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Mistake and Disclosure in a Model of Two-Sided Informational Inputs

Michael J. Borden
Cleveland State University, m.borden@csuohio.edu

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*Michael J. Borden**

I. INTRODUCTION

  This paper will examine some theoretical aspects of contractual non-disclosure and the related doctrine of unilateral mistake. These two legal

rubrics are conceptually similar;[1] each is concerned with the degree to which parties must communicate their understandings about the nature of the contract into which they are about to enter. If one party fails to reveal enough information, the other party may enter into the agreement under a misunderstanding and consequently may attempt to avoid contractual liability on the basis of mistake or on a theory of nondisclosure. The law of contracts clearly attaches a great deal of importance to ensuring that contracting parties have a mutual understanding about their agreement – a meeting of the minds[2] – for that is the cornerstone of mutual assent. Indeed, one of the foundational theoretical goals of contract doctrine is to establish rules of law that will induce parties to reveal information that will reduce the cost of contracting and minimize the negative effects of breach. This "information forcing" concept has received substantial attention by many leading scholars as the animating principle behind the rule of *Hadley v. Baxendale*,[3] which limits consequential damages to those that are foreseeable (i.e., those that have been communicated by the party seeking damages).[4]

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1. Throughout this paper I occasionally use these terms interchangeably. On a doctrinal level the concepts are, of course, not strictly coterminous; thus I differentiate them where necessary in doctrinal discussions. However, much of this paper is concerned with the theoretical implications of mistake and nondisclosure, and at the theoretical level, the two concepts converge as one considers the question framed by Anthony Kronman: "[I]f one party to a contract knows or has reason to know that the other party is mistaken about a particular fact, does the knowledgeable party have a duty to speak up or may he remain silent and capitalize on the other party's error?" Anthony T. Kronman, *Mistake, Disclosure, Information, and the Law of Contracts*, 7 J. LEGAL STUD. 1, 1-2 (1978). As will become apparent, my primary focus is upon nondisclosure.

2. At least, of course, as disclosed through the objective manifestations of their intentions. *See* E. Allan Farnsworth, *Meaning in the Law of Contracts*, 76 YALE L.J. 939, 942-51 (1967).

3. 156 Eng. Rep. 145 (Ex. Ct. 1854).

4. *See generally, e.g.*, Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87 (1989); Lucian Arye Bebchuk & Steven Shavell, *Information and the Scope of Liability for Breach of Contract: The Rule of* Hadley v. Baxendale, 7. J.L. ECON. & ORG. 284 (1991) (developing a model in which socially desirable behavior of buyers and sellers and their behavior under alternative rules is characterized); Charles J. Goetz & Robert E. Scott, *Enforcing Promises: An Examination of the Basis of Contract*, 89 YALE L.J. 1261 (1980) (arguing that limiting damages for unforeseeable consequences of breach can increase efficiency by inducing bargainers to provide information); Charles J. Goetz & Robert E. Scott, *Liquidated Damages, Penalties and the Just Compensation Principle: Some Notes on an Enforcement Model and a Theory of Efficient Breach*, 77

Yet there are, naturally, times when forcing parties to reveal their private information is not desirable. The very nature of market transactions dictates that trade is on one level the result of a seller who values his goods less highly than the buyer. While in cases where both parties enjoy full information, this disparity in valuation is often caused by circumstances affecting the relative need of the parties for the good – a pharmacist would not sell his last bottle of aspirin if he were suffering a migraine. In many other cases, the disparity can be explained by the fact that one party knows something the other doesn't know – the seller of a used car may know that the oil had never been changed for the first 50,000 miles. The buyer of a parcel of swamp land may know that the local government is in the early planning stages of a drainage and development project that will greatly enhance the land's value. Sometimes the law requires full disclosure, while at other times it does not.[5] This ambivalence about disclosure results in a tension which occasionally expresses itself in disputes over whether or not a party to a contract had lived up to his disclosure obligations, and whether, as a result of incomplete information, the less well-informed party is entitled to relief in the form of rescission.

This article focuses on the commentary the law of buyer nondisclosure has generated in the last 30 years,[6] in particular a 1978 article by Professor

COLUM. L. REV. 554 (1977) (asserting that disclosure of idiosyncratic value during negotiations can result in more equitable damages); Robert E. Scott, *A Relational Theory of Default Rules for Commercial Contracts*, 19 J. LEGAL STUD. 597, 609-10 (1990).

5. *See* RESTATEMENT (SECOND) OF CONTRACTS § 161 (1981); E. ALLAN FARNSWORTH, CONTRACTS §§ 4.9-4.15, at 241-64 (3d ed. 1999). Some of the uncertainty in the law of nondisclosure reflects the fact that certain informational asymmetries (the lemon automobile transaction, for example) lead to inefficient transactions, while others may not.

6. Numerous scholars have written on mistake and nondisclosure; indeed, P. S. Atiyah asserted that "[mistake] has proved a fruitful source of academic controversy, and a cynic might conclude that no teacher of the law of contract was worthy of the name unless he had produced at least one paper on the subject." P. S. ATIYAH, AN INTRODUCTION TO THE LAW OF CONTRACT 42 (1961). *See, e.g.,* E. ALLAN FARNSWORTH, ALLEVIATING MISTAKES: REVERSAL AND FORGIVENESS FOR FLAWED PERCEPTIONS (2004); Omri Ben-Shahar & Lisa Bernstein, *The Secrecy Interest in Contract Law,* 109 YALE L.J. 1885 (2000); Robert L. Birmingham, *The Duty to Disclose and the Prisoner's Dilemma: Laidlaw v. Organ,* 29 WM. & MARY L. REV 249 (1988); Kevin E. Davis, *Promissory Fraud: A Cost-Benefit Analysis,* 2004 WIS. L. REV. 535; Deborah A. DeMott, *Do You Have the Right to Remain Silent?: Duties of Disclosure in Business Transactions,* 19 DEL. J. CORP. L. 65 (1994); Melvin A. Eisenberg, *Disclosure in Contract Law,* 91 CAL. L. REV. 1645 (2003); Andrew Kull, *Unilateral Mistake: The Baseball Card Case,* 70 WASH. U. L.Q. 57 (1992); Eric A. Posner, *Economic Analysis of Contract Law After Three Decades: Success or Failure?,* 112 YALE L.J. 829 (2003); Eric Rasmusen & Ian Ayres, *Mutual and Unilateral Mistake in Contract Law,* 22 J. LEGAL STUD. 309 (1993); Alan Strudler, *Moral Complexity in the Law of Nondisclosure,* 45 UCLA L. REV. 337 (1997); Christopher T.

Anthony Kronman[7] and a 1982 article by Professor Saul Levmore.[8] Kronman argued that, when a buyer of a good has discovered heretofore unknown information about that good as a result of a deliberate search, the law should not impose a duty to disclose that information lest the buyer forfeit to the seller the profit of his search and be stripped of his incentive to generate the socially beneficial information.[9] Levmore took Kronman's analysis as a starting point and concluded that the protection buyers with specialized information needed could not be provided by the "silence-is-golden" rule Kronman proposed.[10] Levmore argued that in order to protect such a buyer's ability to capitalize on his private information, and thus preserve future parties' incentive to develop socially beneficial information, a rule of "optimal dishonesty" was required; such a rule would permit the buyer to lie during negotiations, an action that would otherwise constitute fraud.[11] In Part II, I will describe the doctrinal backdrop against which Kronman and others were working and will explain their arguments in greater detail.

Kronman's analysis formed the bedrock of what has become a fairly settled area of contracts scholarship, at least among law and economics scholars.[12] I do not intend to challenge the insights he and Levmore have contributed.[13] Instead, I will demonstrate in Part III that the model upon which these and other modern scholars have based their discussions of buyer nondisclosure is structurally limited, and I will attempt to extend their analysis by introducing and examining a richer model.[14] I will then address the question

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Wonnell, *The Structure of a General Theory of Nondisclosure*, 41 CASE W. RES. L. REV. 329 (1991).

7. Kronman, *supra* note 1.

8. Saul Levmore, *Securities and Secrets: Insider Trading and the Law of Contracts*, 68 VA. L. REV. 117 (1982).

9. Kronman, *supra* note 1, at 13-14.

10. Levmore, *supra* note 8, at 137-38.

11. *Id.* at 139-40.

12. This is not to suggest that his analysis has been universally accepted, but rather that the modern analysis seems to have coalesced around a center of gravity established by Kronman's 1978 article. *See, e.g.*, Birmingham, *supra* note 6 (criticizing Kronman's reading of the case law on nondisclosure); Jules L. Coleman, Douglas D. Heckathorn & Steven M. Maser, *A Bargaining Theory Approach to Default Provisions and Disclosure in Contract Law, in* LIABILITY AND RESPONSIBILITY 173, 235-39 (R.G. Frey & Christopher W. Morris eds., 1991) (critiquing Kronman's claim that protecting a property right in information is efficient).

13. This statement is true regarding Kronman. However, in Part IV's examination of the effect of competing legal rules under my Model, I will at first assume the validity of Levmore's claim about the efficiency of a rule permitting lying. I will ultimately make an argument expressing some doubt about his claim as I attempt to resolve what I reveal to be a conflict between his rule and one I propose. *See infra* Part V.

14. A careful reading of this literature reveals that prior analysis of buyer nondisclosure has consistently focused on factual scenarios in which only one party – the

of which legal rule is the most appropriate to govern the enriched model. I will conclude that in my model, preserving the buyer's incentive to invest in information does not necessarily require the rule Levmore suggested (Optimal Dishonesty) – a rule that, to some extent, offends traditional contract doctrine and theories of contract that are rooted in morality.[15] Further, by emphasizing the communicative or signaling effects of silence, I will suggest that in many contexts, the Silence is Golden rule is conceptually unstable and should not be addressed as a distinct rule in my analysis.[16]

In Part IV, I will compare the efficiency of Levmore's rule to a rule requiring minimal truthful disclosure (which I term a "Word to the Wise" rule) in the context of my model. I will argue that in this model, a Word to the Wise rule is just as efficient as, or only slightly less efficient than a rule of Optimal Dishonesty. But I will not limit my analysis of the appropriate disclosure rule to considerations of efficiency. This article departs from the theoretical monism inherent in economic analysis and often adhered to in autonomy-based contract theory. Instead, I offer a pluralistic approach to the problem this article explores.[17] Thus, in Part V, I discuss whether any compelling reason outside the realm of efficiency militates in favor of a Word to the Wise rule. Finally, I will offer my conclusion that in a model of two-sided informational inputs, a Word to the Wise rule is the better rule, given a multitude of considerations, including efficiency, longstanding contract doctrine, fairness and a perspective from intellectual property theory.

II. CURRENT LAW AND COMMENTARY

A. The Doctrine

Unilateral mistake and inadequate disclosure have long been available as the basis of an attack on the enforcement of contracts.[18] While some commentators have suggested that the law of contracts traditionally never allowed relief to a party on the basis of a unilateral mistake,[19] Corbin's trea-

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buyer – has invested significantly in information affecting the value of the thing being sold. I describe these scenarios as representing a model of one-sided informational inputs. The model I put forth in this article is a model of two-sided informational inputs, where both the buyer and seller have invested substantially in information before the transaction. I describe the two models in detail in Part III.

15. *See infra* Part V.

16. *See infra* Part III.C.

17. *See* Jody S. Kraus, *Reconciling Autonomy and Efficiency in Contract Law: The Vertical Integration Strategy*, 11 PHIL. ISSUES 420, 420-22 (2001). For a brief discussion of monism and pluralism in contract theory, see *infra* Part V.

18. *See* MORTON J. HORWITZ, THE TRANSFORMATION OF AMERICAN LAW, 1780-1860, 263 (1977).

