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Melvin A. Eisenberg†

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This Article is a companion to *Mistake in Contract Law*, 91 CALIF. L. REV. 1573 (2003). Because several concepts in the two companion Articles overlap, the Articles have a few overlapping passages. In particular, the passages in this Article at notes 2-3, 19, and 63-64 substantially replicate counterpart passages in *Mistake*.

Disclosure in Contract Law

Melvin A. Eisenberg

Suppose that A and B propose to enter into a contract for the purchase and sale of a commodity, A knows a material fact concerning the commodity, and B does not know the fact. Should A be required to disclose the fact to B?

There are three strong efficiency reasons for requiring disclosure. The principle that bargains are enforceable rests most securely on a foundation of complete information; requiring disclosure can save the socially wasteful costs of searching for information that the other party already has or of making duplicate searches to generate the same information; and uncorrected mistaken assumptions increase the resources that must be devoted to allocate goods to their highest-valued uses. In addition, social morality indicates that when one party knows a material fact that is relevant to a proposed contractual transaction, and knows that the other party does not know the fact, nondisclosure normally is sharp dealing, or a kind of moral fraud. But against all this, in some classes of cases a requirement of disclosure can lead to inefficiency by decreasing the incentive to invest in the discovery of productive information.

To balance these competing considerations, I develop the basic principle that should govern disclosure in contract law, which I call the Disclosure Principle. Under this Principle, the law should require disclosure of material facts except in those classes of cases in which a requirement of disclosure would entail significant efficiency costs. The Disclosure Principle puts a thumb on the scale—in effect, creates a kind of presumption—in favor of disclosure, because of the efficiency and moral reasons that support disclosure. To overcome this presumption, it is not enough that in a given class of cases a requirement of disclosure would entail some relatively slight efficiency costs. Instead, the presumption is overcome only if disclosure would entail significant efficiency costs.

The Disclosure Principle is not intended to be applied directly to individual cases. Instead, the Principle is a guide to the formulation of a more specific, multi-stranded rule concerning when disclosure is or is not required in given classes of cases. In this Article, I examine the applicability *of the Disclosure Principle to a series of variables, such as whether the relevant information was produced adventitiously or by a deliberate investment, whether the information was properly acquired, whether the information is productive information or mere foreknowledge, whether the knowing party is a buyer or a seller, and whether the parties were in a relationship of trust and confidence. In light of this examination, I develop the following multi-stranded rule that should govern disclosure in contract law: Subject to certain exceptions, an actor with private information concerning material facts, other than her own preferences, intentions, and evaluations, should be required to disclose unless the actor is a buyer, the information is more than mere foreknowledge, the information was not acquired either adventitiously or improperly, and the actor and her counterparty are not in a relationship of trust and confidence such that a reasonable person in the counterparty's position would expect disclosure. The exceptions are that unless the parties are in a relationship of trust and confidence or the information was acquired through improper means, disclosure should not be required if either: (1) the risk that the unknowing party held a mistaken assumption was allocated to that party; (2) the unknowing party was on notice that his assumption was mistaken or failed to conduct a reasonable search; or (3) the social context in which the transaction occurred is a game in which buyers troll for mistakes by sellers.*

INTRODUCTION

Suppose that A and B propose to enter into a contract for the purchase and sale of a commodity. A knows a material fact, F, concerning the commodity. B does not know F. (I will use the term *commodity* to mean anything that can be bought or sold. I will use the terms *fact* and *information* more or less interchangeably. By a *material* fact, I mean a fact that would be likely to influence a reasonable person in B's position in deciding whcther to enter into a contract, and on what terms, other than a fact concerning A's own preferences, intentions, and evaluations.) The problem raised by such a case is whether A must disclose the relevant fact, F, to B. I will call this the *disclosure problem*.

Part I develops the basic principle that should govern the disclosure problem, which I call the *Disclosure Principle*. Under this Principle, the law should require disclosure of material facts cxcept in those classes of cases in which a requirement of disclosure would entail significant efficiency costs. This Principle is intended not as a rule to decide individual cases, but as a guide to the formulation of a more specific, multi-stranded rule concerning when disclosure is or is not required in given classes of cases.

Part II develops the first strand of the rule: Disclosure should be required if the relevant information was acquired adventitiously, rather than deliberately. Information is acquired adventitiously if it is acquired in the course of an activity that is engaged in for purposes other than acquiring the information. Information is acquired deliberately if it is acquired as a result of a deliberate investment in acquiring the information.

Part III develops a second strand: Disclosure should be required if the relevant information consists merely of foreknowledge, even if the information is acquired deliberately. Foreknowledge is advance information that in due time will become evident to all because Nature will autonomously reveal it.

Part IV develops a third strand: Sellers should always be required to disclose.

Part V develops a fourth strand: Disclosure should be required if the relevant information was acquired through improper means.

Part VI develops a fifth strand: Disclosure should be required if the parties are in a relationship of trust and confidence.

