On Mutual Mistakes

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The dilemma of resolving mutual mistakes in the formation of contracts as a historical harbinger of the discipline of Law and Economics

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ABSTRACT

Herein we reconsider what has for over a century been a judicial inconsistency inspiring mostly dismissive scorn. We find a classical disparity in judicial reasoning to have a surprising hidden profundity and we identify it as a sincere though unintentional attempt of erstwhile courts to perform what would today be seen as an admirable effort of social policy making. We shall examine a curious pair of seemingly inconsistent rulings from a century ago and conclude that they are actually consistent with the principles of Law and Economics as understood today, although they were at that time uncomfortably incongruous. The only marvel is how these antique courts were intuitively sympathetic to doctrines beyond the scope of the philosophy and economics available to them.

We also introduce a doctrine, in the nature of a principle of efficiency that aids in the reconciliation of some mutual mistakes as well as other contract avoidance disputes.

1 Dedicated to the memory of E. Allan Farnsworth who challenged me to make sense of these cases.
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INTRODUCTION

The inconsistencies surrounding the precedents allowing the avoidance of contracts for mutual mistake can be explained in one of three ways: (1) they are due to the disorganization of vacillating public policies, (2) the later courts’ disparagement of the earlier reasoning, or (3) they reflect some consistent though unarticulated precept which the original courts were somehow sensitive to but with respect to which they lacked either awareness or vocabulary. The last explanation is the more generous and offers the additional challenge of discovering this posited tacit, subliminal but influential doctrine. We meet this challenge for a celebrated historical pair of apparently irreconcilable but influential rulings by discerning a seminal precedent for the jurisprudence of Law and Economics, which otherwise possesses precious few venerable antecedents.3

MUTUAL MISTAKE

The two particular cases to be reconciled here are the perennial law school saws Sherwood v. Walker,4 in which a dairy farmer sued to avoid the sale of a cow to a butcher on the grounds that what both parties thought was a barren cow was in fact pregnant, and Wood v. Boynton,5 in which the finder of a stone sued to avoid its sale to a jeweler on the grounds that what both parties thought was a topaz was in fact a diamond. The

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3 Early scholarly writings linking law and economics include Charles A. Beard, An Economic Interpretation of the Constitution of the United States of America (1913) and Fritz Berolzheimer, The World’s Legal Philosophies (1912). These, and other works, though well intentioned could not attempt the changes in law that Law and Economics entails since the necessary mathematical structure of economics was not yet developed. This applies to the Michigan court as well, which is why they originally seemed to be inconsistent.
5 64 Wis. 265, 25 N.W. 42 (1885).
jurisprudential dilemma is that plaintiff won the first but not the second, and both are still cited in modern contract law.

In Farnsworth’s *Contracts* he remarks, “Courts have often sought to reconcile cases such as these by explaining that avoidance is allowed only for mistakes that go to the ‘identity’ or ‘existence’ of the subject matter, not for those that go merely to its ‘attributes,’ ‘quality,’ or ‘value.’... If the cases are to be reconciled, some basis other than this specious and artificial reasoning must be found.” 6 A cow, parturient or infertile, is still a cow, but a topaz is not forever. Understanding this, Farnsworth is sensitive to the fact that if the proposed distinction means anything at all, it means the opposite of what it purports to encapsulate.

Generally, in the class of mistakes that go to a basic assumption at the time of the forming of the contract, and which are mutual and material, where the item being sold has been seriously undervalued by both parties, and where

1. the seller has been in possession of the item for some time and is in a superior professional position to evaluate it accurately,

2. the seller is the one who more frequently sells such items and therefore assumes the jeopardy of poor contract-drafting,

3. no practical reformation of the contract is possible other than rescission, and

4. there is no question of conscious ignorance, gross negligence, bad faith, misrepresentation, contractual assumption of risk, etc.,

The rule is that the seller cannot avoid.

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6 Edward A. Farnsworth, *Contracts* 659 (1982). By the way, Michigan has repudiated its earlier reasoning in favor of Farnsworth’s own Restatement Second. Still we shall show that a resolution other than retraction can be made.
This rule is objective and not to be based on principles of social justice or deeper-pocket considerations.