19. *See* Roland R. Foulke, *Mistake in the Formation and Performance of a Contract*, 11 COLUM. L. REV. 197, 11 COLUM. L. REV 299 (1911).

tise explains that the law of contracts has never been so rigid as to categorically exclude the claims of parties who have entered into a contract under a mistaken notion about the identity or value of the asset being bought or sold.[20] Many cases have illustrated this point,[21] ranging from the celebrated United States Supreme Court case of *Laidlaw v. Organ*[22] which concerned a seller's mistake as to the value of a quantity of tobacco, to more recent cases involving misapprehensions about the value of paintings,[23] real property,[24] baseball cards[25] and construction bids.[26]

The simplest of these cases are those involving clerical mistakes in the compilation of bids by general contractors. In these cases, courts have allowed bidders to avoid contracts where, because of transcription or arithmetic errors, they have committed themselves to providing goods and services at prices below their fair market value.[27] These cases have been decided either on the ground that there was no meeting of the minds or that it would be unconscionable to enforce a contract based on such an error, often taking into account whether the non-mistaken party had detrimentally relied on the bid.[28]

Similarly unproblematic have been nondisclosure cases involving home sale transactions where the property contained some hidden defect unknown to the buyer until after the completion of the transaction.[29] The classic example involves the sale of a home which turns out to be infested with termites. The seller is held to have a duty to disclose because the condition was "clear-

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20. JOSEPH M. PERILLO, 7 CORBIN ON CONTRACTS: AVOIDANCE AND REFORMATION § 28.39, at 223-24 (rev. ed. 2002).

21. Some of these cases, it should be noted, are hypotheticals proffered by the drafters of the *Restatement (First) of Restitution* and the *Restatement (Second) of Contracts*.

22. 15 U.S. (2 Wheat.) 178 (1817).

23. Estate of Nelson v. Rice, 12 P.3d 238 (Ariz. Ct. App. 2000) (denying rescission of contract to sell painting because seller was aware of its ignorance of the value of the painting).

24. Obde v. Schlemeyer, 353 P.2d 672 (Wash. 1960); Shrum v. Zeltwanger, 559 P.2d 1384 (Wyo. 1977).

25. In a 1990 Illinois case, a twelve-year-old boy entered a trading card shop and purchased for $12.00 a baseball he knew to be worth $1,200.00. Although the case was settled before any adjudication, Andrew Kull has demonstrated that the mistake committed by the sales clerk would likely have been voidable under the RESTATEMENT (SECOND) OF CONTRACTS § 161(d) (1981). *See* Kull, *supra* note 6, at 62-63.

26. *See, e.g.*, Elsinore Union Elementary Sch. Dist. v. Kastorff, 353 P.2d 713 (Cal. 1960); Boise Junior Coll. Dist. v. Mattefs Constr. Co., 450 P.2d 604 (Idaho 1969).

27. *See Elsinore Union Elementary Sch. Dist.*, 353 P.2d 713; *Boise Junior Coll. Dist.*, 450 P.2d 604.

28. *See* FARNSWORTH, *supra* note 5, § 9.4, at 631-37.

29. *See, e.g.*, Hill v. Jones, 725 P.2d 1115 (Ariz. Ct. App. 1986); *Obde*, 353 P.2d at 672.

ly latent – not readily observable upon reasonable inspection."[30] In an oft-cited example of such a case, *Obde v. Schlemeyer*, the court grounded its decision on considerations of "justice, equity and fair dealing."[31]

Somewhat more difficult cases of unilateral mistake and nondisclosure have involved the sale of a good by a merchant, where the item sold was worth substantially more than the seller thought. An interesting example of such a case, and a wellspring of American jurisprudence on buyer non-disclosure, is *Laidlaw v. Organ*.[32] *Laidlaw* involved a dispute over the sale of a load of tobacco in 1815 just as the War of 1812 was drawing to a close. One result of the War had been a naval blockade of New Orleans which severely limited the volume of trade in and out of the city. Organ, a New Orleans tobacco dealer, had obtained advance notice of the signing of the Treaty of Ghent, which formally ended the War and signaled the lifting of the blockade.[33] Hours before the news was made public, Organ approached the Laidlaw firm and signed an agreement for the purchase of 111 hogsheads of tobacco.[34] Before the contract was signed, Laidlaw's representative asked Organ "if there was any news which was calculated to enhance the price or value of the article about to be purchased."[35] The record does not reveal what response, if any, Organ made. When the news of the treaty spread, the market price of tobacco rose precipitously, and Laidlaw's agent refused to deliver the tobacco as he had promised.[36]

Much is unclear about the ultimate resolution of this case, but Chief Justice Marshall's opinion is noteworthy for the following dicta:

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30. *Id.* at 675.

31. *Id.* Kronman explains the result in *Obde* by noting that requiring seller disclosure would be unlikely to reduce the level of informational investment by homeowners below an inefficient level. Kronman, *supra* note 1, at 25.

32. 15 U.S. (2 Wheat.) 178 (1817).

33. Although the opinion in *Laidlaw* explains that Organ learned of the lifting of the blockade from sailors bringing the news from Europe, some details about Organ's relationship with those seamen remain unclear. The lack of clarity about this relationship has important theoretical ramifications for Kronman and others who have pursued his initial insights. The key unanswered question is whether his tip was fortuitous or was rather the result of his investment in a network of information carriers. If the former, Kronman would see less reason to enforce the contract; if the latter, nondisclosure is appropriate and the contract should be enforced. *See* Kronman, *supra* note 1 (stressing that nondisclosure should be allowed where the buyer's secret information is the result of a purposeful search, but not where it came fortuitously).

34. *Laidlaw*, 15 U.S. (2 Wheat.) at 179.

35. *Id.* at 183. It is precisely this sort of question that led Levmore to argue that efficiency demands that the law permit lying, for if Organ had refused to answer the question (which would have been the rational response under Kronman's analysis), Laidlaw would likely have taken the non-answer as an affirmative Yes. Levmore's claim will be explained more fully below. *See infra* Part II.B.2.

36. *Laidlaw*, 15 U.S. (2 Wheat.) 178.

> The question in this case is, whether the intelligence of extrinsic
> circumstances, which might influence the price of the commodity,
> and which was exclusively within the knowledge of the vendee,
> ought to have been communicated by him to the vendor? The
> court is of opinion that he was not bound to communicate it. It
> would be difficult to circumscribe the contrary doctrine within
> proper limits, where the means of intelligence are equally accessi-
> ble to both parties. But at the same time, each party must take care
> not to say or do any thing tending to impose upon the other.[37]

Despite the opinion's incompleteness regarding certain elements (e.g.,
who won in the lower court, what happened on remand, or how Organ had
responded to Laidlaw's question), what is clear is that Marshall, to some de-
gree, anticipated the law and economics approach to the problem before
him.[38] His ruling tacitly applied Kronman's approach: a buyer whose efforts
yielded him an informational advantage was under no obligation to disclose.
This rule, as Kronman noted, "rewards the intelligence and industry of the
party with the special knowledge."[39] But the decision lacked the steadfast-
ness of a modern economics-driven adjudication, for in requiring the parties
not to "impose" upon one another (whatever that means), Marshall tempered
efficiency with fairness.[40]

After *Laidlaw* came numerous cases, either in the courts or in the fertile
imaginings of the drafters of the Restatements, presenting variations on the
basic fact pattern.[41] Scholars have devoted considerable energy to explaining
and harmonizing the many disparate approaches courts have taken in adjudi-
cating these cases, but a truly comprehensive theory of nondisclosure has
proven elusive.[42] In cases involving construction bids,[43] real property,[44]

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37. *Id.* at 194.

38. Whether or not one agrees with this reading of *Laidlaw*, modern legal econ-
omists would also approve of Marshall's opinion for its emphasis on the institutional
limitations of the judiciary in resolving disputes like this one.

39. Kronman, *supra* note 1, at 11.

40. If we accept that Marshall's opinion is consistent with an economic approach
to nondisclosure, we must also recognize that the case is an early example of a theo-
retically pluralistic judicial approach to contract adjudication, simultaneously empha-
sizing multiple values including efficiency, morality, and institutional capacity. *See
infra* Part V.

41. *See, e.g.*, RESTATEMENT (SECOND) OF CONTRACTS § 161, cmt. d, illus. 4-11
(1981).

42. Kimberly Krawiec and Kathryn Zeiler have undertaken an exhaustive empir-
ical examination of the various theories attempting to explain why courts sometimes
enforce contracts despite material nondisclosure and sometimes do not. The authors
conclude that none of the myriad theories of nondisclosure developed after Kron-
man's 1978 article adequately explains the case law. *See* Kimberly D. Krawiec &
Kathryn Zeiler, *Common-Law Disclosure Duties and the Sin of Omission: Testing the
Meta-Theories*, 91 VA. L. REV 1795 (2005) (demonstrating, through an empirical

paintings,[45] or violins,[46] the results may have turned on many fact-driven variables.[47] As the *Restatement (First) of Restitution* suggests,[48] and some commentators have argued, mistakes about market conditions should be treated differently than mistakes about the product.[49] Some cases turn on whether the seller was sufficiently expert in dealing with his wares or whether the item was shelved erroneously with items of lesser value,[50] and the hair-splitting goes on and on.[51]

It is not the purpose of this paper to undertake a taxonomy of the cases and harmonize them based upon their factual distinctions and the rationales offered by courts and commentators. Rather than explore the permutations of these factual circumstances and the outcomes they suggest, I will proceed by explaining how the predominant economic analysis, as initiated by Professor Kronman, addresses cases involving buyer nondisclosure, particularly where the buyer obtained his private information as the result of a deliberate search for socially useful information.

B. The Commentary

Professor Kronman's influential 1978 article marked the beginning of the modern era in scholarship on nondisclosure. Much commentary followed,[52] but in this discussion I will focus primarily on the work of Kronman, Saul Levmore, and, to a lesser extent, Kim Lane Scheppele.[53] Kronman and

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study of 466 cases, the inadequacy of all the academic attempts to harmonize the nondisclosure cases into an explanatory and predictive theory and concluding that the theoretical underpinnings of the doctrine are hopelessly scattered).

43. *See* O'Neill v. Broadview, Inc., 112 So. 2d 280 (Fla. Dist. Ct. App. 1959); Wil-Fred's, Inc. v. Metro. Sanitary Dist., 372 N.E.2d 946 (Ill. App. Ct. 1978); John J. Calnan Co. v. Talsma Builders, Inc., 367 N.E.2d 695 (Ill. 1977).

44. RESTATEMENT (SECOND) OF CONTRACTS § 161 cmt. d, illus. 7; Wilkin v. 1st Source Bank, 548 N.E.2d 170 (Ind. Ct. App. 1990); Bailey v. Musumeci, 591 A.2d 1316 (N.H. 1991); Ross v. Eichman, 529 A.2d 941 (N.H. 1987).

45. Estate of Nelson v. Rice, 12 P.3d 238 (Ariz. Ct. App. 2000).

46. RESTATEMENT (SECOND) OF CONTRACTS § 152 cmt. g, illus. 14; Smith v. Zimbalist, 38 P.2d 170 (Cal. Dist. Ct. App. 1934).

47. *See* Krawiec & Zeiler, *supra* note 42.

48. RESTATEMENT (FIRST) OF RESTITUTION § 12, cmt. c, illus. 8-9 (1937); *cf.* Laidlaw v. Organ, 15 U.S. (2 Wheat.) 178 (1817).

49. Kronman, *supra* note 1, at 17-18.

50. The *Restatement (First) of Restitution* draws a distinction between such cases, granting relief to the seller only in the latter case. RESTATEMENT (FIRST) OF RESTITUTION § 12, cmt. c, illus. 8-9.

51. *See* Krawiec & Zeiler, *supra* note 42.

52. *See, e.g.*, Birmingham, *supra* note 6; Davis, *supra* note 6; DeMott, *supra* note 6; Eisenberg, *supra* note 6; Kull, *supra* note 6; Rasmusen & Ayres, *supra* note 6; Strudler, *supra* note 6; Wonnell, *supra* note 6.

53. KIM LANE SCHEPPELE, LEGAL SECRETS (1988).

Levmore approached the problem from an economic perspective, searching for rules that would induce efficient levels of investment in information. Scheppele took a different approach, analyzing the problem in terms of her theory of deep and shallow secrets and asking Rawlsian questions about the best legal rule, rather than staking her analysis on the pursuit of efficiency.[54] Charles Fried and Michael Trebilcock are among those who have commented on this problem from a non-consequentialist point of view.[55] Part V will address these deontological perspectives.

