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

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Abstract

In this article, I explain that the modern scholarship on buyer non-disclosure in contract law has stagnated in the 30 years since the publication of Anthony Kronman’s landmark article, *Mistake, Disclosure, Information, and the Law of Contracts*. I show that the prevailing analysis has calcified around a model of “One-Sided Informational Inputs.” Kronman’s contribution was that the law should not require buyers to reveal their private information when that information was the result of a deliberate search. A rule that compels disclosure would be inefficient because it would strip buyers of their incentive to invest in socially useful information. My article initially contributes the observation that all of the subsequent literature focuses on situations in which only the buyer has invested in information (the One-Sided Model).

I then posit a Model of Two-Sided Informational Inputs, in which both buyer and seller have invested in information. In the Two-Sided Model, the question of what is the most efficient disclosure rule yields a different analysis, because now the analysis must take into account two parties’ incentives to invest in information. I argue that in the Two-Sided Model, a rule requiring a bit of truthful disclosure does not pose the risk of inefficiency that it would in the One-Sided Model.
INTRODUCTION

This Article will examine some theoretical aspects of contractual non-disclosure and the related doctrine of unilateral mistake. These two legal rubrics are conceptually similar; each is concerned with the degree to

1 Throughout this Article I occasionally use these terms interchangeably. On a doctrinal level the concepts are not strictly coterminous, thus I differentiate them in doctrinal discussions. However, much of this paper is concerned with the theoretical
which parties must communicate their understandings about the nature of the contract they are about to enter into. 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 non-disclosure. 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 consent. 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, which limits consequential damages to those that are foreseeable (i.e. those that have been communicated by the party seeking damages).\(^3\)

Yet there are naturally many 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 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 – it can also frequently be explained by the implications of mistake and disclosure, and at the theoretical level, the two concepts converge as one considers the question framed by Anthony Kronman: “if 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 at 1-2 (1978).

\(^2\) 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, 943-44 (1967).

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. As mentioned, sometimes the law requires full disclosure while at other times, it does not. The result of this ambivalence about disclosure is a tension which occasionally expresses itself in disputes over whether or not a party to a contract had lived up to his disclosure requirements, 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 contractual non-disclosure has generated in the last 30 years, in particular a 1978 article by Professor Anthony Kronman and a 1982 article by Professor Saul Levmore. 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. Levmore took Kronman’s analysis as a starting point and concluded that the protection that buyers with specialized information needed could not be provided by the “silence is golden” rule Kronman proposed. 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.

The analyses offered by these scholars have formed the bedrock of what has become a fairly settled area of contracts scholarship, at least among law and economics scholars. I do not intend to challenge the insights they

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4 See Restatement (Second) of Contracts § 161 (1979) (hereinafter Second Restatement); E. Allan Farnsworth, Contracts §§ 4.9-4.15 (3d ed. 1999).

5 Kronman, supra note 1.


7 Kronman, supra note 1, at 13-14.

8 Levmore, supra note 6 at 138.

9 Id. at 139-40.

10 This is not to suggest that their analyses have been universally accepted. See, e.g., Robert L. Birmingham, The Duty to Disclose and the Prisoner’s Dilemma: Laidlaw v. Organ, 29 Wm. & Mary L. Rev. 249 (1988) (criticizing Kronman’s reading of the case law on non-disclosure); Jules L. Coleman, Douglas D. Heckathorn, & Steven M. Maser, A Bargain Theory Approach to Default Provisions and Disclosure in Contract Law in R. G. Frey and Christopher W. Morris, Liability and Responsibility 235-39 (1991) (critiquing...
have contributed. Instead, I will demonstrate that the model upon which these and other modern scholars have based their discussions of buyer non-disclosure is structurally limited, and I will attempt to extend their analysis by introducing and examining a richer model. I will then address the question of which legal rule is the most appropriate to govern the enriched model. I will conclude that in my model, the preservation of the buyer’s incentive to invest in information does not necessarily require the rule suggested by Levmore (Optimal Dishonesty), a rule that, to some extent, offends traditional contract doctrine and theories of contract that are rooted in morality. 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.