So why then can the dairy farmer get his cow back?\(^7\)

The difference between upholding the contract and rescission is not a matter of what use the underlying resource will eventually be put to, merely which party should enjoy the enrichment available when the mistake is exposed, or, alternatively who should bear the hazard. Both the butcher and farmer agree that the cow should not be slaughtered; alternately both the finder and the jeweler agree that the diamond should be cut.

It is sometimes more profitable to focus not on the individuals in question but on society as a whole as an interested party. Since the windfall profit does not fall into the public coffers no matter which party wins the suit, the question becomes: which decision is best for the economy in the aggregate by eliminating inefficient fiscal waste?

In *Sherwood*, the buyer is not required to slaughter the pregnant cow, even though butchering was his purpose in purchasing it originally. Since it is now recognized to be worth ten times as much if kept alive, he will undoubtedly sell it to some dairy farmer, perhaps even to the original owner, and enjoy the profits.

Herein lies the Coasean\(^8\) resolution to the problem. Leaving the cow with the original owner puts it already into the hands of a dairy farmer, while transferring it to the butcher puts it into the hands of one who must make another transaction before the resource finally reaches an optimal destination. To allow the seller to avoid the contract in this instance diminishes the prospective total transaction costs by more than one

\(^7\) Other than a bovine right to life?

transaction (the cost of the subsequent butcher-to-farmer transfer plus whatever expense is saved by the initial farmer-to-butcher non-delivery).

Even if the farmer-seller subsequently decides to sell the cow himself to a different party, he is still in a more transaction-cost minimizing position to make such a transfer. Dairy farmers sometimes sell cows to each other and are presumably more familiar with the efficient ways of doing so than butchers who are generally not in the business of selling livestock. The presumption must be that there would be extra learning costs or agency costs involved in such an uncharacteristic transaction – the anathema of utopian economic optimization. Yet some such future transaction would be inevitable if the sale stands.

If the court ruled in this case solely on the basis of minimizing the economic waste of transaction costs in optimum resource reallocation, the contract must be voided – not because the “thing” sold was misunderstood, nor because the price of the goods was grossly misevaluated, but solely to minimize the number of transactions the thing will undergo. The court would thus recognize that transactions themselves are an evil to be tolerated only when absolutely necessary.

Perhaps in a naive way this is what the court had in mind by holding that the mistake went to the “very nature of the thing.” “Things” are bought and sold, flowing through the pipelines of commerce seeking their optimum destinations in the hands of their most effective users. Mistakes derail the transferors from identifying the correct path of flow for these “things.” When the cow was believed to be barren she was a butcher-going-thing; when she was known to be fertile she was more correctly identified
as a dairyman-going-thing. The contract (to sell a barren cow) was therefore made about a thing that “had in fact no existence” as the court held.

On the other hand, in making a similar analysis of *Wood*, we must this time support the contract on the grounds of minimizing the number (and hence presumably the total cost) of transactions. The finder-seller is in no better position to make optimal use of a rough diamond than she was to make optimal use of a topaz. She will still have to transfer the thing to some jeweler who is the next holder in the inevitable chain of the development of the resource. Which jeweler gets to be the next link is a non-economic consideration; and, innocence presumed, the one selected initially is as good as any other. Furthermore, sale-voidance would force an additional transfer and would entail concomitant waste. Therefore, since this conveyance is already heading the “thing” in the right direction through the commerce network, it need not (and should not) be voided. The thing being sold was originally thought to be a jeweler-going-stone and after reevaluation it is still a jeweler-going-stone; therefore the court should let it stay with the jeweler, as it did.

In the case of the stone, only the value of the commodity and nothing in the nature of how it is to be further processed along the lines of commerce has changed by discovering the correct identity/nature of the object. The mistake did not misroute the path of the object, only the tilt joy of the participants.