Part VII develops the following exceptions. Unless the parties are in a relationship of trust and confidence, or the information was acquired through improper means, disclosure should not be required if either (1) the risk that the unknowing party held a mistaken assumption was allocated to that party; (2) the unknowing party was on notice that his mistaken assumption was unfounded or failed to conduct a reasonable search; or (3) the social context in which the transaction occurred is a game in which buyers troll for mistakes by sellers.

I
THE DISCLOSURE PRINCIPLE

Traditionally, the issue raised by the disclosure problem has been cast in terms of whether the knowing party, A, has a duty to disclose the relevant matter to the unknowing party, B—or, to put it differently, whether nondisclosure is permissible, on the one hand, or there is duty of disclosure, on the other. This terminology is functional and convenient, and I will employ it, but two points should be kept in mind.

The first point is that strictly speaking the issue is not whether A must disclose. Rather, the issue is whether A can contract with B without making disclosure. Accordingly, if A abstains from contracting with B, she has no legal duty of disclosure to B even though she has information that would be very valuable to B. Accordingly, the terms "requirement of disclosure" or "duty to disclose" are shorthand phrases for a duty to either disclose or abstain.

The second point is that if we focus on the knowing party, A, the issue is disclosure. However, if we focus on the unknowing party, B, the issue is mistake. In a companion article, *Mistake in Contract Law*,[1] I address various types of mistake in contract law, other than the kind of mistake involved in the disclosure problem. One of these types consists of a mistaken tacit assumption about the present state of the world outside the mind of the actor who holds the assumption (hereafter, a *mistaken assumption*). The paradigmatic nondisclosure case in contract law also turns on a mistaken assumption: A knows both that F is the casc and that B tacitly assumes that Not-F is the case.[2]

The concept of a tacit assumption has been explicated as follows by Lon Fuller:

> Words like "intention," "assumption," "expectation" and "understanding" all secm to imply a *conscious* state involving an awareness of alternatives and a deliberate choice among them. It is, however, plain that there is a psychological state that can be described as a "tacit assumption", which does not involve a consciousness of alternatives. The absent-minded professor stepping from his office into the hall as he reads a book "assumes" that the floor of the hall will be there to receive him. His conduct is conditioned and directed by this assumption, even though the possibility that the floor has been removed does not "occur" to him, that is, is not present in his conscious mental processes.[3]

A more colloquial expression that captures the concept of a tacit assumption is "taken for granted." A tacit assumption is so deeply embedded that it simply doesn't occur to an actor to make the assumption explicit—any more than it occurs to Fuller's professor to think to himself, every time he is about to walk through a door, "Remember to check that thc floor is still in place." Of course, if actors had infinite time and no costs, they

1. Melvin A. Eisenberg, *Mistake in Contract Law*, 91 CALIF. L. REV. 1573 (2003).

2. How do we know that B holds a mistaken tacit assumption about a material fact? Usually, the answer is very simple: the price that B pays or accepts will show that he tacitly assumed that Not-F was the case, because if he knew that F was the case the price would have been demonstrably higher or lower. (Here and in the balancc of this Article, unless the context indicates otherwise I will use the masculine pronoun to refer to thc unknowing party and the feminine pronoun to refer to the knowing party.)

B's lack of inquisitiveness is also relevant. Under the legal principle that presently governs the disclosure problem, disclosure is generally not required. However, there are a number of exceptions to this principle. One of these exceptions is that if B asks A whether A has any knowledge bearing on the transaction and A answers in a false or misleading way, A is guilty of misrepresentation and B can set the resulting contract aside. (Of course, A can simply abstain from contracting, but then there is no disclosure problem. Similarly, A can answer "No comment" or the like, but then B is on notice that A has material information and proceeds at his peril if he does not insist that A disclose. *See infra* Part VII.B.)

The relevance of the legal rule that requires an answer to B's question to be truthful is as follows: If the existence or nonexistence of fact F is material, then unless B tacitly assumes that Not-F is the case, he would almost certainly ask A whether A had any knowledge bearing on whether F was the case. If B does not ask that question, it is almost eertainly because his assumption that F is the case is so deeply embedded that it doesn't even occur to him to ask whether Not-F may be the case.

3. LON L. FULLER & MELVIN ARON EISENBERG, BASIC CONTRACT LAW 743 (7th ed. 2001).

would ransack their minds to think through every one of their tacit assumptions, and make each of those assumptions explicit. But actors do not have infinite time and they do have costs. It would be irrational to take the time and incur the costs to determine and make explicit every tacit assumption, because the costs of doing so would often approach or exceed the expected profit from the contract. It would also normally be virtually impossible to make such a determination. As Randy Barnett has stated:

> [When we add] to the infinity of knowledge about the present world the inherent uncertainty of future events . . . we immediately can see that the seductive idea that a contract can . . . articulate every contingency that might arise before . . . performance is sheer fantasy. For this reason, contracts must be silent on an untold number of items. And many of these silent assumptions that underlie *every* agreement are as basic as the assumption that the sun will rise tomorrow. They are simply *too* basic to merit mention.[4]