In Part III, 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, 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

Kronman’s claim that protecting a property right in information is efficient).

This statement is true regarding Kronman. However, in Part III’s examination 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, however, 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 IV.

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

See infra Part IV.

See infra Part II.C.
the problem this Article explores. Thus, in Part IV, I discuss whether there is any compelling reason outside the realm of efficiency that 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 appropriate rule, given a multitude of considerations, including efficiency, longstanding contract doctrine, fairness and a perspective from intellectual property theory.

I. 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. While some commentators have suggested that the law of contracts traditionally never allowed relief to a party on the basis of a unilateral mistake, Professor Corbin explained 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. Many cases have illustrated this point, ranging from the celebrated U.S. Supreme Court case of Organ v. Laidlaw 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 used books, real property, baseball cards and construction bids.

15 See Jody S. Kraus, Reconciling Autonomy and Efficiency in Contract Law: The Vertical Integration Strategy, in 11 PHILOSOPHICAL ISSUES 420, 420-22. For a brief discussion of the debate over monism and pluralism in contract theory, see infra Part IV.
19 Some of these cases, it should be noted, are hypotheticals proffered by the drafters of the Restatement of Restitution and the Restatement (Second) of Contracts.
21 Restatement of Restitution § 12, Comment c, Illustrations 7 & 8 (1936).
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. 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.

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. 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 “clearly latent – not readily observable upon reasonable inspection.” 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.”

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 the buyer non-disclosure is Laidlaw v. Organ. 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. Hours before the news was made public, Organ approached the Laidlaw firm and signed an agreement for the purchase of 111 hogsheads of tobacco. 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.” 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.\footnote{15 U.S. (2 Wheat.) 178 at 179 (1817).}

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

> 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 accessible to both parties. But at the same time, each party must take care not to say or do anything tending to impose upon the other.\footnote{Id.}

Despite some incompleteness in the report of this case surrounding certain elements (\textit{e.g.} who won in the lower court, what happened on remand, how Organ had responded to Laidlaw’s question), what is clear is that Marshall, to some degree, anticipated the law and economics approach.
to the problem before him. 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.”

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. Scholars have devoted considerable energy to explaining and harmonizing the many disparate approaches courts have taken in adjudicating these cases, but a truly comprehensive theory of mistake and non-disclosure has proven elusive. In cases involving construction bids, land, jewelry, used books or violins, the results may have turned on many fact-driven variables. As the Restatement of Restitution suggests, and some commentators have argued, mistakes about market conditions should be treated differently than mistakes about the

36 Whether or not one agrees with this reading of Laidlaw, Marshall’s opinion would also be approved of by modern legal economists for its emphasis on the institutional limitations of the judiciary in resolving disputes like this one.

Kronman, supra note 1 at 11.

38 If we accept that Marshall’s opinion is consistent with an economic approach to non-disclosure, we must also recognize that the case is an early example of a theoretically pluralistic judicial approach to contract adjudication, simultaneously emphasizing multiple values including efficiency, morality and institutional capacity. See infra Part IV.


40 Kimberly Krawiec and Kathryn Zeiler have undertaken a comprehensive empirical examination of the various theories attempting to explain why courts sometimes enforce contracts despite material non-disclosure and sometimes do not. The authors conclude that none of the myriad theories of nondisclosure developed after Kronman’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 study of over 1000 cases, the inadequacy of all the academic attempts to harmonize the non-disclosure cases into an explanatory and predictive theory, and concluding that the theoretical underpinnings of the doctrine are hopelessly scattered).

41 RESTATEMENT (SECOND) OF CONTRACTS § 153 cmt. a, illus. 1 (1979). Id. cmt. c, illus. 8.

42 Id. § 161 cmt. d, illus. 7.

product; 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; and the hair-splitting goes on and on.