If we ignore the amount of money being exchanged and focus only on the direction the resource takes through the economy we see that the cow was heading in the wrong direction and the stone in the right one. The principle of public policy that underlies both holdings and unifies them is that it is of less concern to the economy
which party makes the windfall profit than that needless waste be avoided through (even court-induced) unnecessary superfluous transactions. The rule of efficiency is virtually a defining precept of Law and Economics.

This principle, in its application to the avoidance of contract for reasons of mutual mistake, or other innocent disputes, can be termed the doctrine of the shortest path.

This doctrine affords a much more satisfactory resolution of the quasi-incoherent holdings in these two cases than verbiage about “identity” or “essence.” What distinguishes these two cases is not the degree of mistake about the identity, not the magnitude of the misevaluation, but solely whether the court would improve the efficiency of the resource’s path-of-transfer by voiding the contract, as gauged by the desire to minimize the total number of transactions necessary for the resource to find its optimal user.

The doctrine of the shortest path is a pragmatic simplification of the admirable yet incalculable desire to be maximally efficient in lubricating commerce and reducing transfer costs. Admittedly, the path of fewest transactions may not always be the path of least total cost, but it has the virtue of being a bright-line distinction and provokes shorter litigation.

The shortest-path-of-transfer explanation meets another subtle challenge facing any “hidden-perception” resolution: namely, it answers the question why the legal principle remained hidden, tacit, naive and unconscious in the recorded judicial holdings, leaving only a web of inscrutable jabberwocky. It is our position that what the judge in the later case wanted to rule was something he felt strongly enough about to merit creating a seemingly inconsistent holding, but about which he was fundamentally
inarticulate since it sadly lay beyond the parlance of the nineteenth century. He may even
have seen the two holdings as unifiable but in an inexpressible way.

The principle that we propose to fit as this tacit reconciliation can also be used for
cases involving mistakes wherein the subject matter is seriously overvalued instead of
undervalued, or in the presence of multiple mistakes.

**SHORTEST PATH PRINCIPLE:** If the nature or value of the subject matter of a
negotiated transfer was innocently mistaken by both parties yet the transfer itself presents
a reasonable path for the employment of the resource, the contract should stand. If the
disadvantaged party can show, in the light of the new information, that the sale is not in a
reasonable path of transfer, and will inevitably have to be undone by a corresponding
correcting-sale, the contract should be avoided.

One might believe that in a totally utilitarian world, any contract that was not
based on a mistake as to the nature or value of the subject matter but which is
subsequently discovered to move some resource in a clearly non-optimal path through the
network of commerce, should also be considered voidable. But this claim involves too
much second-guessing and prohibits calculated risks and speculations. That there is no
oil on the land I bought should not negate the sale.
ONE PARTY MISTAKE

The cases in which a non-optimal transfer is based on a lack of complete information on the part of only one party are usually considered in the light of the doctrines of “duty to disclose” and “allocation of risk.” An economically oriented discussion of this subject is presented in Kronman. A party may be excused from his contractual obligation if he enters the contract being mistaken about a basic assumption that has a material effect and the other party is, or should be, aware of the first party’s mistake. At the same time, there are cases that permit a smart-party to withhold information, causing the dumb-party to be mistaken yet still bound. Hypothetically, there is a seller’s duty to disclose that the signature on the painting is known to be a forgery, but no duty to disclose that a forthcoming critique will destroy the artist’s reputation and devalue even a valid-signature piece.

Kronman postulates that such cases can be reconciled on an analysis of the nature of the non-disclosed information. In short, if the information is acquired by the knowledgeable party through an investment of individual effort (developed expertise, deliberate investigation, etc.), she acquires a property right in it, and should not be required to give it away for free, if at all.

If the information-gatherer were required to share the results of her efforts without compensation, Kronman argues, she might be reluctant to acquire the information in the first place, which would increase the number of non-optimal transfers and be bad for the economy.

