2d 873, 882 (8th Cir. 1979) (reasoning that as a result of building up the goodwill of her own business as well as that of the franchisor, the franchisee stands in a fiduciary relationship with the latter), *cert. denied*, 446 U.S. 918 (1980). Also, a bank's relationship with its borrowers has been held to be of a fiduciary nature. *See, e.g.*, Barrett v. Bank of Am., 183 Cal. App. 3d 1362, 1369, 229 Cal. Rptr. 16, 20-21 (1986) (holding that the relationship of trust and confidence between a bank and its loan customers is quasi-fiduciary).

229. *See, e.g.*, Helms v. Duckworth, 249 F.2d 482, 486-87 (D.C. Cir. 1957) ("[H]older[s] of closely held stock in a corporation bear a fiduciary duty to deal openly with their fellow stockholders and to make disclosure of all essential information."); RESTATEMENT (SECOND) OF AGENCY § 390 (1958) (an agent acting as an adverse party has a duty to deal fairly with the principal); RESTATEMENT (SECOND) OF CONTRACTS § 173 (1979) (a contract between a fiduciary and a beneficiary is voidable if one party is unaware of all relevant facts and legal rights); RESTATEMENT (SECOND) OF TRUSTS § 170(2) (1959) (a trustee dealing on his or her own behalf with the beneficiary has a duty to disclose all material facts to the beneficiary).

alert to all of the relevant facts.[230]

However, this article has suggested reasons beyond the exchange-promise dichotomy for recognizing a category of fiduciary relationships and especially for setting a limit on that concept. Contracts will be made for fiduciary responsibilities by parties until the costs of full disclosure to the fiduciary exceed the benefits of receiving all the relevant information.[231] Costs of disclosure will tend to exceed these benefits where the relationship offers opportunities to appropriate the social efficiencies of nondisclosure. Even if those transactions, considered individually, conferred a $1000 benefit on one party at the expense of a $500 loss to the other, the losing party would have an incentive to make those transactions a part of the compensation package of the benefiting party. Removal of the fiduciary relationship would allow an arrangement of the transactions that creates mutual benefit out of transactions that, individually, were only Kaldor-Hicks efficient.

Beyond the narrow realm of fiduciary relationships, the law of nondisclosure often refers to the customary morality of the commercial community.[232] For example, the *Restatement (Second) of Torts* requires one to disclose information "basic to the transaction, if he knows that the other is about to enter into it under a mistake as to them, and that the other, because of the relationship between them, the customs of the trade or other objective circumstances, would reasonably expect a disclosure of those facts."[233]

"Reasonable expectations" is always a slippery concept, especially since the expectations of commercial parties are often a

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230. *See* Levmore, *supra* note 150, at 135 (noting the problem that effort is wasted learning information for one's own protection that someone else already possesses).

231. *See* Jordan v. Duff & Phelps, Inc., 815 F.2d 429, 436 (7th Cir. 1987) (noting that, to a certain extent, parties may define their obligation to disclose information), *cert. dismissed*, 485 U.S. 901 (1988).

232. Consider, for example, the following:

> The continuing development of modern business ethics has, however, limited to some extent this privilege to take advantage of ignorance. ... It is extremely difficult to be specific as to the factors that give rise to this known, and reasonable, expectation of disclosure. In general, the cases in which the rule stated in Clause (e) has been applied have been those in which the advantage taken of the plaintiff's ignorance is so shocking to the ethical sense of the community, and is so extreme and unfair, as to amount to a form of swindling, in which the plaintiff is led by appearances into a bargain that is a trap, of whose essence and substance he is unaware.

RESTATEMENT (SECOND) OF TORTS § 551 comment 1 (1977).

233. *Id.* § 551(2)(e).

function of the governing legal rules. It is tempting to conclude that the "reasonable expectation" is the expectation that is in accordance with the better ethical view of a particular practice.[234] Such a conclusion, however, would miss the epistemological gain from deducing what pre-legal morality had actually evolved to govern particular types of transactions. The general acceptance of nondisclosure in a particular setting may be due to the presence of one or more efficiencies.[235] Regarding nondisclosure as unethical in another setting may result from an absence of opportunities for efficient transactions in that setting.