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, in Part II, explain how the predominant economic analysis, as initiated by Professor Kronman, addresses cases involving buyer non-disclosure, 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 non-disclosure. Much commentary followed, but in this Part, I will focus primarily on the work of Kronman, Saul Levmore, and, to a lesser extent, Kim Lane Schepple. Kronman and Levmore approached the problem from an economic perspective, searching for rules that would induce efficient levels of investment in information. Schepple 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. Charles Fried and Michael Trebilcock are among those who have commented on this problem from a non-consequentialist point of view. These deontological perspectives will be addressed in Part IV.

48 Kronman, supra note 1 at 17-18.
49 See Krawiec & Zeiler, supra note 40.
1. Kronman’s Approach

A significant portion of Professor Kronman’s analysis focused on the following scenario, which was drawn 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 one 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, the 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. The estate sued, seeking relief on theories of mutual mistake and non-disclosure.

Kronman used the dispute as the basis for his analysis, focusing his attention on whether the law should require a buyer to disclose the information he has developed through his deliberate search—his investment in technology. 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 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. Such a rule would, in turn, strip future actors of their incentive to invest in information that would be socially (and privately) useful. Owning all the property rights in the asset, the seller, if


56 Kronman, and numerous other scholars, have based their analysis of buyer’s non-disclosure 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. Hereafter, we will depart from 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 non-disclosure and I continue in this convention of treating this transaction as one between the oil prospector and the wheat farmer.

57 See Kronman, supra note 1 at 16.

58 Id.
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. 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.

2. Levmore’s Contribution

Saul Levmore advanced the analysis when he examined the same factual scenario and argued that Kronman’s proposed Silence is Golden rule does not go far enough. He 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 asking price by at least ten percent?” Truthful answers to such questions would obviously reveal the special information and allow the seller to free ride on the buyer’s investments in information either by demanding a higher price for the asset or by refusing to deal and extracting the mineral himself.

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. 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

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59 Id. at 14.
60 Levmore, supra note 137-38.
61 Id. at 139-41.
62 Id. at 138-40.
63 Id.
protecting the Buyer’s property interest in his information is to adopt a rule that permits lying in such cases. 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.

3. Scheppele

In her book, Legal Secrets, Kim Lane Scheppele explores non-disclosure 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.” With shallow secrets, Levmore’s pointed questions can be asked and the asker, as Scheppele asserts, has a legal right to the truthful answer. 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. Yet Scheppele finds this unsettling. “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.”

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

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64 Id. at 139
65 Id. at 140
66 Scheppele, supra note 52 at 21.
67 Id.
68 Id.
69 Id. at 21-22. More will be said about Scheppele in Part IV. 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 II and provides some useful vocabulary for that discussion. Moreover, Scheppele’s work stands as a prominent example of a theoretical inquiry into buyer non-disclosure from outside of the law and economics perspective.
any news he should know. 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. Similarly, under Scheppelé’s distinction, oil, baseball cards, rare books and jewelry are all cases of shallow secrets. They may not exactly be shallow strictly in Scheppelé’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 be 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. I call this model the Standard Model or the One-Sided Information Model. In Section II, 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.

II. TWO MODELS: AN EXAMINATION OF THE STANDARD MODEL AND A COMPARISON WITH THE ENRICHED MODEL

In characterizing this outcome as a transfer, I have trod upon somewhat contentious ground. Kronman, in his analysis of Laidlaw, stated that the information possessed by Organ 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 10 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. As a result, it does seem as though the Laidlaw transaction only involved a transfer.