11 Cf. e.g., Laidlaw v. Organ, 15 U.S. (2 Wheat) 178. CF, Restatement 2nd Sec. 154
12 Information as product dates to Laidlaw ibid.
While agreeing that non-optimal transfers are bad for society, the doctrine of shortest path leads to a different analysis. If one party knows a material fact that would make the contracted sale non-optimal commodity-pathwise, and can keep this hidden with impunity, then he is causing a loss to society by increasing the total number of transactions the thing is destined to take, and does not deserve legal protection. A seller might know of a reason that the sale to this buyer is sub-optimal for facts not limited to the nature of the subject matter. This will also create avoidable waste. In such a case a seller who practices such non-disclosure may be assuming the risk of having the contract avoided unless her information can be considered the result of sufficient more-than-ordinary personal efforts as to make it a significant property right.

The distinction between people keeping information secret and people making a mistake by not having the information is a nicety and the non-disclosing party should only be punished if it would be the custom in such transfers for one in the position of the non-disclosing party to know the truth of this matter. If it were standard in the jewelry business for a jeweler to be able to recognize any diamond in the rough then it would be hard for a jury to believe that such a mistake were innocent. A “reasonable man similarly situated would or should know” seems to be implied by the assumption of innocence. Generally speaking it may be that precious little information is customary for sellers and buyers to know.

The “knew or should have known” standard also answers the challenge of the incentive for willful ignorance. “I didn’t know I shouldn’t sell the dissolving suture to a heart surgeon,” may be an adequate claim from Wal-Mart but rings hollow when coming from a surgical supply house. It will still behoove a prospective seller and buyer to learn
the reasonable amount about the true future optimal disposition of the object being
transferred, or risk having the contract voided. The punishment here for being
unreasonable is not so drastic that it should cause undue hardship.

Kronman postulates that the danger is that a party may be dissuaded from seeking
information that might aid the other party more. If the stone brought to the jeweler could
reasonably be believed by him to be a topaz but he recognizes that it might be a diamond
he may delay determining the truth until he has purchased it, if that does not deviate from
standard practice in his profession by a radical amount. Since the resource’s path could
reasonably be toward a jeweler in either case this should be tolerated. In such a case the
identity effects only the price not the path of the commodity. Misevaluations that do not
deflect the path through commerce are rare but represent no particular loss to the
economy; only loss to a particular party. Society only feels the loss if at some point the
misidentification leads to a costly divergence.

Contra to this principle is Justice Marshall’s opinion in *Laidlaw v. Organ*:

The question in this case is, whether the extrinsic circumstances, which might influence the price of the
commodity and which were exclusively within the knowledge of the vendee, ought to have been
communicated by him to the vendor? The court is of the opinion that he was not bound to communicate it.
It would be difficult to circumscribe the contrary doctrine within proper limits.\(^{13}\)

The doctrine of the shortest path might provide just such useful “proper limits.”

\(^{13}\) See id.
CONCLUSION

What we have proposed is not a claim that Law and Economics was derived directly from these two Michigan cases, nor even that these cases influenced the slow infiltration of economic intuition into judicial thinking. Yet they do illustrate that the sensibility to optimum economic behavior predates Pareto optimality\textsuperscript{14} and Kaldor-Hicks efficiency.\textsuperscript{15,16} Our cases here are in tune, albeit perhaps unwittingly, with intellectual thinking “in the air” from the time of Adam Smith’s *The Wealth of Nations* 1776 and Jeremy Bentham’s *An Introduction to the Principles of Morals and Legislation* 1789, up to Thorstein Veblen’s *Theory of the Leisure Class* 1899. They contributed their own fragrance to this bouquet even if tumultuously so. These decisions do seem to bear a sense of disapproval to waste due to extra transactions; to adjudicate against waste is tantamount to weighing economic consequences on the scales of justice.

Though usually immune to the influence of academic wisdom from outside disciplines when the law invents its own wheel it is often somewhat round.

\textsuperscript{14} Vilfredo Pareto, *Manuale d’Economia Politica* (1906).
\textsuperscript{16} The accepted wisdom on the birth of Law and Economics is that it is attributed to later individuals. At the Plenary Session of the American Law and Economic Association on May 24, 1991, four men were honored as the “founders” of the field: Ronal Coase, Guido Calabresi, Henry Manne, and Richard Posner.