1. Kronman's Approach

A significant portion of Professor Kronman's analysis focused on the following scenario, which he drew from a dispute involving Texas Gulf Sulphur's purchase of rights in a tract of land in Ontario, Canada. Texas Gulf Sulphur had invested a great deal of money and time conducting aerial surveys of land in the region and had concluded that there was a likelihood of valuable mineral deposits under farmland owned by the estate of Murray Hendrie. Armed with this discovery, Texas Gulf Sulphur purchased for $500 an option on mineral and surface rights in the Hendrie property. By the option's terms, within two years following its execution, Texas Gulf Sulphur could obtain mining rights on the property for the price of $18,000. As it turned out, copper, silver and zinc deposits under the Hendrie tract were worth something on the order of one billion dollars. The representatives of the estate were none too pleased, even though they had retained a right to ten percent of the profits in the event substantial deposits were discovered.[56] The estate sued, seeking relief on theories of mutual mistake and nondisclosure.

Kronman used the dispute as the basis for his analysis, focusing his attention on whether the law should require a buyer to disclose information he has developed through his deliberate search – his investment in technology.[57]

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54. Scheppele's analysis has endured criticism from various quarters. *See, e.g.,* Marc Ramsay, *The Buyer/Seller Asymmetry: Corrective Justice and Material Non-Disclosure*, 56 U. TORONTO L.J. 115 (2006). But it remains useful both for its terminology and as a jumping off point for a Rawlsian analysis.

55. *See* CHARLES FRIED, CONTRACT AS PROMISE (1981); MICHAEL J. TREBILCOCK, THE LIMITS OF FREEDOM OF CONTRACT (1993).

56. For a thorough discussion of the facts surrounding the purchase of rights on the Hendrie property, and the parties' settlement of their lawsuit, see MORTON SHULMAN, THE BILLION DOLLAR WINDFALL (1970).

57. Kronman and numerous other scholars have based their analysis of buyer's nondisclosure on the Texas Gulf Sulphur experience without slavish adherence to the actual facts. For example, little attention is paid in the literature to the fact that the actual seller was the Royal Trust Company, trustee of Murray Hendrie's estate, and of its indisputable sophistication. Indeed, Kronman is one of the few who highlight the fact that the sellers of the interest in the mining rights reaped some $100,000,000 for their trouble as a result of retaining a 10% interest in the profits from any mine that might be discovered. SHULMAN, *supra* note 56, at 80. Hereafter, we will depart from

Kronman's answer is a resounding No. In this instance, because the buyer has invested in information that is socially useful, a rule requiring that he disclose that information before completing the transaction is undesirable as it would inevitably result in the seller refusing to sell at a price that reflects his original, unenlightened understanding about the value of the asset.[58] Such a rule would, in turn, strip future actors of their incentive to invest in information that would be socially (and privately) useful.[59] Owning all the property rights in the asset, the seller, if he were entitled to learn the buyer's special information, would gain for himself the surplus generated by the buyer's efforts. The appropriate legal response, said Kronman, would be for the law to permit the buyer to remain silent about his information, thereby creating and protecting for the buyer a property interest in his information and thus preserving his incentive to deliberately acquire socially useful information.[60] As Kronman put it:

> One effective way of insuring that an individual will benefit from the possession of information . . . is to assign him a property right in the information itself – a right or entitlement to invoke the coercive machinery of the state in order to exclude others from its use and enjoyment. The benefits of possession become secure only when the state transforms the possessor of information into an owner by investing him with a legally enforceable property right of some sort or other.[61]

2. Levmore's Contribution

Saul Levmore advanced Kronman's analysis when he examined the same factual scenario and argued that Kronman's proposed Silence is Golden rule does not go far enough.[62] Levmore recognized that prudent sellers bargaining in the shadow of the law would learn to ask important questions such as, "Do you have any information about natural resources such as gas, oil, and minerals, proposed legislation, nearby construction, or the like, such that if I share your knowledge, I would be likely to increase my sale price by ten percent or more?"[63] Truthful answers to such questions would obviously reveal the information and allow the seller to free ride on the buyer's invest-

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significant fidelity to the actual facts of the dispute. A stylized version or versions of the facts of this dispute has overtaken the discourse on buyer nondisclosure, and I continue in this convention of treating this transaction as one between the mineral prospector and the wheat farmer.

58. *See* Kronman, *supra* note 1, at 16.
59. *Id.*
60. *Id.* at 14.
61. *Id.*
62. Levmore, *supra* note 8, at 137-38.
63. *Id.* at 139.

ments in information either by demanding a higher price for the asset or by refusing to deal and extracting the mineral himself.[64]

Levmore pointed out that the Silence is Golden rule does not protect Kronman's buyer because such a rule is worthless in the face of the clever questioning seller. The buyer who responds to such a question with silence has spoken volumes.[65] The seller is perfectly able to deduce the answer and probably to figure out, at least approximately, what his original mistake was. The rationally self-interested buyer sees that his only real choice is to deny that there is any such information. Levmore therefore asserted that the only effective way to accomplish Kronman's goal of protecting the Buyer's property interest in his information is to adopt a rule that permits lying in such cases.[66] While recognizing that such deceit would ordinarily constitute actionable fraud, Levmore argued that permitting this sort of deception would be socially useful because it would protect searchers' incentives to invest in research that will inure to the common good.[67]

3. Scheppele

In her book, *Legal Secrets*, Kim Lane Scheppele explores nondisclosure in several settings. Scheppele's analysis provides a distinction between what she calls deep and shallow secrets. According to Scheppele, "when the target suspects that there might be a secret, we find shallow secrets. When the target is completely in the dark, never imagining that relevant information might be had, we find deep secrets."[68] With shallow secrets, Levmore's pointed questions can be asked, and the asker, as Scheppele asserts, has a legal right to the truthful answer.[69] With deep secrets, Scheppele claims that no such questions will be asked and thus no lying is required nor, one might conclude, is any legal rule permitting lying.[70] Yet Scheppele finds this unsettling.

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64. *Id.* In some cases, a truthful answer of "yes" would reveal only the *existence* of some information. In other cases, such a truthful answer would reveal the information itself. The distinction between these two cases lies at the heart of the distinction between the model of nondisclosure I put forward in Part III of this article and the model of nondisclosure addressed by Kronman, Levmore and many others.

65. *Id.* at 137.

66. *Id.* at 139-40.

67. *Id.* at 140. Levmore's argument in favor of lying has a certain logical appeal and does seem to provide a safer legal environment for parties who may invest in socially useful information. Although it may appear to promote efficient transactions as a rule governing disclosure in particular cases, one should not overlook the fact his rule would erode all parties' overall confidence in the trustworthiness of their contracting partners and, to that extent, would reduce efficiency in contract law. *See infra* Part IV. A.

68. SCHEPPELE, *supra* note 53, at 21 (emphasis omitted).

69. *Id.*

70. *Id.*

If the targets have no idea that the information exists, let alone what the information consists of, then the targets have a more forceful case that the secret amounts to fraud. The targets cannot protect themselves against information they cannot imagine, and so the secret-keeper can always gain advantage at the expense of the target.[71]

As an example, the secret in *Laidlaw v. Organ* was a shallow secret because Laidlaw's agent was sufficiently clued in to ask whether there was any news he should know.[72] He essentially asked Levmore's question. Had the buyer answered truthfully, he would not have been able to obtain the tobacco at the favorable price and would have transferred to the seller the monetary value he would otherwise have captured in the ensuing sale.[73] Similarly, under Scheppele's distinction, oil, baseball cards, rare books and paintings

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71. *Id.* More will be said about Scheppele in Part V. A brief introduction to her theory is useful here because her deep/shallow secret construct sheds some light on the distinction between the Standard Model and the Two-Sided Model I introduce in Part III and provides some useful vocabulary for that discussion. Moreover, Scheppele's work stands as a prominent example of a theoretical inquiry into buyer nondisclosure from outside of the law and economics perspective.

72. 15 U.S. (2 Wheat.) 178, 183 (1817).

73. In characterizing this outcome as a transfer, I have trod upon somewhat contentious ground. Kronman's analysis of *Laidlaw* stated that the information Organ possessed concerning the signing of the Treaty of Ghent was, in fact, socially useful insofar as the sale price of the transaction operated as a signal to the market about the value of tobacco. He claimed that the transaction helped bring the information about the War to the market which, by extension, conveyed information to farmers about what crops to plant. In a 1988 article, Robert Birmingham challenged Kronman's conclusion that Organ's information produced any social gain, claiming instead that the transaction embodied only a transfer payment with Organ getting more money and Laidlaw getting less. Birmingham points out that the case report states that the contract was executed soon after sunrise on February 19, 1815, and that the news of the end of the war was made public at eight o'clock that morning. Displaying his realist stripes, Birmingham puts the damning question to Kronman, "How long before eight o'clock is a sunrise in winter in New Orleans?" *See* Birmingham, *supra* note 6, at 270-71. Whatever one thinks about the Efficient Capital Market Hypothesis and the 20 minutes it takes for the market to impact information into share price, it seems unlikely that much impacting took place that February morning nearly two centuries ago. As a result, it does seem as though the *Laidlaw* transaction only involved a transfer.

Birmingham's point stems from Jack Hirshleifer's distinction between "foreknowledge" and "discovery." Jack Hirshleifer, *The Private and Social Value of Information and the Reward to Inventive Activity*, 61 AM. ECON. REV. 561 (1971). Foreknowledge is knowledge that "will, in due time, be evident to all." *Id.* at 562. Such information involves "only the value of *priority* in time of superior knowledge." *Id.* By contrast, discovery is the "recognition of something that possibly already exists, though hidden from view" until the discovery is made. *Id.*

are all cases of shallow secrets. They may not exactly be shallow strictly in Scheppele's sense, but I propose a slight alteration in the definition of the term. They are shallow in the sense that they are easily discovered, provided the seller is given just a hint about his misapprehension of the true facts.

Yet these examples share more than this trait of shallowness. Each of the cases so far discussed in this paper can be said to fit into a model that has calcified and become the standard subject of analysis since Kronman's 1978 article.[74] I call this model the Standard Model or the One-Sided Information Model. In Section III, I will describe the Standard Model and explain its limitations. I will then introduce and explain a Two-Sided Model and discuss the effect on each model of the Kronman-Levmore approach.

III. TWO MODELS: AN EXAMINATION OF THE ONE-SIDED MODEL AND A COMPARISON WITH THE ENRICHED MODEL

A. The One-Sided Model

Whether we are talking about cases involving land with minerals underneath it, a hogshead of tobacco, a baseball card, or rare books, the model of buyer nondisclosure examined by Kronman and those who have followed him has been marked by a structural limitation that results from the factual similarities of these disputes. Let us consider Kronman's example.

In the *Texas Gulf Sulphur* case (as in all the cases mentioned in Part II), there was a seller in possession of an asset about whose identity and value he was mistaken. Along came a buyer who, because of his investment in information, became aware of the true value and identity of the asset. This model has four salient features. First, a seller sitting upon an inert asset; that is, a seller who is doing nothing but possessing the asset and using it as he finds it and as he understands it. Second, an inert asset: the ore is either there under the land or it is not; the painting is either valuable or it is not. We might describe this as the binary nature of the asset's existence.[75] Furthermore, there is nothing that the seller has done to affect the existence or value of the asset, and the asset is not changing. Third, a buyer who, by contrast, has an informational input that does affect the value of the asset. Fourth, the buyer's prior investment in information that has caused the asset to move to a higher value use. We can describe this model as the one-sided informational input

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74. I do not wish to suggest that all recent scholarship on nondisclosure has followed in Kronman's mode of analysis. Rather, I mean that whether the scholar has employed an efficiency- or autonomy-oriented analysis, or has agreed or disagreed with Kronman, the problem has consistently been modeled similarly by almost all who have approached it.

75. The binary nature of the asset's existence has been referred to by some economists as "discrete quality variation." Janet Kiholm Smith & Richard L. Smith, *Contract Law, Mutual Mistake, and Incentives to Produce and Disclose Information*, 19 J. LEGAL STUD. 467 (1990).

model because only the buyer has invested in information which affects the value of the asset being bought or sold.