I do not wish to suggest that all recent scholarship on non-disclosure 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.
A. The Standard Model

Whether we are talking about cases involving land with minerals underneath it, a hoghead of tobacco, a baseball card, or rare books, the model of buyer non-disclosure and unilateral mistake 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 I), 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. The salient features of this model are 1) 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. 2) An inert asset: the ore is either there under the land or it is not. We might describe this as the binary nature of the asset’s existence. Furthermore, there is nothing that the seller has done to affect the existence or value of the asset, and the asset is not changing. 3) A buyer who, by contrast, has an informational input that does affect the value of the asset. 4) The buyer’s prior investment in information that has led to the release of the value of the asset. We can describe this model as the one-sided informational input model with an inert asset. Only the buyer has invested in information which affects the value of the asset being bought or sold.

As a result, it is simple enough, from an economic perspective, to figure out the 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 informational input. Under such a rule, there would be no informational investment and thus no socially beneficial discovery of the ore. As a consequence of the structure of the model, this analysis

73 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. LEG. STUD. 467 (1990).

74 Some might argue that in some of the cases that fit into the standard model, legally required 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
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, both the seller and the buyer invest in information which affects the value of the asset. 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 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, 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.

was minimal and thus is undeserving of the protection of a rule permitting non-disclosure. 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 non-disclosure fit into a pattern that I am describing as the Standard Model.

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 Sulfur 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).
Here we have a case of two-sided informational inputs with a dynamic, as opposed to inert, asset. Both Seller and Buyer have invested in information affecting the value of the asset. As distinct from the mineral-rich land example, the Seller has both created the asset and done all it can to maximize and realize its value. He has not merely been sitting on the asset oblivious to its potential uses and value. Not only has the Buyer invested in information to increase the value of the asset, but the Seller has as well. So the salient features of the Two-Side Model are 1) a seller who has invested in information; 2) a dynamic asset, that is, one which has changed in form and value as a result of the inputs of the seller; 3) a buyer whose inputs will increase the value of the asset; and 4) a prior investment in information on the part of the buyer.

Now assume that the Buyer has purchased all the Seller’s rights to the asset at the $50 million price mentioned above. Once the Seller recognizes that he has sold something of much greater value than he had originally thought, he wishes to recoup his product by suing the Buyer for rescission under the doctrine of unilateral mistake or upon a theory of inadequate disclosure. What duty of disclosure should the law impose upon the 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 III, 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 incentives to invest in socially useful information.

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 55 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 oil-rich land scenario from Kronman onward. See supra note 56. 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, that if I share your knowledge, I would be likely to increase my asking price by at least ten percent?” would effectively transfer the surplus created by the buyer’s informational investment to the seller. Levmore, supra note 6 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.
without offending contract doctrine and traditional notions of fairness. I call this a Word to the Wise Rule.\footnote{I will demonstrate that whereas a word to the wise is sufficient in the Standard Model, it is not in the Two-Sided Model.} 

\section*{C. An Explanation of Why the Kronman-Levmore Approach is Necessitated by the Structure of the Standard Model}

Initially, it is worthwhile to consider how the approaches of Kronman and Levmore are related to, and determined by, the structural features of the Standard 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, believes that in order to protect Buyer’s property interest in his information and thus his incentive to invest at a socially optimal level, the law should permit lying 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, more aptly, 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 sale for seven dollars is actually an obscure but very valuable work.\footnote{Christopher T. Wonnell, The Structure of a General Theory of Nondisclosure, 41 Case W. Res. L. Rev. 329, 342.} Wonnell explores the possibility that the expert might attempt to sell the information. 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.”\footnote{Id.} At first
such a sale may seem plausible, but of course the buyer has, without revealing his secret, conveyed to the seller all the information she 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 clothing, 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 information 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 disclose 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 answer even the unasked question for himself. Thus neither Kronman’s rule of non-disclosure 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.

It should be noted at this point that Kronman seems not to have fully accounted for the precariousness, or shallowness, of the buyer’s secret. By contrast, Levmore’s discussion of the clever seller’s questions emphasized his understanding that only a thin barrier separates the seller in the Standard Model from the information he needs to frustrate the buyer’s plan. This is a key insight and the driving reason behind his advocacy of the more aggressive rule permitting lying.