The gencral principle that should govern shared mistaken assumptions is that if the assumption would provide a basis for relief to the adversely affected party if the assumption was explicit, so too should the assumption provide a basis for relief to that party if it is tacit, provided the assumption is material. The reason for this principle is that in such cases the contract implicitly allocates away from the adversely affected party the risk that the assumption was mistaken. Because the mistaken tacit assumption in the paradigmatic nondisclosure case is not shared, the disclosure problem cannot be resolved on the basis of contractual interpretation. Instead, the problem can be resolved only by determining the circumstances under which disclosure should be required. The objective of this Article is to develop a multi-stranded rule to govern that issue.

The rules of contract law can ultimately be justified only on the basis of social propositions—that is, propositions of policy, principally in the form of efficiency; propositions of morality, principally in the form of social morality[5]; and propositions of experience. Analysis of the disclosure problem in these terms turns on the resolution of three overlapping issues:

• Whether a legal rule that furnished relief to the unknowing party would provide efficient or inefficient incentives to contracting parties generally.

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4. RANDY E. BARNETT, CONTRACTS: CASES AND DOCTRINE 1163 (2d ed. 1999).

5. By *social morality*, I mean moral standards that claim to be rooted in aspirations that apply to all members of the community and, on the basis of an appropriate methodology, can fairly be said to have substantial support in the community or can be derived from norms that have such support. In contrast, *critical morality* consists of moral standards whose truth does not depend on community beliefs and attitudes, except insofar as such beliefs and attitudes are relevant to the application of the moral standards.

• Whether it is morally proper for the knowing party to take advantage of the other party's lack of knowledge of a material fact.

• Whether a legal rule that allowed the knowing party to enforce a promise, or retain a benefit, based on the other party's lack of knowledge of a material fact would confer upon the knowing party an unearned and ungifted advantage. The law typically protects advantages that have been earned or gifted, but it is not solicitous to protect unearned and ungifted advantages. Sometimes an advantage that one actor gains through another's lack of knowledge may be earned. Sometimes, however, such an advantage may be exploitive at worst and lucky at best.

In some cases, the social propositions that are relevant to a given issue all point in the same direction. In other cases, the relevant social propositions may conflict. Where such a conflict occurs, a legal rule should be fashioned that assigns proper weight and an appropriate role to each norm and policy, given the context at hand. This can be accomplished either by concluding that in the context at hand one policy goal or moral value trumps the others, or by crafting a rule that is a vector of all relevant goals and values. In the latter case, good judgment must be exercised to determine such issues as the degree of relevance and the relative weight of the conflicting goals and values, and whether and how those goals and values can be reconciled with only minimal loss to each.

Several paradigm cases exemplify the disclosure problem. Here are two of them.

> *Illustration 1.* Brown owns an income-producing apartment house that she knows has an illegal septic tank. Brown offers to sell the property to Andrews for $400,000, a price that is based on the sale of comparable properties in the area. Andrews tacitly assumes that the apartment house is lawful income-producing property and agrees to purchase it for $400,000. If the illegality of the septic tank was known, the apartment house would be worth only one-tenth that price. Brown does not disclose to Andrews the problem with the septic tank, and Andrews purchases the property for $400,000.[6]
>
> *Illustration 2.* Beta Mineral Co. is in the business of mining, smelting, and selling minerals. Beta's geologists identify promising sectors of public lands and farmland areas that have not previously been thought to have minerals. If a sector of public land seems promising, Beta's geologists make further investigation by going onto the land. If a sector of farmland seems promising, Beta overflies the land with a plane that has instruments that detect

6. This Illustration is a variant of *Lenawee County Board of Health v. Messerly*, 331 N.W.2d 203 (Mich. 1982). In that case, however, neither party knew the relevant facts.

magnetic anomalies in the earth below. A magnetic anomaly is a sign of mineralization, but many anomalies are caused by minerals that have no commercial value, or by ore that cannot be economically mined because the ore body is not rich enough to justify the costs of mining it. If the geologists find a promising anomaly on farmland, Beta purchases the relevant farm at a farmland price through its wholly owned subsidiary, Sigma Farmland Company, and then begins exploratory drilling. Usually, this drilling finds only noncommercial or non-mineable minerals (in which case Beta resells the land at the farmland price), but periodically Beta finds a mineable body of ore. Beta finds an extremely promising magnetic anomaly under Farmer Adams's farm, and Sigma purchases the farm at the market price for farmland in the area. Sigma does not disclose to Adams the existence or significance of the anomaly beneath his land. If the anomaly was known, the property would be worth significantly more than the price Sigma paid.[7]

Whether the knowing party is under a duty to disclose in cases like *Illustrations 1* and *2* is one of the most intractable issues in contract law. A major reason is this: In most issues in contract law, morality and policy point in the same direction. In the disclosure problem, however, morality and policy often point in different directions.