Given these features, it is simple enough, from an economic perspective, to figure out the optimal rule to govern disputes arising after the sale of the asset when the seller claims that he was disadvantaged by his lack of information: the efficient rule is the one that assigns appropriate incentives for investment in information. Any rule that would force the buyer to reveal his information would, as pointed out by Kronman, Levmore, and others, strip the buyer of his incentive to create the information and would thus deprive society of the benefit of that information. Under such a rule, there would be no informational investment and thus no socially beneficial discovery of the ore.[76] As a consequence of the structure of the model, this analysis necessarily only takes account of one party's incentive to invest in information.

B. The Two-Sided Model

A different, and more complicated, problem is revealed if we enrich the model by considering a transaction in which both the buyer and the seller contribute informational inputs to a dynamic (as opposed to inert) asset. In such a model, the seller and the buyer each invest in information which affects the value of the asset.[77] We can call this model a Model of Two-Sided Informational Inputs (the Two-Sided Model). In examining this Two-Sided Model, the theorist must now reconsider what is the appropriate rule regarding pre-contractual disclosure of information, for the choice of a rule now affects both parties' incentives to invest in information. As an example of such a situation, consider the following hypothetical.

Seller is a pharmaceutical company whose product is a patented drug that controls diabetes. It is a medically important and profitable drug that

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76. Some might argue that, in some of the cases that fit into the standard model, requiring disclosure would not lead to social loss or would cause only negligible or temporary social loss. For example, in the case of a mispriced baseball card, surely a $7.00 Honus Wagner card would not last long on the shelf, and even if it did, so what? One response to this contention is that in the baseball card case, the informational investment was minimal and thus does not deserve the protection of a rule permitting nondisclosure. Kronman himself makes the distinction between casually and purposefully acquired information and maintains that the former is less deserving of protection under his theory. But my point at this juncture is not to question the adequacy of Kronman's theory, nor its ability to capture all cases. Rather, I wish to emphasize only that the factual scenarios analyzed consistently in the literature on nondisclosure fit into a pattern that I am describing as the Standard Model.

77. Steven Shavell has pointed out that in most transactions the seller has a pronounced advantage in the ability to acquire information about his asset for the simple reason that he alone possesses the asset. The *Texas Gulf Sulphur* case is but one example where the seller's exclusive possession of the asset does not prevent the buyer from developing information about it. Steven Shavell, *Acquisition and Disclosure of Information Prior to Sale*, 25 RAND J. ECON. 20, 34 (1994).

Seller has developed by dint of great financial investment in extensive scientific research. In Seller's hands, the drug is worth, say, $50 million. Unbeknownst to Seller, Buyer has been examining the chemical properties of the drug, and after exhaustive research and testing, Buyer has discovered that when combined with some of Buyer's own proprietary scientific processes and products, the diabetes drug can be transformed into a drug that will cure cancer. In Buyer's hands, the drug would be worth $10 billion. Buyer approaches Seller and offers to purchase all rights in the drug at a cost reflecting a premium over Buyer's estimate of the expected net present value of the future profits to flow from the marketing of the drug as a diabetes treatment.[78]

Here we have a case of two-sided informational inputs with a dynamic asset. Seller and Buyer have each invested in information affecting the value of the asset. As distinct from the mineral-rich land example, Seller has both created the asset and done all it can to maximize and realize its value. It has not merely been sitting on the asset oblivious to its potential uses and value.[79] Not only has Buyer invested in information to increase the value of the asset, but Seller has as well. So the salient features of the Two-Sided Model are, first, a seller who has invested in information. Second, a dynamic asset, that is, one which has changed in form and value as a result of the seller's inputs. Third, a buyer whose inputs will further increase the value of the asset. Fourth, a prior investment in information on the part of the buyer.

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78. By suggesting that Buyer will offer a premium over his estimate of Seller's expected net present value, I am contradicting finance theory, which suggests that a seller will sell at any price above his expected net present value. The introduction of a premium at this point is an expedient aimed simply at circumventing any negotiating difficulties, in order to introduce the hypothetical in a simplified form. Buyer's offering price will receive greater attention in Part IV.B.

79. Some might object to my description of the Standard Model on the following grounds. Given the historical description of the actual transaction that took place between the estate of Murray Hendrie and Texas Gulf Sulphur, it is unrealistic to premise an argument on the notion that the seller was unaware of the nature of its farmland. See SHULMAN, supra note 56, at 72-86. My response to this assertion is twofold. First, as has already been mentioned, there is a degree of stylization and infidelity to historical fact that pervades the scholarly analysis of the mineral-rich land scenario from Kronman onward. See supra note 58. Second, and more significantly, the primary focus of my argument is to demonstrate that Levmore's rule of Optimal Dishonesty is unnecessary in a Model of Two-Sided Informational inputs. Recall that Levmore's argument rests on the premise that a truthful answer, or even silence, in the face of a question such as, "Do you have any information about natural resources such as gas, oil, and minerals, proposed legislation, nearby construction, or the like, such that if I share your knowledge, I would be likely to increase my sale price by ten percent or more?" would effectively transfer the surplus created by the buyer's informational investment to the seller. Levmore, supra note 8, at 139. Given this premise, it is evident that Levmore himself has done away with adherence to the facts of the original dispute. Many other commentators have followed suit.

Now assume that Buyer has purchased all Seller's rights to the asset at the purchase price mentioned above. Once Seller recognizes that he has sold something of much greater value than he had originally thought, he wishes to recoup his asset by suing Buyer for rescission upon a theory of inadequate disclosure. What duty of disclosure should the law impose upon Buyer in this case?

Before I endeavor to answer that question, I will, in the next section, address the interrelationship between the Kronman-Levmore analysis and the structure of the standard One-Sided Model. Then, in Part IV, I will argue that a rule permitting lying is in many cases unnecessary in the Two-Sided Model. I will demonstrate that a rule requiring minimal, truthful disclosure preserves the buyer's incentive to invest in socially useful information without offending contract doctrine and traditional notions of fairness. I call this the Word to the Wise Rule.[80]

C. *An Explanation of Why the Structure of the One-Sided Model Necessitates the Kronman-Levmore Approach*

Initially, it is worthwhile to consider how the approaches of Kronman and Levmore are related to, and determined by, the structural features of the One-Sided Model. Recall that Kronman's approach would grant the buyer the right not to disclose his information. He could just buy the asset while remaining silent. Levmore, going a step further, argues that protecting the buyer's property interest in his information, and thus his incentive to invest at a socially optimal level, requires permitting the buyer to lie in response to sellers' questions about value. It is important to understand the connection between the desirability of these rules and the way the problem is modeled.

With one-sided information, especially in cases of shallow secrets, the problem for the buyer is that a word to the wise is sufficient to convey the vital information to the seller. If the purchaser of an under-priced baseball card or used book betrays his special knowledge even by merely raising an eyebrow portentously when he hears the price or failing to conceal his enthusiasm over the sale, he is likely to tip off the seller. The seller, while he has done nothing to affect the value of the asset, can be expected to understand the nature of his business sufficiently to recognize and interpret the signs of an over-anxious buyer. Having done so, he will re-price the asset or refuse to sell it, in either case appropriating all or a portion of the surplus to himself. Thus, either a right to remain silent or (per Levmore) a right to lie is needed to preserve the Buyer's incentive to invest in information.

Or, to take an example provided by Christopher Wonnell: suppose an art history professor walks into a garage sale and recognizes that a painting on

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80. I will demonstrate that, whereas a word to the wise is sufficient in the One-Sided Model, it is not sufficient in the Two-Sided Model.

sale for seven dollars is actually an obscure but very valuable work.[81] Won-nell explores the possibility that the expert might attempt to sell the informa-tion. Wonnell imagines the buyer 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."[82] At first, such a sale may seem plausible, but of course the buyer has, without explicitly revealing his secret, conveyed to the seller all the information he needs to avoid a mistake. It is not difficult to imagine the seller's thought process as he takes a quick peek around the garage: hmm, lawnmower – I don't think that's an antique; used baby cloth-ing, nope; Dutch oven, not valuable, etc. Even if the seller is only able to narrow his list of potentially valuable junk to his baseball cards, his costume jewelry and his painting, he will, with minimal further effort and cost, be able to decipher the offer and appropriate the professor's information to his sole benefit. Here we see again the shallowness of this sort of secret.

Wonnell's discussion of the difficulty involved in selling the informa-tion without revealing it hints at what I consider the inherent instability of the concept of nondisclosure (and thus the Silence is Golden rule) in the context of the One-Sided Model. As a practical matter, a rule that simply excuses the buyer from any duty to volunteer his private information does not necessarily function to allow the buyer to safeguard it. Recall that Levmore's rule of Optimal Dishonesty arises from the expectation that sellers will ask pointed questions about value before selling. Once alerted to the fact that something is amiss in the imminent transaction, the seller can pause a moment and an-swer even the unasked question for himself. Thus, neither Kronman's rule of nondisclosure nor the possibility of selling the information satisfactorily solves the information-protection problem posed in the One-Sided Model. If the goal is to reward and encourage investments in information, Levmore's rule seems preferable.

Kronman seems not to have fully accounted for the precariousness, or shallowness, of the buyer's secret.[83] By contrast, Levmore's discussion of the clever seller's questions emphasized his understanding that only a thin barrier separates the seller in the One-Sided Model from the information he needs to frustrate the buyer's plan. This is a key insight and the driving reason behind his advocacy for the more aggressive rule permitting lying.

Kronman was somewhat more sanguine about the buyer's ability to re-tain his private information during negotiations. He considered whether the buyer had any alternative ways of capitalizing on his information short of

81. Wonnell, *supra* note 6, at 342.
82. *Id.*
83. Kronman stated generally that a buyer with special information may simply sell his information to the other party. Kronman, *supra* note 1, at 15 n.42. To be fair, he did proceed to circumscribe that assertion by noting that such a transaction would not be so simple for the buyer in the *Texas Gulf Sulphur* case. *Id.* at 21 n.57 (describ-ing the free rider problem that would arise among neighboring landowners attempting to obtain the buyer's information without paying for it).

holding his tongue and buying the land.[84] Kronman explored whether the buyer could sell his information to the landowner.[85] Although he concluded that such a transaction would be unlikely to benefit the buyer (the seller in the information transaction), he minimized the significance of the fact that the buyer would have to "convince the landowners of the value of the information without actually disclosing it,"[86] implying that it is surmountable.

Instead, he emphasized that the true problem arises once the parties agreed that the seller ought to buy the as-yet-undisclosed information: the information cost to the landowner is too great to bear alone. The landowner would then round up his neighbors to purchase the information jointly and then would face the resulting free rider problems arising from the joint action.[87] The fact that Kronman rested this part of his analysis on the free rider problems facing the joint purchasers of the information shows that he was looking beyond the problem identified by Levmore – the problem that accounts for the difference between the rules that they advocate. Indeed, Kronman apparently believed that it is possible to negotiate a sale of the secret information without the landowner figuring out what is on the table, or under his land, and therefore avoid having to pay for it. As Kronman sees it, a word to the wise is not sufficient in this scenario. Levmore and I disagree.

To summarize, we have Kronman and Levmore insisting that the buyer needs the law to recognize and protect his proprietary interest in his private information by granting him a privilege or right to conceal information, essentially a right to completely exclude the seller from access to this information. The distinction between their positions – Kronman wants only a right not to speak whereas Levmore insists on a right to lie – is only about means, not ends, and Kronman would probably agree with Levmore about the need to protect lying, though he had the decency not to argue it.

Whether or not Kronman would believe that there is an important difference between his position and Levmore's, the fact remains that each author's view of the problem and its solution was substantially influenced by the way both modeled the problem. The reason a buyer needs the right to remain silent or to lie is inextricably linked to both the shallowness of the buyer's concealed information and the binary nature of the submersed value in the One-Sided Model. Either there are valuable minerals under the ground, or there

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84. *Id.* at 15 n.42, 21 n.57.

85. *Id.*

86. *Id.* at 21 n.57. For an account of the negotiations between Texas Gulf Sulphur and surrounding landowners, see SHULMAN, *supra* note 56.