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

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80 Kronman stated generally that a buyer with special information may simply sell his information to the other party. 7 J. LEG. STUD. 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 (describing the free-rider problem that would arise among neighboring landowners attempting to obtain the buyer’s information without paying for it).
of holding his tongue and buying the land.\textsuperscript{81} Kronman explored whether the buyer could sell his information to the landowner.\textsuperscript{82} 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,”\textsuperscript{83} implying that it is surmountable.

Instead, he emphasized that once the parties agreed that the seller ought to buy the as yet undisclosed information, the true problem arises: that the 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.\textsuperscript{84} 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,\textit{ essentially a right to completely exclude the seller from access to this information}. The distinction between their positions – Kronman wanted only a right not to speak whereas Levmore thought a right to lie was needed – is only about means, not ends, and Kronman would probably agree with Levmore about the need to protect lying,\textit{ 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

\textsuperscript{81}\textit{Id.}
\textsuperscript{82}\textit{Id.}
\textsuperscript{83}\textit{Id.} For an account of the negotiations between Texas Gulf Sulphur and surrounding landowners, see Shulman, \textit{supra} note 55.

\textsuperscript{84} The free rider problem Kronman is referring to is the fact that some of the surrounding landowners 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, \textit{supra} note 1 at 21.
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. By this I mean that either there are valuable
minerals under the ground or there 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.

In other words, 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. 85
He restores the piece to its original position, and uses the momentary pause,
or *locus poenintentiae*, 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 non-disclosure 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. 86

Just so, in the One-Sided Model, unless the buyer has a great poker
face 87 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
conceal. 88 Such a seller, upon reflection does not have to think too hard
about why the Buyer is so eager. Armed with even the small amount of

85 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.
86 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.
87 See infra note 90 and accompanying text for a discussion of the communicative
nature of silence.
88 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 “on whose behalf are you
purchasing this land?” Levmore, supra note 6 at 140.
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. Only one party – the seller – can control the 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 land is resource rich, or would 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 land.

It is this feature of the Standard 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, we see that the non-disclosure rules advocated by Kronman and Levmore are necessary in the standard model of unilateral mistake and non-disclosure 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. Non-disclosure 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. 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

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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 permitting an informed party to enter – and enforce – contracts which his information suggests are profitable, without disclosing the information to the other party.” I will pursue this perspective further in Part V.A.

Some argue that this disclosure is efficient because it signals to the market and leads to better pricing. See RICHARD POSNER, ECONOMIC ANALYSIS OF LAW 111 (7th ed. 2007).
of the One-Sided Model as I have described it. Furthermore, in view of the communicative character of non-disclosure, 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.

III. 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 Word to the Wise Rule 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 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, 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 normative perspective beyond economic efficiency. Therefore I will, in Part IV, 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 it. To put it simply, the Buyer will approach the Seller with an offer and, in response to 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. In the Two-Sided Model, the need to lie is significantly diminished. When 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. 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 Buyer’s special use – his deep secret – even if told that the asset will be more valuable in the Buyer’s hands.

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. Assuming Buyer had sufficient financial information about Seller’s business to make an attractive offer, Seller will behave rationally and sell the asset for a reasonable profit at a price above its 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.

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91 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 V.B.

92 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.

93 For the sake of simplicity, we can assume that the Seller owns all the shares of a corporation whose sole asset is the diabetes drug.
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 that 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 the 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 the Buyer. Unlike the minerals under the ground, this hidden value is not easily imagined or revealed. This scenario represents a particularly deep secret.

In this case, a word to the wise is not sufficient to tip off the Seller. There being no simple way for the Seller to figure out the 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 the Buyer’s incentives 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, the Buyer retains the surplus from the transaction. Second, a bit of disclosure does convey some information that can affect the sale price and thus reduce some of the Buyer’s incentive because the expected profit from his informational investment will be smaller. Third, because Buyer’s incentives to invest in information are preserved, the social gains derived from Buyer’s investment in information are also preserved. Fourth, the Buyer does convey some information to the 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 that a Word to the Wise rule might be somewhat more costly to the Buyer.