Begin with morality. At least when actors are dealing face-to-face on an individual basis—rather than, say, through institutional intermediaries in a relatively anonymous market, like an auction or a stock market—social morality indicates that if one actor knows a material fact that is relevant to the transaction, and knows that the other actor does not know the fact, nondisclosure is sharp dealing, or a kind of moral fraud. For example, in *Smith v. Hughes*, Chief Justice Cockburn considered a hypothetical like *Illustration 2* and said, "The case put of the purchase of an estate, in which there is a mine under the surface, but the fact is unknown to the seller, is one in which [the contract would be binding, but] a man of tender conscience or high honour would be unwilling to take advantage of the ignorance of the seller."[8]

7. This Illustration is a variant of the facts underlying *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968) (en banc), a leading insider-trading case. Insider trading is itself a paradigm of the disclosure problem, although it is governed largely by federal law, primarily Rule 10b-5 under the Securities Exchange Act.

8. 6 L.R.-Q.B. 597, 604 (1871) (Eng.). *See also, e.g.*, Barry Nicholas, *The Obligation to Disclose Information: English Report, in* CONTRACT LAW TODAY: ANGLO-FRENCH COMPARISONS 166 (Donald Harris & Denis Tallon eds., 1989). *Cf.* MICHAEL J. TREBILCOCK, THE LIMITS OF FREEDOM OF CONTRACT 117-18 (1993):

> [A difficulty with a nondisclosure rule is revealed acutely in cases such as that of a prospector who through research of various kinds, including flying over vast expanses of farmland taking magnetic soundings, develops a well-informed hunch that a particular block of farmland may have serious potential as a mineral reserve or an oil-drilling site, and does not disclose this fact to the incumbent farmer before purchasing the land at a price that reflects only agricultural uses.] Although welfare considerations seem fairly unambiguously

In addition to the moral obligation, there are strong efficiency reasons for requiring disclosure.

To begin with, the principle that bargains should be enforced according to their terms rests most securely on a foundation of complete information. As Michael Trebilcock puts this point, quoting Milton Friedman:

> Even the most committed proponents of free markets and freedom of contracts recognize that certain information preconditions must be met for a given exchange to possess Pareto superior qualities. For example, to recall the statement of Milton Friedman: "The possibility of coordination through voluntary cooperation rests on the elementary—yet frequently denied—proposition that both parties to an economic transaction benefit from it, *provided the transaction is bilaterally voluntary and informed*."[9]

Furthermore, requiring disclosure may save socially wasteful costs of searching for information that the other party already has, or of making duplicate searches to generate the same information. Trebilcock writes:

> One might also reasonably argue that requiring disclosure for this range of defects avoids various forms of socially wasteful transaction costs, such as a succession of prospective buyers hiring mechanics to inspect cars before purchase or, in the event of purchase in the absence of accurate information, further transactions that might be entailed in moving the goods to their socially most valuable uses, given the now fully revealed condition of the goods.
>
> . . . .
>
> . . . [Absent a requirement] of disclosure of material facts known to one party and unknown to the other . . . the second party and other prospective contracting parties may be induced to invest in wasteful precautions to generate information about the asset that is already possessed by the first party and can be transmitted at trivial marginal social cost.[10]

> to militate in favor of non-disclosure by the buyer, . . . the deliberate exploitation by the buyer of the farmer's ignorance of a crucially important fact bearing on the real value of his property seems to involve the taking of advantage of a less that fully autonomous choice by the farmer if one views as pre-conditions for fully autonomous choices, as even Milton Friedman does, lack of coercion and full information. 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 . . . the buyer would not wish his ignorance to be exploited by the seller in this fashion, even though such a precept may come at a cost in terms of long-run community welfare. . . . [T]he farmer might reasonably ask why his interests should be sacrificed to this greater social end (without his informed consent); that is, why should he be used as a means to the ends of others?

9. TREBILCOCK, *supra* note 8, at 117 (1993) (quoting MILTON FRIEDMAN, CAPITALISM AND FREEDOM 13 (1962)) (emphasis by Trebilcock).

10. *Id.* at 108, 112. Here is another example. Suppose that if a factory property is condemned, the owner will receive fair compensation but his business will be seriously disrupted. Accordingly, buyers

Finally, as stated by Anthony Kronman, nondisclosure "is a cost to the contracting parties themselves and to society as a whole since the actual occurrence of a mistake always (potentially) increases the resources which must be devoted to the process of allocating goods to their highest-valuing users,"[11] if only by potentially adding transaction costs.