In short, while the Kaldor-Hicks benefits from nondisclosure practices will not always translate into mutual benefits, there is not as dramatic a gap between these two efficiency concepts as may at first appear Competition can convert Kaldor-Hicks efficiency into mutual benefit, as can packaging transactions as long term relationships. In contexts where nondisclosure appears likely to generate efficiency gains, one might wish to have clear evidence that the express terms or customary understandings of a particular trade called for full disclosure before declaring that the background rule permitting nondisclosure had been contractually varied.[236]

B. Summarizing the Rules of Nondisclosure

The focus of this article, which has been on the benefits of certain nondisclosure practices, should not be misinterpreted as a theory that nondisclosure is generally unobjectionable. Rather, the focus is a counterweight to a literature which is heavily oriented toward condemning nondisclosure as tantamount to fraud. Because of this emphasis, however, the reasons that nondisclosure is a highly suspect practice bear repeating.

Apart from its distributional effects, trading without disclosure is a source of stark inefficiencies. If a homeowner is aware of termite infestation or that a polluting factory will soon be operat-

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234. Consider the ambiguity between description and prescription in the *Restatement (Second) of Torts*. *See supra* note 232.

235. *See* R. SUGDEN, THE ECONOMICS OF RIGHTS, CO-OPERATION AND WELFARE 25-29 (1986) (arguing that existing rules of morality are based on efficient strategies).

236. The relationship between the underlying case for a particular background rule, or "default" rule, and the clarity of evidence that must be present to vary that rule is explored in Ayres & Gertner, *supra* note 177, at 123 (The courts should "establish 'safeharbors' of contractual language that will be sufficient to reach contractual outcomes.").

ing next door, there are substantial inefficiencies in allowing a transaction to take place without disclosure. For one thing, transaction costs are incurred in negotiating the sale, moving in, and moving out.[237] More importantly, the buyer may make inappropriate decisions in reliance on faulty or incomplete information, whereas the seller could have made sensible, corrective decisions if still in possession of the property.[238] Finally, the fact of the sale confers none of the customary confidence that the buyer values the commodity, which is a house with termites or a house near a factory, more highly than does the seller; the buyer may indeed value it less.

It would be ideal to construct a general theory of nondisclosure.[239] Toward this future endeavor, this article has sought to articulate the general structure of a nondisclosure theory that might guide future understanding in this area. The general framework for the nondisclosure problem should include appropriate open-ended clauses to accommodate the probability of particular types of future knowledge.

It is important that the factors relevant to the exchange-promise dichotomy be separated from those relevant to the affirmative, exchange-based efficiencies arising from nondisclosure. As noted earlier, the same factors that aggravate the social costs of an inefficient nondisclosure tend to increase the benefits from a nondisclosure in a setting where efficiency gains from nondisclosure are possible.[240] The disclaimability problem should also receive a more explicit treatment than it has in the past. Toward this end, the following tentative rules might be considered:

> Rule 1. *Duty to Disclose — In General*
> A. Unless nondisclosure is privileged under Rule 2, a party to a contract is under an obligation to disclose facts pertinent to the contractual exchange whenever the risk that nondisclosure will frustrate the process of mutually beneficial exchange outweighs the prospect that a disclosure duty would unduly jeopardize the security of promissory transactions.

237. *See supra* text accompanying notes 33-34.

238. *See* Levmore, *Waiting for Rescue: An Essay on the Evolution and Incentive Structure of the Law of Affirmative Obligations*, 72 VA. L. REV. 879, 907 (1986) (arguing that sellers will have a "fair incentive" to obtain information about their property if buyers routinely ask to inspect the property before buying).

239. For a discussion of the history of nondisclosure theories from Cicero to Levmore, see Lawson, *supra* note 66, at 740-45.

240. *See supra* text accompanying notes 75-87.

B. In making the assessment dictated by Section A, courts should consider the following factors:
1. The materiality of the fact not disclosed;
2. The extent to which the undisclosed information is readily accessible to the other contracting party;[241]
3. The difference in the degree of intelligence and commercial sophistication of the parties;
4. Any action taken by the nondisclosing party to prevent discovery;
5. Whether the defect is intrinsic or extrinsic to the commodity involved in the transaction;
6. Such other facts as the courts might find pertinent in weighing the competing policies outlined in Section A of this Rule.

Rule 2. *Privilege of Nondisclosure*
A. Notwithstanding Rule 1, and subject to Rule 3, a party to a contract is under no obligation to disclose information to the extent that such nondisclosure is privileged by virtue of the social utility that such nondisclosure generates in any of the ways identified in Section B of this Rule.
B. A party is under no obligation to disclose:
1. Information about the property being purchased that the owner of such property might not have discovered within a reasonable period of time;[242]
2. Information about the increase in value of the property being purchased that is generated as an external benefit of purchaser activity [243]
3. Information about impending supply and demand conditions for the commodity where the general market will receive correct signalling from the changes in the prices generated by trades;
4. Information that could be used by the other transacting party in an opportunistic or extortionate manner;
5. Information that must remain undisclosed to preserve other efficiencies that the courts may identify.