94 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 III.D.
2. **Scenario Two:** Effect of a Word to the Wise Rule on Seller’s Incentive to Invest in Information.

Upon hearing the Buyer’s offer and his confident, if reluctant assertion that Yes, indeed there is some information in Buyer’s possession that might lead the Seller to raise his asking price, the 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 the Seller. I will address these possible outcomes in order of their probability, starting with the one I deem most likely.

One possibility is that the Seller invests more in information and **failing to discover Buyer’s private special information**, sells to Buyer. Such an outcome 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 and is also outweighed by the positive incentive on the buyer to invest in socially useful information. Nevertheless, in order to endorse a rule that would induce this quantum of overinvestment, some non-economic justification is required.

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 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 the 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 the 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 poses an interesting problem of comparing the efficiency gains implicit in the *ex post* result with the *ex ante* problem of the Buyer’s reduced incentive. My response to this problem is to stress that under the assumptions of the Two-Sided Model, this scenario is highly unlikely, so any efficiency loss must be accordingly discounted.

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95 The same can be said for the next two variations as well; such a justification is offered in Part IV.
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 the 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 the Seller’s hands. The conclusion to be drawn from this outcome 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 the 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 non-disclosure. 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. For example, the ability of parties to price assets would be substantially impaired and this would lead them to take costly excess 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. 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.

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96 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, “it would be difficult to circumscribe” the applicability of such a rule. 15 U.S. (2 Wheat.) 178 (1817).

97 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.” RICHARD POSNER, ECONOMIC ANALYSIS OF LAW 111 (7th ed. 2007).
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 the Seller to make informational investments of his own. The three variant outcomes reflect varying assessments of the 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, it becomes evident that, even assuming that minimal disclosure by the Buyer will induce the Seller to invest in research, the Buyer’s investment in information will be rewarded and the asset will change hands.

Despite the generally positive outcomes under a Word to the Wise rule, the analysis nevertheless reveals that there is some private welfare loss to the Buyer as we move from a rule of Optimal Dishonesty to a Word to the Wise rule. 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. Additionally, this set of outcomes also entails an 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 IV.

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.

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).

By this I mean that any distributive loss occasioned by the sharing of the surplus will reduce the 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.
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 the 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 the seller 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 the Buyer has revealed that he is not simply buying the asset in order
to continue 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 the 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 and a comparative analysis of other transactions within
the pharmaceutical industry to arrive at a valuation. 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 our Buyer), and only one
buyer. 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. Without external forces driving

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

101 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.

102 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.
the parties toward a pricing solution, the parties are left to engage in strategic behavior. As one recent commentator has put it,

- The 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.103

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’d either refuse to deal or demand a significant portion of the surplus).

Given the difficulties in pricing posed by the bilateral monopoly in our Model, I will assume that the Buyer’s offering price will equal his best guess as to the Seller’s assessment of the present value of the asset104 plus a premium for the 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 the Seller’s capacity to drive a hard bargain.

Under a Word to the Wise rule, the sale price will increase, reflecting the Seller’s enhanced ability to discern the Buyer’s valuation as a result of minimal disclosure and additional information generated by the 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 the Seller may not sell because he is determined to discover the secret information for himself.105

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104 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 will be used instead of Buyer’s estimate of Seller’s valuation.

105 I address this problem in Part V.
Having come up with this admittedly primitive account of the sale price, I’ll simply state that as the sale price goes up, so does the distributive loss for the Buyer. Equally primitively, I’ll 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 the Seller. I have attempted in this Section to demonstrate that Levmore’s rule is unnecessary in buyer non-disclosure cases captured by the Two-Sided Model. However, I have also shown that there are scenarios 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 incentives to invest for the Buyer? 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.