On the other hand, at least in some kinds of cases there are efficiency arguments against a duty of disclosure. This is exemplified by *Illustration 2*. Suppose Beta (or its subsidiary, Sigma) was required to disclose the magnetic anomaly to Farmer Adams before concluding a contract. Then Farmer Adams might contact other mineral companies, tell them what Beta has found, and begin an auction for his land. In that case, Beta would have incurred very significant exploration costs from which it would derive no benefits, and might stop pursuing this kind of exploration. Since exploration for minerals is a socially valuable activity, to the extent that a duty of disclosure had such an effect it would be undesirable on efficiency grounds. Furthermore, in cases like *Illustration 2* the knowing party's gain is typically earned as a return on its investment in acquiring information. While the size of the return may look very large when we focus on the single transaction taken in isolation, the return may in fact be moderate if we take into account the actor's total investment in acquiring information, much of which may be nonproductive. Accordingly, if Beta finds a body of mineable ore on Farmer Adams's property it will reap a huge return on its investment in that property, but Beta's return will be much more modest if measured against all of Beta's investment in acquiring information.

Taking into account the efficiency gains from and the moral reasons for a disclosure regime and the possible efficiency losses that a duty of disclosure might entail in some kinds of cases, the following general principle should guide the formulation of more specific rules in this area: The law should require disclosure of material facts except in those classes of cases in which a requirement of disclosure would entail significant efficiency costs. I will call this the *Disclosure Principle*. The Disclosure Principle puts a thumb on the scale—in effect, creates a type of presumption—in favor of disclosure, because of the efficiency and moral reasons that support disclosure. To overcome this presumption, it is not enough that in a given class of cases a requirement of disclosure would entail some

normally do not want to buy a factory that is the subjeet of actual or prospective condemnation proceedings. Seller, who owns a factory, has learned through his network of contacts that the City is about to set in motion proceedings to condemn the building. A number of potential buyers are interested in purchasing the factory. If Seller is required to disclose that condemnation proceedings are planned, the potential buyers will acquire the information at no cost. If Seller is not required to disclose, each potential buyer will be required to make an independent search for information bearing on whether the City may be planning to condemn the property.

11. Anthony T. Kronman, *Mistake, Disclosure, Information, and the Law of Contracts*, 7 J. LEGAL STUD. 1, 2-3 (1978). Despite these arguments, neither Trebilcock nor Kronman advocate a general duty of disclosure.

relatively slight efficiency costs. Instead, the presumption is overcome only if disclosure would entail significant efficiency costs.[12]

The Disclosure Principle is not intended to be applied directly to individual cases. Instead, the Principle is a guide to the formulation of a more specific, multi-stranded rule concerning when disclosure is or is not required in given classes of cases. The balance of this Article will be devoted to developing the strands of that rule.

II
INFORMATION THAT IS ADVENTITIOUSLY ACQUIRED

A. *Information that is Not Acquired by a Deliberate Investment Made for that Purpose*

The stage-setting work on the disclosure problem is Anthony Kronman's 1978 article, *Mistake, Disclosure, Information, and the Law of Contracts*.[13] Kronman developed two concepts to govern the problem. Under the first concept, disclosure should be required if the relevant information was acquired by the actor casually. Information is acquired casually if the costs that were incurred to engage in the activity that produced the information were not incurred for the purpose of acquiring information. To put this differently, information is acquired casually if it is acquired in the course of an activity engaged in for purposes other than acquiring the information. In contrast, under the second concept disclosure should not be required if the relevant information was acquired as the result of the actor's deliberate and costly search for information. Kronman illustrated the two concepts as follows:

> In some cases, the individuals who supply information have obtained it by a deliberate search; in other cases, their information has been acquired casually. A securities analyst, for example, acquires information about a particular corporation in a deliberate fashion—by carefully studying evidence of its economic performance. By contrast, a businessman who acquires a valuable piece of information when he accidentally overhears a conversation on a bus acquires the information casually.[14]

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12. TREBILCOCK, *supra* note 8, considers "a general presumption in favour of disclosure of material facts known to one party and unknown to the other," in light of the efficiency goal of moving assets to their most productive uses with as few transaction costs as possible. *Id.* at 112. However, he rejects the presumption, as so formulated, on the ground that it fails to emphasize whether requiring disclosure would reduce the incentives to generate and utilize information in the first place. *Id.* The Disclosure Principle formulated in this Article does emphasize incentives to generate information. As to incentives to utilize information, see *infra* text accompanying notes 19-23.

13. *See* Kronman, *supra* note 11.

14. Kronman, *supra* note 11, at 13. Kronman did not argue that the two concepts should be made legal rules, because he believed it would be too costly to determine on a case-by-case basis whether information was casually or deliberately acquired. Instead, he proposed that the concepts be used as a guide to formulate specific rules that would either require disclosure or permit nondisclosure of various

In discussing the casual acquisition of information, Kronman points out that "by being denied the [right not to disclose], one who has casually acquired information will not be discouraged from doing what—for independent reasons—he would have done in any case."[15] This point, however, is not an affirmative reason for requiring disclosure. After all, the law could take the position that an actor who has acquired information casually is simply lucky, and is entitled to make use of the information without disclosing it.[16] Kronman's affirmative reasons for the casual-acquisition concept seem to be as follows: (1) Mistakes are costs and disclosure will prevent those costs.[17] (2) Since an actor who acquires information casually makes no investment in its acquisition, subjecting him to a duty to disclose is not likely to reduce the production of socially useful information.[18]

Several arguments could be made that nondisclosure should be permissible even in the case of information that was acquired casually, but none of these arguments are of sufficient weight to overcome the presumption of the Disclosure Principle.