Rule 3. *Waiver of Privilege of Nondisclosure*
A. The privilege of nondisclosure outlined in Rule 2 may be

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241. Omitted from this list is the factor, which Keeton included, of whether it is the buyer or the seller who fails to disclose. *See supra* text accompanying note 23. In certain circumstances, status as buyer or seller may be relevant to the issue of access to information. However, considering it separately tends to confuse the issues of privilege and materiality.

242. This would include both intrinsic and extrinsic information. *See supra* text accompanying notes 104-07 (purchase of land for a railroad presenting a hybrid situation).

243. For this purpose, it would not matter whether the information reached the other party immediately or after a lengthy interval. *See supra* text accompanying notes 90-96.

waived in any of the following ways:
1. Express contractual language calling for full disclosure or warranting that a party does not possess inside information;
2. Relationships of such trust and confidence that full disclosure is reasonably expected, where there has been no express disclaimer of full disclosure;
3. A course of dealing, performance, or trade usage calling for full disclosure, where there has been no express disclaimer of full disclosure;
4. Affirmatively stating facts that are misleading by virtue of undisclosed information or become misleading by circumstantial changes.
5. Other methods which convince the court that the parties did not intend to assert their privileges.
B. In ascertaining whether the parties have waived a privilege of nondisclosure, the courts should independently examine the strength of the efficiency claims made for the nondisclosure under Rule 2. If evidence supporting an efficiency claim is strong, a finding of waiver must be supported by correspondingly strong evidence.

Rule 4. *Gap-Filling, Including Consequential Damages*
A. When ruling upon issues unaddressed in a contract, a court may consider the effect of a particular gap-filling rule in encouraging the disclosure of relevant facts. This consideration may be given weight under the following circumstances and will have the following significance:
1. Where the disclosure is required under the factors identified in Rule 1 and is excluded from the examples listed as privileged within Rule 2, the court has reason to select the rule encouraging disclosure; or
2. Where the disclosure is one in which nondisclosure would be privileged under Rule 2, the court has reason not to select the rule encouraging disclosure, unless the privilege has been waived under Rule 3.
B. Unless the parties provide otherwise, damages for breach of contract should not include special consequential damages that could have been disclosed by the parties, unless such nondisclosure is privileged under Rule 2 and the privilege has not been expressly or impliedly waived under Rule 3.

VII. CONCLUSION

A general theory of nondisclosure has remained elusive for both courts and commentators. The various positions have not lacked rhetorical support from the judiciary; one court argued

that "a person may with perfect honesty and propriety use to his own advantage the superior knowledge of property he desires to purchase, that has been acquired by skill, energy, vigilance and other legitimate means . . . ."[244] A second tribunal condemned "the inherent unfairness involved where a party takes advantage of such [inside] information knowing it is unavailable to those with whom he is dealing."[245] Seemingly expressing a moderate position between these two extremes, another court observed that "law in its sanctions is not coextensive with morality. It cannot undertake to put all parties to every contract on an equality as to knowledge, experience, skill and shrewdness."[246]

As this article has sought to demonstrate, the way out of this rhetorical impasse is to draw certain basic distinctions. First, it is essential to distinguish arguments which advocate a tolerance of nondisclosure in order to protect the security of transactions from those arguments approving or privileging nondisclosure in order to advance independent public policies. Second, one must differentiate between types of nondisclosure patterns. Nondisclosures that merge resources and information are fundamentally different from nondisclosures that sever the two. Equally basic differences exist between nondisclosures where the trading itself can and cannot serve as a pricing proxy for the information. Finally, nondisclosures of information that would create incentives for opportunism or would block the formation of enterprises that confer external benefits represent distinct categories of cases.

No general theory that seeks to condemn, praise, or tolerate the phenomenon of nondisclosure can be sufficiently sensitive to these important distinctions, nor can a theory that lists "factors" for courts to consider in a grand balance, since the factors that cut in one direction when the issue is the security of transactions may argue for the opposite result when the issue is privilege.[247] Ironically, a general theory can only succeed when it is recognized that there are discrete types of both nondisclosure transactions and arguments, and that each type must be evaluated separately within the broader theory.

244. Hays v. Meyers, 139 Ky. 440, 442-43, 107 S.W. 287, 288 (1908).

245. Cady, Roberts & Co., 40 S.E.C. 907, 912 (1961).

246. Goodwin v. Agassiz, 283 Mass. 358, 363, 186 N.E. 659, 661 (1933).

247. *See supra* text accompanying notes 82-87.