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 seem 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 mutual mistakes as well as other contract avoidance disputes such as one-party mistakes, impossibility, etc.

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 latter 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 latter 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 girl 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 large 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 as a living beast, 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

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\(^7\) 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 courts 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 sheerly 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 forces an additional transfer, 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 joy of the participants.

If we ignore the amount 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 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. What the judge in the later case wanted
was to express was something he felt strongly enough about to merit creating a seemingly
inconsistent holding, but about which he was inarticulate since it sadly lay beyond the
parlance of the nineteenth century.
The same principle can 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 original negotiated transfer was innocently mistaken yet presents a reasonable path for the employment of the resource, the contract should stand. If the disadvantaged seller 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, she should be able to avoid.

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 for the same reasons as above.

Most often, reason dictates, such contracts are probably based on some blunder somewhere, but it is also possible that the non-optimality arises after the drafting of the contract through changed circumstances. The law already acknowledges that some such contracts may be avoided under the doctrines of impossibility, impracticability, and frustration of purpose. The shortest path principle may also subsume these pleas to discharge the duty of performance as well as it does in mutual mistake cases.

For example, consider when X has signed a contract to paint a house but breaks his arm. If the contract is not voided then X must make yet another contract with another painter to paint the house. This makes two contracts to be fulfilled. If the contract is voided then the home-owner must find a new painter – leaving only one contract. If the thing is seen as the house-painting, then in the first case it “travels” through two
transactions and in the second case through one. This metaphor can be replaced with the obvious legal language in expansion of the shortest path principle. If Y buys a year’s supply of dog food but his dog dies, then to force him to accept delivery of the dog food obviously will necessitate more transactions, and wastes time in the dog-food-thing finding its optimal user.

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.9 A party may be excused from his contractual obligation if he enters the contract being mistaken about a material fact and the other party is, or should be, aware of the first party’s mistake.10 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.11 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 on 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,

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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.

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. If the painting is authentic but will soon be deemed worthless by this collector it will reenter the market no nearer its proper destination. It will still have some optimal use to serve – e.g., in the private collection of a true admirer, for educational purposes in a school, in the hands of a patient speculator who intends to wait for the artist’s rehabilitation, etc. but its first sale was uninformed and directionless. When viewed in this light, the question of whether the proposed transfer is moving the resource towards its ultimate commercial position is completely independent of how the knowing party came to possess his information and what cost gathering this knowledge might have required.

It will still behoove a prospective seller and buyer to learn more about the true future optimal disposition of the object being transferred, or risk having the contract voided not just risk underpayment or overpayment.
Kronman postulates that the danger is that a party may be dissuaded from seeking information that might aid the other party more. A stone thought by both parties to be an emerald may not be carefully investigated by a seller who fears it is in fact a less valuable topaz and is willing to risk underselling a diamond. Assuming that topazes, emeralds and diamonds would all be transferred to the same next owner in their optimal disposition path the sale would stand. If all the future owners are the same for each gem the stone might go unevaluated, but with no particular loss to the economy. The loss would only be felt if at some point the gem-paths diverged.

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.12

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

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 optimality13 and Kaldor-Hicks

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12 See id.
efficiency.\textsuperscript{14,15} Our cases here are in tune, albeit perhaps unwittingly, with intellectual thinking “in the air” from the time of Adam Smith’s \textit{The Wealth of Nations} 1776 and Jeremy Bentham’s \textit{An Introduction to the Principles of Morals and Legislation} 1789, up to Thorstein Veblen’s \textit{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 do 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 when the law invents its own wheel it is often somewhat round.


\textsuperscript{15} 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.