87. The free rider problem Kronman is referring to is the fact that some of the surrounding landowners (who also have valuable minerals under their land) would wish to obtain TGS' information without paying for it, or by paying less than their share of the purchase price. If most of the neighbors had agreed to pool their money to buy the information, some might yet refuse to pay, betting that they could free ride on their neighbors' investment. This coordination problem could lead to the acquisition not taking place. *See* Kronman, *supra* note 1, at 21 n.57.

are not; the painting is rare and valuable, or it is not. No creativity on the part of the seller is required to develop the asset: it exists. One merely needs to recognize or even suspect that fact. With one-sided information and an inert asset, a word to the wise is thus sufficient to apprise the seller of its existence, and deprive the buyer of a return on his investment in information.

At this point, the seller is in a position similar to that of a chess player who is just about to complete his move by taking his finger off his piece when he reads the glee on the face of his opponent.[88] He restores the piece to its original position, and uses the momentary pause, or *locus poenitentiae,* to diagnose his miscalculation and avoid it. Although in chess, the erring player may, through earlier missteps, have already dug himself into an irredeemably deep hole, the seller in the One-Sided Model nondisclosure case can save himself in one move by merely telling the buyer that the product has been mispriced, or that it is no longer for sale.[89]

Likewise, in the One-Sided Model, unless the buyer has a great poker face or is entitled by the law to conceal or dissemble, the seller will, upon just a hint of the truth, be able to figure out the reality the buyer wishes to obscure.[90] Such a seller, upon reflection does not have to think too hard about why the buyer is so eager. Armed with even a small amount of information that would necessarily be transmitted by any rule less indulgent than Levmore's, the seller can avail himself of the momentary pause available to the player who has not removed his finger from the top of his figurative chess piece. The power to initiate this pause, essentially a preservation of the status quo, is precisely the prerogative of the holder of property rights that Kronman and Levmore have identified.[91] Only one party – the seller – can control the

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88. Please indulge the use of juvenile rules of chess. I play most often with my young daughter and permit her to make these sorts of provisional moves. The analogy remains useful.

89. This is something of a simplification. It is not difficult to imagine a scenario in which, because of prior actions of the parties, the seller finds himself in check or checkmate. Perhaps the seller has advertised that everything in the store is to be sold as is at posted slash and burn prices, his prices are INSANE. Or perhaps he has made the same representations to the buyer privately. Such particulars are dealt with under the rules of offer and acceptance. In order to retain the focus on the modeled forms of unilateral mistake, I wish to stick to the assumption that before the deal is consummated, the seller has not made an irrevocable offer.

90. Levmore has recognized the objection that the buyer can avoid this problem by engaging a representative to negotiate the transaction and not telling the agent about the existence of the minerals. He notes that this creates additional transaction costs, and, in the spirit of his initial insight, points out that just as surely as sellers will learn to ask the questions about the asset being sold, they'll learn to ask, "[o]n whose behalf are you purchasing this land?" Levmore, *supra* note 8, at 140.

91. But here I want to assert that the seller is not the only party in possession of property rights. While the seller has an indisputable right not to sell the asset he owns, the buyer also has a property right of sorts. Kronman has pointed out that as a descriptive matter, contract law creates a species of property rights in information "by

pace in this way, and this is the vital advantage the seller holds. During that pause, the seller would be able either to deduce that his asset is more valuable than he had thought or continue to ask questions. Those questions, whether put to the buyer or a third party, would quickly lead the seller to the truth about the value of his property.

It is this feature of the One-Sided Model – the fact that the value is right there under the seller's nose if he can just get someone to flip on the light switch for him – that necessitates the buyer-protective rules advocated by Kronman and Levmore. Without them, it is simply too easy for the seller to capitalize on his position as property owner to appropriate the value of the buyer's investment in information and at the same time leech him of his incentive to make such an investment.

To sum up, the nondisclosure rules advocated by Kronman and Levmore are necessary in the standard model of nondisclosure because of the shallowness of the information and its binary nature. Any rule requiring more from the buyer would give a strategic advantage to the seller allowing him to appropriate the entire surplus created by the buyer's efforts. This advantage would destroy the buyer's incentive to invest in information and, in many cases, prevent the release of value that benefits society.

Moreover, the foregoing suggests that it may not be functionally meaningful to characterize Kronman's rule as one that truly involves silence. Nondisclosure (i.e., saying nothing) in response to Levmore's question will undoubtedly convey information to the seller and may often convey all the information necessary to destroy the buyer's advantage.[92] For our purposes, then, the conceptual distinctness of a Silence is Golden rule is substantially diminished, as it tends to merge with a rule of full disclosure in the context of the One-Sided Model as I have described it. Furthermore, in view of the communicative character of nondisclosure, in the context of the Two-Sided Model, a Silence is Golden rule tends to merge with what I have termed a Word to the Wise rule – a rule requiring minimal truthful disclosure. Thus, in the next Part's discussion of the effect of competing legal rules in the context of the Two-Sided Information Model, I will confine my analysis to a comparison of Levmore's rule of Optimal Dishonesty and my Word to the Wise rule.

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permitting an informed party to enter – and enforce – contracts which his information suggests are profitable, without disclosing the information to the other party." Kronman, *supra* note 1, at 15. I will pursue this perspective further in Part VI.A.

92. Some argue that this disclosure is efficient because it sends signals to the market and leads to better pricing. *See* RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 111 (7th ed. 2007).

IV. RULE (EFFICIENCY) ANALYSIS IN THE MODEL OF TWO-SIDED INFORMATIONAL INPUTS

In this Part, I will compare the effects of Levmore's Optimal Dishonesty rule and my Word to the Wise rule within the context of the Two-Sided Model. Because this model involves investments in information by both the buyer and the seller, the comparison will necessarily explore the effects of the two rules on the incentives of both parties to invest in information. This analysis proceeds in the consequentialist economic mode of assessing the effects of legal rules on the parties' incentives to invest in information and basing conclusions about the desirability of such rules on their impact on aggregate social wealth. I present a series of four scenarios based on a single fact pattern but entertaining different assumptions about the behavior of the seller. The first scenario is the simplest and reflects the strongest example in support of my hypothesis that a rule of Optimal Dishonesty is unnecessary in a Two-Sided Model. This initial example is followed by a suite of three variations in which the seller behaves in predictable ways in response to the buyer's offer and which differ with respect to the result of the seller's own additional investment in research.

I will conclude that a Word to the Wise rule in the Two-Sided Model is, depending on certain assumptions and conjectures,[93] as efficient as, or only slightly less efficient than Levmore's rule of Optimal Dishonesty. Because the former rule is not subject to the doctrinal or moral objections that accompany the latter, it will ultimately prove to be the more desirable rule if one is to consider any mainstream normative perspective beyond economic efficiency. Therefore I will, in Part V, consider whether the deontological perspective of such contract theorists as Charles Fried provide any insights that might help resolve the conflict between the two rules.

A. Optimal Dishonesty in the Two-Sided Model

A rule of Optimal Dishonesty in the Two-Sided Model will yield basically the same efficiency analysis as it did under the Standard One-Sided Model, so I will not elaborate on it. To put it simply, the buyer will approach the seller with an offer and, in response to the seller's question about information affecting value, will lie and will garner the surplus created by his investment in information. In short, the buyer's right to lie preserves his incentive to invest in information and is thus efficient. But of course this rule offends both legal doctrine and broadly held notions of fairness. Moreover, such a rule is, to a significant degree, not necessary in the Two-Sided Model. When

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93. Here I am referring to conjectures I make in Part IV.B. These conjectures are my estimates about the probability of various courses of action the Seller may follow when he learns that the Buyer has some unspecified secret information. These estimates reflect significant empirical assumptions with which some may disagree.

the buyer approaches a seller who has already fully examined, comprehended and exploited the asset to the best of his ability, the buyer has little to lose from a bit of divulgence.[94] Whereas, in the Standard Model, the merest perception by the seller of some hidden value would cause the buyer to lose the entire transaction, the same cannot be said in the Two-Sided Model. Because the seller has had every opportunity to exploit his asset, there is little or no danger that he can divine the buyer's special use – his deep secret – even if told that the asset will be more valuable in the buyer's hands.[95]

B. *Word to the Wise in the Two-Sided Model*

1. Scenario One:

To illustrate the fact that a bit of disclosure about the existence of a more profitable use will not reveal the nature of that use, let us return to our hypothetical involving the pharmaceutical companies. Buyer makes an offer to purchase all of Seller's rights in the diabetes drug.[96] Assuming Buyer had sufficient financial information about Seller's business to make an attractive offer, Seller will behave rationally and sell the asset for any price above its expected net present value. This baseline outcome assumes no affirmative duty of disclosure and further assumes that Seller has not asked Buyer whether he has any special information about the asset.

Next, assume that, under a Word to the Wise rule, Buyer has truthfully answered Levmore's question about whether he has any information that would affect the value of the asset. Will Seller behave differently now that he knows Buyer has another use for the asset? One possibility is that he will not because he has exhausted the set of possible uses for the asset to the greatest extent of his abilities. The knowledge that Buyer may have an alternative higher value use for the asset may lead Seller to indulge in what I have referred to as the momentary pause. Indeed, that pause may last substantially longer than it would in a baseball card shop or a garage sale, but because the Seller has already invested heavily in information in developing the asset, he will not get far at all in guessing the special use. The essence of the special use is that it is the non-obvious result of specialized investment in information and the unique creative insights of Buyer. Unlike the minerals under the ground, this hidden value is not easily imagined or revealed. This scenario represents a particularly deep secret.

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94. The Model, viewed in this light, begins to resemble a standard corporate acquisition – the common scenario of an acquiring company wishing to purchase a division or subsidiary of another company. For a discussion of the relevance of this interpretation of the model, see *infra* Part VI.B.

95. Of course, if the buyer should make such a bold revelation, the seller can be expected to raise his asking price. This bargaining dynamic is discussed below.

96. For the sake of simplicity, we can assume that Seller owns all the shares of a corporation whose sole asset is the diabetes drug.

In this case, a word to the wise is not sufficient to tip off Seller. There being no simple way for Seller to figure out Buyer's secret knowledge merely because he knows that some such knowledge exists, it is not necessary to advocate a rule permitting lying in order to preserve Buyer's incentive to invest in information. This scenario represents the strongest case for the claim that in the Two-Sided Model, a Word to the Wise rule is as efficient as Levmore's Optimal Dishonesty rule.

The foregoing scenario under a Word to the Wise rule also reflects the simplest and most optimistic outcome of the transaction under the Two-Sided Model. It suggests the following conclusions. First, in contrast to the One-Sided Model, Buyer retains the surplus from the transaction notwithstanding the disclosure. Second, a bit of disclosure does convey some information that can affect the sale price and thus reduce some of Buyer's incentive because the expected profit from his informational investment will be smaller.[97] Third, because Buyer's incentive to invest in information is preserved, the social gains derived from Buyer's investment in information is also preserved. Fourth, Buyer does convey some information to Seller that, beyond affecting the sale price, might induce the Seller to invest further in information. This fourth observation indicates that there is another possible result of minimal disclosure that suggests a Word to the Wise rule might be somewhat more costly to Buyer.

2. Scenario Two: Effect of a Word to the Wise Rule on Seller's Incentive to Invest in Information

Upon hearing Buyer's offer and his confident, if reluctant assertion that yes, indeed there is some information in Buyer's possession that might lead Seller to raise his asking price, Seller might avail himself of that momentary pause and undertake to go back to the laboratory and do some research of his own. But, as we have noted, he has already brought this product as far as he can; that is one of the core premises of the model. Nevertheless, it is worthwhile to consider the possible outcomes of such an investment in information on the part of Seller. I will address these possible outcomes in order of their probability, starting with the one I deem most likely.[98]

One possibility is that Seller invests more in information and failing to discover Buyer's private information, sells to Buyer. Despite his inability to ascertain Buyer's secret information, Seller may at this stage engage in tougher bargaining and thereby extract some of the surplus created by Buyer's investment in information. Knowing that he is acting under imperfect information, the rational Seller would likely attempt to assess the value of the

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97. For a discussion of the effect of minimal disclosure under a Word to the Wise Rule on the pricing stage of negotiations, see *infra* Part IV.D.