IV. 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

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106 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, 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 he 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.
basic legal doctrine (fraud makes contracts voidable) as well as on fairness grounds. 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. I choose to embrace a normatively pluralistic approach not only because the efficiency analysis of Part III may not yield a satisfactorily determinate ranking of the two rules, but also for a broader theoretical reason. As Melvin 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.

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

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107 As Christopher Wonnell aptly put it, Levmore’s theory “tests one’s tolerance for utility’s demands on morality.” Wonnell, supra note 51 at 361.


109 Melvin A. Eisenberg, THE THEORY OF CONTRACTS, in THE THEORY OF CONTRACT LAW: NEW ESSAYS 241 (Peter Benson ed., 2001). See also Trebilcock, supra note 108 at 241 (noting that the “private ordering paradigm . . . simultaneously promotes individual freedom (autonomy) and social welfare”).
by courts – the collectivity acknowledges that individuals have rights and cannot just be sacrificed to collective goals.\footnote{Trebilcock, supra note 108 at 107 (describing the pluralism inherent in Fried’s autonomy theory of contract).} 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 de-ontological 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.”\footnote{Wonnell, supra note 51 at 362. A more appropriate comparison would be a comparison between my proposed rule and a rule of non-disclosure. 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 non-disclosure. See supra pages __ - __.} 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.

In Contract as Promise, Charles Fried addresses the case of the oil company seeking exploration rights from the farmer and considers whether buyer non-disclosure is akin to fraud.\footnote{At this point, Fried is describing non-disclosure in the One-Sided Model.} 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.”\footnote{Fried, supra note 108 at 80.}

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.”

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.” His rationale is that the general conventions governing the behavior of each party creates expectations that the buyer might justifiably be withholding pertinent information.

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. Still, just as Fried disavowed a generalized 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.

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 “it 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.” Fried takes a similar position, asserting that the oil company “is making [the seller’s] ignorance the means by which it achieves its ends, increases in profits.” But recall that Fried moderates his concern for the seller when the seller is also an expert in mineral 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.

Using Rawls’ framework, we might ask whether contracting

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114 Id. at 81-82.
115 Id. at 79.
116 Trebilcock, supra note 108, at 117.
117 JOHN R. 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,
parties in the original position would consent to a rule requiring minimal disclosure. Indeed Schepple supports her theory of the non-disclosure cases by asking Rawlsian questions. Schepple contends that individuals acting behind a veil of ignorance would agree to rules that (1) provide relief against catastrophic losses from non-disclosure (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 it. 

Equal access, for Schepple, 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.”

Schepple’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]orbid deep secrets prevents one party from taking advantage of another who cannot defend herself.” In our case, Schepple’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. With this shallow secret, Schepple’s third proposition is satisfied in our Model, as both parties have equal access. The only difficult question under Schepple’s approach is whether non-disclosure of the actual secret – as opposed to its mere existence – is required as a result of the maximin principle of avoiding catastrophic loss by the Seller.

But Schepple’s conclusion is not self-evident. As Marc Ramsay has pointed out, “it makes no sense to ‘protect’ the seller by forcing buyer preferences and psychological tendencies. 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.” 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.” Rawls at 152. 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. 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.

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

119 Schepple, supra note 52 at 77.

120 Id.

121 Id.

122 Recall that a shallow secret exists where the target has reason to suspect the existence of relevant information. Schepple supra note 52 at 21.
disclosure of material facts, since forcing disclosure does not improve the seller’s situation.\textsuperscript{123} Seller doesn’t exactly lose anything in the Two-Sided Model by selling without Buyer’s information. She sells at a price equal to or above the market price. She is merely deprived of the benefit created by Buyer’s investment.\textsuperscript{124} In Fried’s terms, she has no conventional expectation of that surplus. Moreover, in a world in which disclosure were required, the Buyer is unlikely to simply turn over the information to the Seller.\textsuperscript{125} Rather, the transaction would not take place, for in such a world, the Buyer would not have gone to the trouble to develop the information in the first place.\textsuperscript{126}

Indeed the entire discussion of a buyer’s duty to disclose in these circumstances almost strains our notions of common sense. Ramsay states if 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.\ldots 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 the additional concern for the well-being of other persons.\textsuperscript{127}

\textsuperscript{123} Ramsay \textit{supra} note 53 at 129.