To begin with, it might be argued that although casually acquired information is neither earned nor gifted, an actor who learns such information is lucky, and entitled to reap the benefits of her luck. It is true that in some cases it is acceptable for an actor to make use of an unearned and ungifted benefit. For example, if the golden pheasant flies over your backyard and drops a golden egg, the egg is yours to keep. In these cases, the actor who benefits is said to be lucky. In many cases, however, an actor is not morally entitled to retain an unearned and ungifted benefit. In such cases, the actor is not lucky. What constitutes luck is largely a matter of

categories of information. The contours of these rules would turn on whether information in the relevant category was usually acquired casually or deliberately, not on whether the information in the actual case was acquired casually or deliberately. *Id.* at 17-18.

Although specific rules to govern disclosure are desirable, and any specific rules in this area will be somewhat over-inclusive, under-inclusive, or both, rules that depended on determinations whether a given kind of information is *usually* acquired casually or deliberately would be excessively so. Furthermore, rules like this would be extremely costly to formulate and administer, because the appropriate classifications of information would be almost endlessly contested. It is no accident, I suspect, that Kronman himself formulates only one rule of this type—a rule that information about changing market conditions would not need to be disclosed.

Moreover, Kronman exaggerated the cost of determining whether information is acquired through casually or through deliberate search. It will usually be easy to show that information was acquired casually; and if information was not acquired casually, it should be deemed to have been acquired deliberately.

15. *Id.* at 14.

16. Indeed, such a position is taken in the cases under SEC Rule 10b-5. Under these cases, an actor who is not in a contractual relationship with a corporation, and who adventitiously learns information concerning the corporation, does not violate Rule 10b-5 by trading on the basis of such information without disclosing it. This position, however, is in whole or substantial part based on the courts' interpretation of Rule 10b-5 and § 10(b) of the Securities Exchange Act.

17. Kronman, *supra* note 11, at 2.

18. *Id.* at 15-16.

social morality and policy, which may change over time, and law, which will normally follow social morality and policy. Therefore, whether an actor who casually acquires information is lucky is not the starting point of analysis but the conclusion. If, on the basis of relevant social propositions, the actor should be able to use the information without disclosing it, she is lucky; if she shouldn't, she is not lucky. The issue is not whether she is lucky but what the rule should be. Accordingly, the concept of "luck" has no independent weight in determining the application of the Disclosure Principle to a given class of cases. If there is no reason of morality or policy to protect or enforce an unearned and ungifted advantage, an attempt to utilize the advantage may be exploitive or worse.

Next, it might be argued that requiring disclosure of information that is casually acquired would provide inefficient incentives for the development of skill and knowledge. Even when an actor acquires information casually, she may understand the value of the information only because of an investment that she has made in developing her skill and knowledge. For example, in Kronman's bus hypothetical, suppose that A is a business school graduate who is engaged in the real-estate business. A overhears a conversation which she correctly understands to mean that unknown to the general public, the Highway Department is about to approve plans for a new highway running through an agricultural area. A realizes that the farms adjacent to the proposed highway will sharply escalate in value once the highway is publicly announced, because the farmland will have valuable new commercial uses. Within the next several days, and before the new highway is announced, A purchases options on ten such farms. A did not ride the bus to acquire information, but she did invest in the acquisition of skill and knowledge that enabled her to evaluate information that bears on the value of real estate. Most people who heard the same conversation would have gotten nothing out of it. However, although it is conceivable that the possibility of picking up material information casually might be part of the mix of motivations in deciding to acquire skill and knowledge, the effect, if it exists, would be vanishingly small. Accordingly, even if a rule that required disclosure of information that is casually acquired would very marginally diminish the incentive to acquire skill and knowledge, that cost would not be sufficient to overcome the presumption in favor of disclosure under the Disclosure Principle.

A third possible argument against a rule that required disclosure of information that is casually acquired is that although such a rule would not significantly dampen the incentives to acquire information, it would discourage the efficient *utilization* of information.