98. Here I confess to the highly subjective and speculative nature of my ranking of the probabilities of these outcomes.

information, assess the likelihood that another buyer might have similar information that would cause it to engage in a bidding contest, or seek to initiate a bidding contest itself. Any of these actions would increase the purchase price. Such an outcome also entails wasteful over-investment on the part of Seller, which is a social loss. But that loss is dwarfed by the social gain that results from the movement of the asset to its higher valuing user[99] and is also outweighed by the positive incentive on the buyer to invest in socially useful information. Nevertheless, some non-economic justification is required to endorse a rule that would both induce this quantum of overinvestment and reduce Buyer's return on his investment in socially useful information.[100]

A second possibility (which I deem to be of fairly low probability) is that Seller invests more in information and again comes up with nothing, but this time he refuses to sell because he is determined to discover the secret. This scenario reflects the worst possible outcome because it results in inefficient duplicative search and a significant social loss because the world is deprived of the cure for cancer. It also has the effect of depriving Buyer of a return on his informational investment, a result which, when extrapolated across all transactions, reduces the incentive of all buyers to invest in socially useful information.

Third (and highly unlikely), Seller invests more in information and discovers the cure. Here, the social value of both parties' investment is released, but at the two-fold cost of duplicative investment in information and Buyer's lost incentive to invest in the information that led him in the first place to provoke Seller's own search. This scenario presents a happy ending in the particular case, but it poses an interesting problem of comparing the efficiency gains implicit in the *ex post* result with the *ex ante* problem of Buyer's reduced incentive. My response to this problem is to stress that under the assumptions of the hypothetical, this scenario is highly unlikely, and so any efficiency loss must be accordingly discounted.

C. Some Observations about Efficiency under a Word to the Wise Rule

I have presented two outcomes under a Word to the Wise rule. The first, and simpler one, flows from the straightforward application of my claim that in the Two-Sided Model, Buyer has little to lose from minimal disclosure. He will be able to profitably purchase the asset so long as he can come up with an attractive offering price based on an accurate assessment of the value of the asset in Seller's hands. The conclusion to be drawn from this outcome

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99. Of course, the social gain will not always dwarf the social and private loss contemplated in this scenario. But given the parameters of the hypothetical transaction illustrating the Two-Sided Model, the assertion is plausible.

100. The same can be said for the next two variations as well; such a justification is offered in Part V.

is that a Word to the Wise rule is as efficient as a rule of Optimal Dishonesty in a Model of Two-Sided Informational Inputs because it protects Buyer's incentive to invest in socially useful information and fosters the movement of an asset from a lower value user to a higher value user. In fact, it may be more efficient, if one takes into account the inefficiencies across the economy created by a rule that permits fraudulent misrepresentations.

Up to this point, I have avoided objecting to Levmore's claim that Optimal Dishonesty is more efficient than nondisclosure. Of course, this claim is controversial not only on moral grounds, but also because if Optimal Dishonesty were really the operative disclosure rule governing contracts, significant inefficiencies would result throughout the economy.[101] For example, the ability of parties to price assets would be substantially impaired, and this would lead them to take costly and often excessive precautions to avoid overpaying or undercharging. Parties would also waste resources attempting to independently verify assertions made by their contracting partners. Others would refrain from entering contracts with those whom they did not fully trust, or would force them to incur bonding costs to insure veracity. These and many other negative consequences would flow from a law of contracts that permitted lying, even in circumscribed situations – for the parties would not always know when such conditions were present.[102] Furthermore, Levmore's claim assumes that the parties involved never deal with one another more than once and that there are no harmful reputational consequences for the practitioner of Optimal Dishonesty. All of this is to say that even if my most optimistic scenario seems to lack a degree of plausibility or universalizability, it must be compared with a realistic understanding of the ramifications of Levmore's rule.

The second outcome, which is really a set of three possible outcomes, takes into account the possibility that a Word to the Wise rule will induce Seller to make informational investments of his own. The three variant outcomes reflect differing assessments of Seller's determination to search and the likelihood of success in such a search. By weighting these outcomes in accordance with my estimates of their likelihood, I conclude that, even assuming that minimal disclosure by Buyer will induce Seller to invest in research, Buyer's investment in information will be rewarded, and the asset will change hands.

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101. This is so even if such a rule were applicable only to a certain subset of contracts, namely those in which a buyer has valuable information he wishes to conceal from his seller. Parties would not know when they were operating under a rule permitting lying. In the words of the first Justice Marshall, "[i]t would be difficult to circumscribe" the applicability of such a rule. Laidlaw v. Organ, 15 U.S. (2 Wheat.) 178, 194 (1817).

102. Richard Posner has characterized fraud as the "positive investment in manufacturing and disseminating misinformation." Lying in contract negotiations is thus inefficient because "[t]his investment is wasted from a social standpoint." POSNER, *supra* note 92, at 111.

Despite the generally positive outcomes under a Word to the Wise rule, the analysis nevertheless reveals that there is some private welfare loss to Buyer as we move from a rule of Optimal Dishonesty to a Word to the Wise rule.[103] This distributive loss in the particular case, though not by itself relevant to an efficiency analysis, must be seen as suggestive of a corresponding allocative loss.[104] Additionally, this set of outcomes also entails a social loss arising from wasteful over-investment by the seller as well as a small expected social loss given the possibility that the sale will not take place. Two questions thus present themselves: First, is there a theory that justifies or requires the minimal disclosure I have described given the social and private loss it would produce? Second, how can we evaluate the relative desirability of these two rules given a variety of considerations, including efficiency, autonomy, fairness and legally and culturally inspired social expectations? These questions will be taken up in Part V.

D. The Valuation Quandary

Before moving on to address these questions, it would be useful to arrive at a valuation of the distributive loss in order to assess its magnitude as compared with its probability (which we can posit). The magnitude of the distributive loss is conceptually simple to define, yet to quantify it with precision is beyond the scope of this article. In concept, the distributive loss is a function of the sale price; the higher Seller can push the sale price as a result of the limited knowledge about Buyer's use he gains under a Word to the Wise rule, the greater the distributive loss to Buyer and thus the lower the return on (and incentive for) his investment in information.

The difficulty of estimating the sale price under our Model derives from the fact that this model of exchange resembles a bilateral monopoly once Buyer has revealed that he is not simply buying the asset in order to continue

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103. A comparison to intellectual property theory is useful here. Mark Lemley has suggested that the conception of intellectual property as analogous to real property is inapt. Whereas extensive property rights are necessary in real property in order to internalize negative externalities, in intellectual property, there are no such negative externalities. Thus a complete right to exclude is not necessary. To furnish innovators with sufficient incentive to invent, all that is needed is enough legal protection to assure a return of sunk costs plus a reasonable profit. In other words, there is no need to fully internalize the *positive* externalities that result from an invention. Since, as Kronman has pointed out, the absence of a duty to disclose is tantamount to the creation of property rights in the Buyer's secret information, the allocative loss from minimal disclosure in the Two-Sided Model may be acceptable under Lemley's conception of intellectual property. Mark A. Lemley, *Property, Intellectual Property, and Free Riding*, 83 TEX. L. REV 1031 (2005).

104. By this I mean that any distributive loss occasioned by the sharing of the surplus will reduce Buyer's expected return on his informational investment on an *ex ante* basis. This reduction will, in turn, reduce the probability that he, or other buyers, will undertake any given investment in information.

marketing the diabetes drug. Before this morsel of information is revealed, Seller and Buyer are engaging in a market transaction. There is a market price (or reasonably narrow range of prices) for Seller's asset. Finance techniques such as the capital asset pricing model will allow the buyer and seller to agree to the value of the asset using Seller's financial data and projections, market share price (if Seller's firm is publicly traded), and a comparative analysis of other transactions within the pharmaceutical industry to arrive at a valuation.[105] Although Seller may wish to drive a hard bargain, the value of the asset is, within some margin of error, knowable.

However, once Buyer has revealed that there is some other unspecified use to which he, and he alone, can put Seller's asset, the notion of a market price becomes inoperative, and the parties enter into the realm of the quasi-bilateral monopoly. A bilateral monopoly is a bargaining problem that involves only one seller and only one buyer, and thus no market price. In our model, by hypothesis, there is only one seller (the holder of a patent for which there are no substitutes acceptable to Buyer), and only one buyer.[106] There are no external bargaining alternatives or other pricing signals that would provide a bargaining structure or context for our Buyer and Seller under these circumstances. Economists conclude that a bilateral monopoly leads to price indeterminacy.[107] Without external forces driving them toward a pricing solution, the parties are left to engage in strategic behavior. As one recent commentator has put it:

> [T]he valuation task is highly interdependent: buyer and seller must make offers and demands based on how much they know about the other's reservation price. The seller wants to demand as much as possible given what she knows about the buyer's reservation price, and the buyer wants to offer as little as possible given what he knows about the seller's reservation price. . . . Economic theory cannot determine the outcome of bilateral monopoly bargaining. Instead, the outcome of bilateral monopoly bargaining depends on the negotiators' ability to wield bargaining power and invoke procedural and substantive norms of bargaining to their advantage.[108]

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105. *See* Ronald J. Gilson, *Value Creation by Business Lawyers: Legal Skills and Asset Pricing*, 94 YALE L.J. 239 (1984), for a discussion of the lawyer's role in helping parties arrive at sale prices using the Capital Asset Pricing Model.

106. One might raise the objection that this is not a true bilateral monopoly because there are other possible buyers. Indeed it is true that there may be other buyers, but those buyers would be buying Seller's asset for conventional reasons (better management, synergies through improved with other assets held by such buyers, market concentration, etc.) and would fit into the bargaining scenario assumed above with an ascertainable market price.

107. Numerous theoretical models have been offered to provide a solution to this problem. Any attempt to incorporate them here is beyond the scope of this article.

108. Scott R. Peppet, *Contract Formation in Imperfect Markets: Should We Use Mediators in Deals?*, 19 OHIO ST. J. ON DISP. RESOL. 283, 302 (2004). *But see* Dale

Clearly our Seller's lack of knowledge of Buyer's intended use for the product both impedes the bargaining process and, as noted earlier, makes the transaction possible (if Seller knew the secret, he would either refuse to deal or demand a significant portion of the surplus).

Given the difficulties in pricing posed by the quasi-bilateral monopoly in our Model, I will assume that Buyer's offering price will equal his best guess as to Seller's assessment of the present value of the asset[109] plus a premium for Seller to induce him to sell. When Buyer approaches Seller with his offering price, if he is entitled to lie, we can presume that he will get the asset for the offering price, plus some amount that reflects Seller's capacity to drive a hard bargain.

Under a Word to the Wise rule, the sale price will increase, reflecting Seller's enhanced ability to discern Buyer's valuation as a result of minimal disclosure and additional information generated by Seller. The sale price may also increase as a result of Seller's demand to recoup the expense of his additional research. A final observation about the sale price is that it may, of course, not exist. Recall that one possible outcome is that Seller may not sell because he is determined to discover the secret information for himself.[110]

Having come up with this admittedly primitive account of the sale price, I will simply state that as the sale price goes up, so does the distributive loss for Buyer. Equally primitively, I will assert that while the probability of a moderate rise in sale price is relatively high, the probability of the sale's non-occurrence is quite low. I thus conclude that the distributive loss resulting from moving from Optimal Dishonesty to Word to the Wise is appreciable but not significant. I also conclude that the allocative loss, given the low probability I have ascribed to the three outcomes in the second set, is relatively low.

My conclusion here is that from an economic perspective, a Word to the Wise rule is either as efficient as, or only slightly less efficient than, a rule of Optimal Dishonesty in the Two Sided Model, depending on the course of action taken by Seller. I have attempted in this Section to demonstrate that Levmore's rule is unnecessary in buyer nondisclosure cases captured by the Two-Sided Model.[111] However, I have also shown that there are scenarios

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B. Truett & Lila J. Truett, *Joint Profit Maximization, Negotiation, and the Determinacy of Price in Bilateral Monopoly*, 24 J. ECON. EDUC. 260 (1993) (presenting a solution to the problem of bilateral monopoly under the assumption of single-product firms where neither party possesses absolute bargaining power over the other).