\textsuperscript{124} Trebilcock agrees. “[T]he gains forgone by sellers in the event of non-disclosure by buyers\ldots 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 non-disclosure of adverse material facts.” \textit{Supra} note 108 at 114.

\textsuperscript{125} Ramsay, \textit{supra} note 53 at 128.

\textsuperscript{126} Of course, at this point, we find ourselves doubling back to the straightforward application of the economic reasoning of previous sections of this paper. Ramsay states “if 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.\ldots 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 the additional concern for the well-being of other persons.” \textit{Id}, at 137. Alan Strudler takes a similar position, concluding that Rawls’ difference principle is not well suited to a normative assessment of non-disclosure 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\ldots In fact, negotiation law seems a particularly bad candidate for discharging the safety net function.” See Alan Strudler, \textit{Moral Complexity in the Law of Nondisclosure}, 45 UCLA L. REV. 337, 368-69.

\textsuperscript{127} Ramsay \textit{supra} note 53 at 137.
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.\footnote{Id. at 132-149.} “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.”\footnote{Id. at 133.} 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.\footnote{Ramsay, supra note 53 at 140.} 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.”\footnote{Id. at 140.} Such a perspective also undercut Scheppel’s abhorrence of deep secrets.

This view seems to me to be the most sensible. The notion that contracting parties, particularly in the firm-to-firm context,\footnote{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. 966 (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 53 at 136.} 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.\footnote{Fried, supra note 105 at 165. 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 supra note 132 at 1146.} Those conventions, in turn, are supported both by law (contract law does not require disclosure in the Two-Sided Model)
and by practice (typical merger and acquisition transactions do not include representations and warranties by the buyer of the sort contemplated here).\textsuperscript{134}

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.

V. FINAL THOUGHTS

A. Comparison Between the Rules

All of this leads us to what may be an intractable comparison between these two rules.\textsuperscript{135} 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 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 consequentially slightly reduces all buyers’ incentive to invest in socially useful information.

\textsuperscript{134}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 reps 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).

\textsuperscript{135}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 Jody S. Kraus, Reconciling Autonomy and Efficiency in Contract Law: The Vertical Integration Strategy, in 11 PHILOSOPHICAL ISSUES 420, 420-22.
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’ve 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. 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, Lemley argues that 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.

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. 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 duty to disclose that would limit 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 normal market norms, rather than the kind of exceptional

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137 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 (1968).
138 Lemley, supra note 136 at 1046-58
139 Id.
140 Id. at 1050.
141 Kronman, supra note 1 at 14;
rules that Lemley criticizes in intellectual property and that Levmore
endorses in the context of buyer non-disclosure.142

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 the 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 that they will share the surplus and avoid a standoff. Several possible arrangements suggest themselves: a joint venture, a license arrangement, royalties for the Seller, and a deal that leaves the Seller with some stock in the Buyer’s company.143 Whichever of these choices the parties agree on, the problem of valuation remains.144 To be sure, given the reduction 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 making sure it gets baked. The alternative forms of transaction just mentioned minimize the already slim probability that it will not.

CONCLUSION

143 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 Goldberg, The Gold Ring Problem, 47 U. Tir. L.J. 469 (1997).
144 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 knowledge that will release the surplus. At best, an auction could generate a market valuation for the diabetes firm qua diabetes firm. But that does not really get at the heart of the valuation problem embedded in the model.
In this Article, 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 slightly more likely 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.