Take the following case:

> *Illustration 3.* A and B are friends. B invites A to a party at his house. While at the party, A notices that B has a very rare first

> edition of Adam Smith's *The Wealth of Nations*, personally autographed by Adam Smith. The previous week, A had learned casually in the course of a dinner conversation with a rare-book collector that any editions of *The Wealth of Nations* signed by Adam Smith, particularly the first edition, were exceptionally valuable. B obviously doesn't realize that the book is valuable, because he is using it as a doorstop. A offers to buy the book from B for $5. B accepts.[19]

Trebilcock says, of a hypothetical in which a professor of economics buys *The Wealth of Nations* cheaply at a garage sale:

> . . . . [E]ven if we assume that the acquisition of expertise in rare first editions of famous economic treatises by the [buyer] . . . can be viewed as casually acquired . . . there is the further issue of whether enforced disclosure will diminish his incentives to *utilize* this information in the marketplace, thus retarding the movement of resources from lower-valued to higher-valued uses. Clearly, enforced disclosure will have this effect. This would be so even if the buyer quite casually in the course of dinner conversation with a rare book collector acquired information about the true value of a rare book and later fortuitously spotted it for sale . . . . In the rare book case, if buyers cannot act on undisclosed information, an uninformed buyer may purchase the book for a doorstop or window jam.[20]

Here is an elaborated version of the argument that a duty to disclose casually acquired information will lead to the inefficient utilization of information, as applied to *Illustration 3*. If A is required to disclose the value of *The Wealth of Nations* to B before buying the book, B will either keep the book or sell it to A or a third party at full market value. Therefore, A will not profit from her information. Because A will not profit, she has no incentive to diselose. Because she has no incentive to disclose, the book will not be moved to a higher valued use. I will call this the *utilization argument*.

In many or most of the cases that might be put to advance this argument, the question is not squarely raised, because either the information should be disclosed for a reason other than the fact that it was casually acquired, or there should be no duty to disclose as a result of an exception to a disclosure rule.[21] *Illustration 3* might fall into the former category, by

19. *Illustration 3* is loosely based on a hypothetical developed by Trebilcock.

20. TREBILCOCK, *supra* note 8, at 113.

21. For example, Trebilcock puts forth the following hypothetical:

> Suppose a weekend hiker passing through a ravine on the periphery of a farmer's land stumbles across oil seepage from a crevice. Further investigation suggests a strong possibility of an oil deposit on the farmer's land. Here a rule of disclosure may have no effect on the likelihood of *generation* of this information, but such a rule will operate as a major disincentive to its *utilization* in procuring a transaction with the farmer, thus . . . retarding the movement of resources from lower- to higher-valued uses.

virtue of the relationship between A and B.[22] Assume, however, that the utilization question is squarely raised. In the context of a case like *Illustration 3*, the argument has two flaws.

First, the argument assumes that only economic incentives count. In *Illustration 3*, however, A is likely to inform B even if A will not profit by doing so, either because B is A's friend and A owes B the obligations that friends owe to each other, or because A hopes for some future reciprocity by B.

Second, even if it were true that only economic incentives count, it is also true that A can profit from her information even if she is under a duty to disclose. Recall that the term *duty to disclose* is shorthand for a duty to disclose or abstain. Even if A was under a duty to either disclose her information to B or abstain from eontracting with B to purchase *The Wealth of Nations*, A would be free to sell the information to B, by making the following offer: "You own something whose value is much greater than you realize. I will tell you what it is, if you agree to split the profits with me." A has an economic incentive to propose this transaction, because otherwise she gets no economic return. B has an incentive to accept this transaction, for the same reason.

The first point, that noneconomic incentives will often suffice to produce disclosure, has a limited ambit, although it might nevertheless lead to disclosure even among persons who are not in a social relationship. However, the second point, that the knowing party has an economic incentive to propose a bargain to sell his information, applies across the board. Indeed, actors enter into bargains just like this all the time. There is an entire line of business in which companies locate funds that belong to actors, such as missing heirs, who don't realize that the funds exist, and then make bargains with the actors to provide the relevant information in exchange for a percentage of the funds.[23]

As in the case of incentives to acquire skill and knowledge, therefore, even if a rule that required disclosure of casually acquired information would diminish the utilization of information, that effect would be very

TREBILCOCK, *supra* note 8, at 113. This hypothetical is somewhat ambiguous, because the seepage is discovered casually but the prospect of oil is determined by deliberate investigation. Accordingly, this hypothetical is not really a pure utilization casc. Suppose, however, that there was no further investment. Instead, the hiker buys the land, without disclosing the seepage, because based on the seepage it's a good bet that there is oil under the land, and if there isn't the hiker can almost certainly resell the land at the price he paid. Because the seepage will presumably become evident to everyone, including the farmer, within a relatively short time, the hypothetical secms to involve foreknowledge, and for the reasons discussed in Part III, below, foreknowledge should always be disclosed.

22. *See infra* Part VI.

23. *See, e.g.*, Locator of Missing Heirs, Inc. v. Kmart Corp., 33 F. Supp. 2d 229 (W.D.N.Y. 1999); Intersource, Inc. v. Kidder Peabody & Co., 1992 WL 369918 (S.D.N.Y. Nov. 20, 1992).

small—too small to overcome the presumption in favor of disclosure under the Disclosure Principle.[24]

Finally, it may be argued that a rule requiring disclosure of adventitiously acquired information would dampen the efficient allocation of resourees. I will show below that this possible cost is also very small.