109. My initial illustration of the model suggested that the "asset" is the Seller's entire company. If it is a public company with no other products, then the market price may be used instead of Buyer's estimate of Seller's valuation.

110. I address this problem in Part VI.

111. The foregoing analysis has explored the impact of two legal rules on the parties' incentives to invest in information, but I have omitted two perspectives that might logically have come into view. I have examined Buyer's incentive to invest *ex ante*, that is, before the transaction with Seller, and Seller's incentive to invest *ex post*,

under which Levmore's rule seems preferable from an efficiency standpoint. What then justifies endorsing a Word to the Wise rule over Optimal Dishonesty when the former entails both the small probability of allocative inefficiency and a relatively high probability of some distributive loss and a concomitant decrease in Buyer's incentive to invest? The next Part addresses this question and the related question of how to assess the relative desirability of the two rules, given the foregoing efficiency analysis.

V. A DIFFERENT NORMATIVE PERSPECTIVE

The analysis up to this point has been conducted entirely in the consequentialist mode using efficiency as the guiding norm. But our treatment would be incomplete if it did not address the problem from an alternative normative viewpoint. This is so for two reasons. First, and most obviously, we are stuck with the inconvenient possibility that the best rule from the point of view of efficiency is one that is hopelessly at odds with basic legal doctrine (fraud makes contracts voidable) as well as undesirable on fairness grounds.[112] Moreover, although we have at times taken Levmore's efficiency claims at face value, we should not ultimately disregard the pervasive disutility and lack of transactional certainty across all contracts that would result from a default rule permitting lying. This disutility, though hard to quantify, further muddles any comparison of the efficiency of the two competing rules under the Two-Sided Model.

Second, we have yet to approach our problem from the non-instrumentalist point of view espoused by Charles Fried and others.[113] I choose to embrace a normatively pluralistic approach not only because the efficiency analysis of Part IV may not yield a satisfactorily determinate ranking of the two rules, but also for a broader theoretical reason. As Melvin

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that is, after Buyer has approached. But what about Seller's incentive to invest *ex ante* and Buyer's incentive to invest *ex post*? As to the latter, the issue is irrelevant because the Model does not suggest any such investment. As to the former, its relevance is doubtful. Given the Model's explicit assumption that the Seller has already done all it can to develop the asset, and the tacit assumption that it is acting in a competitive market, we can assume that the Seller has already taken into account the fact that there exist other actors who will compete with it either in the product market or through acquisitions.

112. As Christopher Wonnell aptly put it, Levmore's theory "tests one's tolerance for [utility's] demands on morality." Wonnell, *supra* note 6, at 361.

113. *See* FRIED, *supra* note 55; James Gordley, *Equality in Exchange*, 69 CAL. L. REV. 1587 (1981); Ramsay, *supra* note 54; *see also* TREBILCOCK, *supra* note 55. Trebilcock, though a law and economics scholar, explores in *The Limits of Freedom of Contract* the interrelationship between deontic and efficiency theories of contract, ultimately rejecting the claim that they can be reconciled through a convergence theory.

Eisenberg has written in a critique of monistic normative approaches to contract theory:

> Part of the human moral condition is that we hold many proper values, some of which will conflict in given cases, and part of the human social condition is that many values are relevant to the creation of a good world, some of which will conflict in given cases. Contract law cannot escape these moral and social conditions. In contract law, as in life, all meritorious values must be taken into account, even if those values may sometimes conflict, and even at the expense of determinacy. Single-value . . . theories of the best content of law must inevitably fail precisely because they deny the complexity of life.[114]

This pluralistic approach recognizes that the law pursues morally satisfying outcomes, redistribution, and efficiency – among other goals. According to Fried, "by pursuing these goals according, but only according, to established conventions – including conventions ordained prospectively by courts – the collectivity acknowledges that individuals have rights and cannot just be sacrificed to collective goals."[115] In this passage, Fried criticizes law and economics for both its utilitarianism and its monism, and also sets out one of the important features of his theory of contract – that convention is often the repository of norms that will inform judicial decision making.

A thorough exploration of the problem as I have modeled it must ask whether adherents of such deontological perspectives would argue that a Word to the Wise rule is morally required. I will not undertake a comparison of the two rules from a moral theory perspective because a rule permitting lying obviously is unacceptable under any serious moral theory. This is so despite the observation by Christopher Wonnell that Levmore may be claiming that "false answers which only neutralize questions which should not be asked are not immoral."[116] After concluding that there is at best an equivocal case from a deontic normative perspective for affirmatively requiring disclosure, I will return in the next Part to an economic argument from intellectual property theory to propose a resolution to the conflict between the two rules.

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114. Melvin A. Eisenberg, *The Theory of Contracts, in* THE THEORY OF CONTRACT LAW: NEW ESSAYS 206, 240-41 (Peter Benson ed., 2001). *See also* TREBILCOCK, *supra* note 55, at 241 ("[T]he private ordering paradigm . . . simultaneously promotes individual freedom (autonomy) and social welfare . . . .").

115. TREBILCOCK, *supra* note 55, at 107 (describing the pluralism inherent in Fried's autonomy theory of contract).

116. Wonnell, *supra* note 6, at 362. A more appropriate comparison would be a comparison between my proposed rule and a rule of nondisclosure. However, as I have already explained, for the purposes of this article little or no meaningful distinction exists between my rule and a rule of nondisclosure. *See supra* note 92 and preceding and following text.

In *Contract as Promise*, Charles Fried addresses the case of the oil company seeking exploration rights from the farmer and considers whether buyer nondisclosure is akin to fraud.[117] Establishing an outer boundary of his argument, Fried asserts that there is no duty for a person to rescue another person from his mistaken understanding about facts in the world. However, he goes on to assert that by paying only the going price for farmland in the region, "the oil company is not simply failing to relieve distress, not simply failing officiously to remove ignorance, it is making that ignorance the means by which it achieves its ends, increases its profit."[118]

In Fried's view, the buyer has violated the Kantian imperative of respect for persons and its injunction against using another person as a means. For Fried, this behavior results in an "imperfect agreement [that] should not be enforced unless there is some equitable ground for enforcing it. The fact that the oil company knowingly seeks to take advantage of the farmer's ignorance hardly raises such an equity in its favor. And without some equity the deal just dies."[119]

But Fried goes on to consider a variation of the transaction in which the seller is not a farmer but a large natural resources holding company. He concludes that in such a case, "we are little inclined . . . to deny the oil company the fruits of its bargain."[120] His rationale is that the general conventions governing the behavior of each party create expectations that the buyer might justifiably be withholding pertinent information. In fact, by allowing courts a degree of discretion to deny relief in cases of mistake and nondisclosure, contract law embraces the notion of convention in this context.[121]

This variant fact pattern seems to resemble the Two-Sided Model, though the resemblance may be imperfect. Nevertheless, Fried's willingness to grant the oil company the fruits of its bargain tends to cut against a firm conclusion that his autonomy theory supports a requirement of disclosure by the Buyer in the Two-Sided Model. Still, just as Fried disavowed a genera-

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117. FRIED, *supra* note 55. At this point, Fried is describing nondisclosure in the One-Sided Model.

118. *Id.* at 80.

119. *Id.* at 81-82.

120. *Id.* at 82.

121. The Restatement section on nondisclosure treats an omission as an assertion where a party "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 nondisclosure of the fact amounts to a failure to act in good faith and in accordance with reasonable standards of fair dealing." RESTATEMENT (SECOND) OF CONTRACTS § 161(b) (1981). This provision's reliance on good faith and fair dealing corresponds neatly with Fried's notion of convention. The same can be said of the Second Restatement's rule on mistake, which grants relief only where the mistaken party has not assumed the risk of the mistake. A party bears the risk of the mistake not only when he does so expressly by contract, but also when "the risk is allocated to him by the court on the ground that it is reasonable in the circumstances to do so." *Id.* at § 154(c).

lized duty to relieve distress or gratuitously provide helpful information outside of the contracting context, he also made perfectly clear that lying during negotiations presented an easy case for non-enforcement.[122]　Somewhere between Fried's rejection of a duty of full disclosure and his prohibition against lying we can perhaps make out an endorsement of our Word to the Wise rule.

Michael Trebilcock, in considering the transaction between the oil prospector and the farmer, claims that "[i]t may be plausible to argue that the buyer's conduct violates the Kantian categorical imperative of equal concern and respect in that if roles were reversed (as in the termite cases), the buyer would not wish his ignorance to be exploited by the seller in this fashion."[123] Fried makes the same Kantian point when he reproaches the oil company for taking profits at the expense of the ill-informed seller.[124]　But recall that Fried moderates his concern for the seller when the seller is also an expert in oil exploration (akin to the seller in our pharmaceutical example). Trebilcock's tepid reproach to the buyer really just puts us back again in the position of asking Fried's question about the conventional expectations of the expert seller.

If Fried's theory presents at least an implicit endorsement of a limited duty of disclosure, where else are we to look for a rationale for our Word to the Wise rule? Another way to determine whether a bit of disclosure ought to be required would be to undertake a Rawlsian analysis of the issue.[125]　Using Rawls' framework, we might ask whether contracting parties in the original position would consent to a rule requiring minimal disclosure.[126]　Indeed, Scheppele supports her theory of the nondisclosure cases by asking Rawlsian questions.　Scheppele contends that individuals acting behind a veil of ignor-

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122. *Id.* at 79.

123. TREBILCOCK, *supra* note 55, at 117.

124. FRIED, *supra* note 55, at 80.

125. JOHN RAWLS, A THEORY OF JUSTICE (1971).　Generally speaking, Rawls proposes a thought experiment to aid in making just rules for society.　He suggests that choices about rules ought to be made behind a "veil of ignorance" about ones own social position, preferences and psychological tendencies.　*Id.* at 136.　This process yields a set of choices that under which each person would "have a[] . . . right to the most extensive basic liberty compatible with a similar liberty for others." *Id.* at 60.　Some degree of economic inequality is tolerable as long as the disparities "are both (a) reasonably expected to be to everyone's advantage, and (b) attached to positions and offices open to all." *Id.*　It should be noted that Rawls intended his thought experiment to be used to work out the contours of "the basic structure of society. They are to govern the assignment of rights and duties and to regulate the distribution of social and economic advantages." *Id.* at 61.　Although his method is perhaps better suited to answering fundamental questions about a just society than to scrutinizing particular rules of contract law, innumerable scholars have used it as a template for assessing the moral valence of particular rules.

126. Again, it makes little sense to ask whether a person in the original position would consent to Levmore's rule.

ance would agree to rules that (1) provide relief against catastrophic losses from nondisclosure (reflecting Rawls' maximin principle); (2) require disclosure of deep secrets; and (3) ensure that when secrets are shallow, both parties to a transaction have equal access to them.[127] Equal access, for Scheppele, means that both parties must "have equal probabilities of finding the information if they put in the same level of effort; and [second, they must be] capable of making this equivalent level of effort."[128]

Scheppele's Rawlsian analysis yields the conclusion that disclosure of deep secrets is morally required, particularly when the stakes are large. This is so, she maintains, because "[f]orbidding deep secrets prevents one party from taking advantage of another who cannot defend herself."[129] In our case, Scheppele's injunction against deep secrets militates in favor of a Word to the Wise rule. Adhering more closely to her terminology, we can see that the disclosure required by this rule ("Yes, there is some other information that would affect the price") would convert the deep secret to a shallow one.[130] With this shallow secret, Scheppele's third proposition is satisfied in our Model, as both parties have equal access. The only difficult question under Scheppele's approach is whether nondisclosure of the actual secret – as opposed to its mere existence – is required as a result of the maximin principle of avoiding catastrophic loss by Seller.

But Scheppele's conclusion is not self-evident. As Marc Ramsay has pointed out, "it makes no sense to 'protect' the seller by forcing buyer disclosure of material facts, since forcing disclosure does not improve the seller's situation."[131] Seller does not exactly lose anything in the Two-Sided Model by selling without Buyer's information. He sells at a price equal to or above the market price. She is merely deprived of the benefit created by Buyer's investment.[132] In Fried's terms, she has no conventional expectation of that surplus. Moreover, in a world in which disclosure were required, Buyer would be unlikely to simply turn over the information to Seller.[133] Rather, the transaction would not take place, for in such a world, Buyer would not have gone to the trouble to develop the information in the first place.[134]

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127. SCHEPPELE, *supra* note 53, at 77.

128. *Id.* at 109.

129. *Id.* at 77.

130. Recall that a shallow secret exists where the target has reason to suspect the existence of relevant information. *Id.* at 21.

131. Ramsay, *supra* note 54, at 129.

132. Trebilcock agrees. "[T]he gains forgone by sellers in the event of nondisclosure by buyers . . . probably do not reduce utility as much (assuming the declining marginal utility of wealth) as the reductions in wealth (out-of-pocket losses) sustained by buyers in the event of seller nondisclosure of adverse material facts." TREBILCOCK, *supra* note 55, at 114.

133. Ramsay, *supra* note 54, at 128.

134. Of course, at this point, we find ourselves doubling back to the straightforward application of the economic reasoning of previous sections of this paper.

Indeed, the entire discussion of a buyer's duty to disclose in these circumstances strains our notions of common sense. Ramsay states:

> [I]f all contracts are reversible just because the 'winning' party would not like the outcome if positions were reversed, the set of legitimate contracts will be rather small. . . . As far as duties to render assistance are concerned, [Kantian analysis] establishes that one cannot always neglect the well-being of other persons, but it does not prohibit us from failing to render assistance on particular occasions. It certainly does not establish the conclusion that contractual bargaining is the place where we should routinely express this additional concern for the well-being of other persons.[135]

Ramsay, however, provides another alternative for a deontic rationale for a rule requiring some disclosure. Ramsay puts forward a theory of "robust corrective justice" that supports mandating some Buyer disclosure in my Model.[136] "Corrective justice, as Aristotle explained it, is a matter of justice in private transactions between persons in [a] civil society. It is concerned with the voluntariness or fairness of private transactions between persons."[137] Corrective justice applies in contract law by demanding that agreements must meet standards of fairness and voluntariness in order to be valid. Clearly, fraud or physical duress constitute obvious violations of these standards, but that only begins to frame the question for our purposes.

Ramsay further explains that *robust* corrective justice dictates that "once a person makes a decision to enter pre-contractual bargaining, she must accept that it is impermissible for her to take unfair advantage of these personal disadvantages. And for proponents of robust corrective justice, the failure to disclose material facts is a clear example of unfair . . . advantage taking."[138] Ramsay contrasts this version of robust corrective justice with an account of "non-robust corrective justice." On this view, a proper conception of respect for persons "will preserve the idea that parties need not bargain with the intent of serving another person's interests."[139] Such a perspective also undercuts Scheppele's abhorrence of deep secrets.

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135. Ramsay, *supra* note 54, at 137. Alan Strudler takes a similar position, concluding that Rawls' difference principle is not well suited to a normative assessment of nondisclosure rules. "Even if it makes sense to insist that society as a whole provide some safety net to protect those who are worst off, it may not additionally make sense to insist that each institution or practice within a society provide a safety net. . . . In fact, negotiation law seems a particularly bad candidate for discharging the safety-net function." *See* Strudler, *supra* note 6, at 368-69.

136. Ramsay, *supra* note 54, at 132-49.

137. *Id.* at 133.

138. *Id.* at 140.

139. *Id.*

This view seems to be the most sensible. The notion that contracting parties, particularly in the firm-to-firm context,[140] would not expect full disclosure of all material facts is consonant with the recourse to social and commercial conventions that Fried recommends to support his theory in particular cases.[141] Those conventions, in turn, are supported both by law (contract law does not require disclosure in the Two-Sided Model) and by practice (typical corporate acquisition transactions do not include representations and warranties by the buyer of the sort contemplated here).[142]

In conclusion, it appears from our brief review of mainstream deontic approaches to contract theory that concerns for fairness do not necessarily *require* disclosure by the buyer in the Two-Sided Model. It is, however, beyond doubt that morality-based theories of contract reject Levmore's rule of Optimal Dishonesty. Thus, it is equally clear that from this normative perspective, a Word to the Wise rule is preferable.

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140. Louis Kaplow and Steven Shavell have argued that in the context of firm-to-firm transactions, efficiency norms should be the guiding principle for the resolution of contract disputes. Louis Kaplow & Steven Shavell, *Fairness Versus Welfare,* 114 HARV. L. REV. 961 (2001). Although this portion of my analysis aims to stick exclusively to non-consequentialist reasoning, there are inevitably gaps of indeterminacy in the Kantian account that beg for some independent, pragmatic perspective to come up with an answer. We ultimately need a place to "draw the line between what people can expect of us as a matter of right and what they must regard as a matter of generosity or gift." Ramsay, *supra* note 54, at 136.

141. FRIED, *supra* note 55. Kaplow and Shavell are in agreement with Fried on this issue, as they point out that "notions of fairness concerning contracts correspond to internalized social norms." *See* Kaplow & Shavell, *supra* note 140, at 1146.

142. In corporate acquisitions, buyers' representations and warranties are almost always limited to representations about the quality of the consideration given. Thus when a buyer pays cash in an acquisition, it makes no representations or warranties beyond the strictly legal ones concerning its power to enter into the transaction, etc. When the purchase price is paid in securities, the buyer will make representations and warranties about the quality and risk of those securities. But it is exceedingly rare for a buyer to make any representations or warranties about how it intends to use the asset it is purchasing.

In the event of a transaction under my Model that is less than an outright purchase (an earnout, license or royalty arrangement) the representations and warranties might become more extensive. But if the transaction were to take such a form, the question of disclosure would already have been resolved in favor of more disclosure. *See* DAVID A. BROADWIN, NEGOTIATING AND DOCUMENTING BUSINESS ACQUISITIONS 130-31 (1997).

VI. FINAL THOUGHTS

A. Comparison Between the Rules

All of this leads us to what may be an intractable comparison between these two rules.[143] Optimal Dishonesty could be seen to be slightly superior from an efficiency standpoint – particularly if one ignores the ambient efficiency loss that would arise in a world in which fraud were permitted – but it suffers from doctrinal and fairness problems. If one takes into account the inefficiencies caused by a rule permitting lying, a Word to the Wise rule may indeed be more efficient. Word to the Wise does not entail these inefficiencies but reduces somewhat the share of the surplus the buyer can capture, poses some small risk that the asset will not change hands, and consequently slightly reduces all buyers' incentive to invest in socially useful information.

So which rule, in the final analysis, is preferable? Perhaps this question can be answered by resort to an argument from intellectual property theory. This seems a logical place to look since the transaction I have used to illustrate my model is also properly viewed as an intellectual property problem. Patent rights create a temporary monopoly for the patentee. While this departure from market competition represents a significant diversion from the norm in a market economy, it is justified on the basis that patent rights allow innovators a period of time to recoup and profit from what are often significant investments in research and development, thereby promoting the creation of socially useful technologies. Yet some scholars have begun to rethink intellectual property from the ground up, taking issue with the very name of the discipline.

Mark Lemley has suggested that the conception of intellectual property as analogous to real property is inapt.[144] Whereas extensive property rights are necessary in real property in order to internalize negative externalities,[145] in intellectual property, there are no such negative externalities.[146] Thus, a complete right to exclude is not necessary.[147] To furnish innovators with sufficient incentive to invent, Lemley argues all that is needed is enough legal

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143. Jody Kraus has reviewed various strategies for reconciling efficiency-based contract theories with those founded on autonomy, and has argued that a "vertical integration strategy . . . provides the only principled reconciliation of efficiency and autonomy approaches within a unified normative contract theory." For a thorough discussion of these strategies, see Kraus, *supra* note 17, at 421.

144. Lemley, *supra* 103, at 1031-32.

145. The tragedy of the commons parable explains that in order to avoid destructive over-consumption, actors need to fully internalize the costs of their economic activity. Only by owning property can such actors make efficient decisions about the allocation of their resources. Garrett Hardin, *The Tragedy of the Commons*, 162 SCI. 1243, 1244-45 (1968).

146. *See* Lemley, *supra* note 103, at 1046-58.

147. *See id.*

protection to assure a return of sunk costs plus a reasonable profit.[148] In other words, there is no need to fully internalize the *positive* externalities that result from an invention.

I suggest that an analogous argument can be made in our case. As Kronman has pointed out, the absence of a duty to disclose is tantamount to the creation of property rights in the buyer's secret information.[149] The same, of course, can be said about a rule of Optimal Dishonesty. Perhaps the application of Lemley's theory here can justify the imposition of a limited duty to disclose that would curtail the buyer's ability to fully internalize the positive externalities that result from his investment. The analogy, to be sure, is not perfect. But this solution accomplishes similar ends. It permits the buyer to recoup and profit from its investment in information; it promotes innovation, but it make concessions to fairness and competition that comport with conventional market norms, rather than the kind of exceptional rules that Lemley criticizes in intellectual property and that Levmore endorses in the context of buyer nondisclosure.[150]

B. Form of Transaction

A choice between the two rules I have considered will not only affect the parties' incentives to invest in information. It is also likely to affect the form of transaction between the parties. On one level, the entire problem this paper has addressed can be seen as one of transaction costs. The informational asymmetry between the parties may, as I have shown, prevent them from reaching an agreement that will actualize the potential value generated by Buyer's investment in information. Under a rule of Optimal Dishonesty, this will not occur. But we have already catalogued the deficiencies of such a rule. Yet if we are to prefer a Word to the Wise rule and its attendant potential for some degree of allocative inefficiency, we need to account for the case in which Seller refuses to sell. Is there a way to avoid this result?

One possibility is that under a Word to the Wise rule, the parties will find a way to structure the deal so they will share the surplus and avoid a standoff. Several possible arrangements suggest themselves: a joint venture, a license arrangement, royalties for Seller, and a deal that leaves Seller with some stock in Buyer's company.[151] Whichever of these choices the parties agree on, the problem of valuation remains.[152] To be sure, given the reduc-

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148. *Id.* at 1050-54.

149. Kronman, *supra* note 1, at 15.

150. Lemley, *supra* note 103.

151. Victor Goldberg has explored the possibility of these alternative forms of transaction as a way to overcome transaction costs similar to those involved here. *See* Victor P. Goldberg, *The Gold Ring Problem*, 47 U. TORONTO L.J. 469 (1997).

152. The valuation problem could be solved within a market context if the seller chose to initiate an auction. Although this possibility seems conceptually attractive, it is at odds with the premise that the buyer is the only actor with access to the know-

tion in profit to the buyer that would result from such cooperative arrangements, these alternatives represent a second best solution. But given my assumption of a substantial surplus, the problem is not one of how to divide the enlarged pie, but rather of making sure it gets baked. The alternative forms of transaction just mentioned minimize the already slim probability that it will not.

VII. CONCLUSION

In this paper, I have expanded on the Kronman-Levmore analysis of a buyer's duty to disclose by altering the model these scholars and others have used to discuss the problem. I have shown that in my model, Levmore's rule permitting lying is not necessary in most cases. I have concluded that while the rule of Optimal Dishonesty may be more likely than Kronman's Silence is Golden rule to result in the transfer of the asset in question to the highest value user, it is only marginally more likely than a rule that requires minimal truthful disclosure in response to generalized questions from the seller. I have suggested that the latter rule is preferable because it does no harm to doctrine or notions of fairness. I have also suggested that a Word to the Wise rule is consonant with an emerging view of intellectual property that argues against granting monopoly profits to the holder of a patent. Finally, I have suggested that transactions can be structured in ways that both preserve the buyer's incentive to invest in socially useful information (albeit somewhat less profitably) and avoid the risk that the asset will not reach its highest value user.

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ledge that will release the surplus. At best, an auction could generate a market valuation for the diabetes firm *qua* diabetes firm. Prices established at such an auction might also reflect other buyers' innovative uses for the diabetes firm. But that does not really get at the heart of the valuation problem embedded in the model.