To summarize, one strand of the rule that should govern the disclosure problem is that an actor should be required to disclose information that was casually acquired. In formulating that strand of the rule, however, I will hereafter use the term *adventitiously acquired*, which captures the basic idea somewhat better than the term *casually acquired*. By information that is adventitiously acquired, I mean, like Kronman, information that an actor acquired in the course of an activity that she engaged in for purposes other than acquiring the information.

B. *Information that is Acquired by a Deliberate Investment Made for that Purpose*

Under Kronman's deliberate-acquisition concept, disclosure should not be required in the case of "information whose acquisition entails costs which would not have been incurred but for the likelihood, however great, that the information in question would actually be produced."[25] The basic reason that Kronman advances to support this concept is that requiring disclosure of information that was acquired through a deliberate investment would significantly diminish the incentive to make such an investment, and therefore would significantly diminish production of valuable information. The idea here is that if contract law required disclosure of information that was acquired by deliberate investment, actors would not make such investments, because the investments would not generate a return.

In developing this concept, Kronman refers briefly to the exploration case on which *Illustration 2* is based, but he emphasizes a very different paradigm casc, *Laidlaw v. Organ*.[26] This case was decided by the United States Supreme Court in 1817, in an opinion by Chief Justice Marshall, in the days when the Court was still extensively engaged with commercial issues. The opinions in both the Supreme Court and in the federal district court are exceptionally brief, and as a result some of the facts in the case are unclear. The following account of the case is based on the district court opinion, the bill of exceptions to that opinion, the arguments of counsel, and a few straightforward inferences based on those sources.[27] In keeping

24. This is presumably what Kronman has in mind when he says that "where the decline in the production of a certain kind of information [that is caused by rcquiring disclosure] is small, it is likely to be more than offset by the corresponding social gain that results from the avoidance of mistakes." Kronman, *supra* note 11, at 14.

25. *Id.* at 13.

26. 15 U.S. (2 Wheat.) 178 (1817).

27. *See id.* (including these sources in the reporter's note).

with the approach usually taken by commentators, I will focus only on the nondisclosure issue in the case.[28]

In early 1815, a British fleet was blockading New Orleans as part of the War of 1812. (Indeed, the greatest battle of the war was fought at New Orleans at this time.) On Saturday, February 18, 1815, three Americans, White, Shepard, and Livingston, were for some reason with the British fleet, and there got news that the war had been ended some time earlier by a peace treaty signed at Ghent. News of the end of the war had been published in British newspapers. It seems likely that the news was imparted to the fleet through delivery of these newspapers, although perhaps the news was imparted by delivery of letters from England. White quickly prepared a handbill with news of the peace treaty for distribution in New Orleans. The handbill was published in New Orleans at 8:00 a.m. on Sunday, February 19.

The price of tobacco in New Orleans would immediately rise when news of the peace became generally known there, because tobacco shipments would no longer be blockaded. Sometime after sunrise on Sunday, but before 8:00 a.m., when White's handbill was published, Shepard conveyed news of the peace privately to Organ, a merchant, and Organ then purchased 111 hogsheads of tobacco from Peter Laidlaw & Co., at the then-going (pre-news) price. As a result of the news of the peace treaty, the price of tobacco in New Orleans increased 30-50%. Laidlaw then either refused to deliver or seized back the tobacco. Organ brought suit for specific performance, damages, or both. The district court instructed the jury to find for Organ.

The Supreme Court concluded that Organ was not under a duty to disclose the news of the peace to Laidlaw:

> 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

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28. There was an added element in the case. This case involved a purchase of tobacco from Laidlaw by Organ, who was acting on the basis of undisclosed material information that concerned the value of tobacco. During the discussions leading up to the contract, Organ was asked if there was any news that was calculated to enhance the price or value of tobacco. It is unclear exactly how, if at all, Organ responded, although it seems that he either remained silent or was evasive. The district court instructed the jury to find for Organ. Laidlaw appealed not only on the ground that Organ was under a duty to disclose, but also on the grounds that Organ's response or lack of response to the question was wrongful, and that the issue was a mixed question of law and fact that should have been left to the jury. The outcome was that the Supreme Court reversed and remanded the case for a new trial, on the ground that "the absolute instruction of the judge was erroneous, and that the question, whether any imposition was practised by the vendee upon the vendor ought to have been submitted to the jury." *Id.* at 195.

> equally accessible to both parties. But at the same time, each party must take care not to say or do any thing tending to impose upon the other.[29]

Laidlaw v. Organ is the centerpiece of Kronman's argument that the law should not require the disclosure of information that has been deliberately acquired. In fact, however, as I will show in succeeding Parts of this Article, in several important classes of cases the law should require the disclosure of information that has been deliberately acquired, and *Laidlaw* falls squarely within one of those classes, *foreknowledge*.

It is tempting to view the dichotomous concepts of adventitiously and deliberately acquired information as together constituting the complete universe of the disclosure problem, in the sense that in a contractual context all information is either adventitiously acquired and must be disclosed, or deliberately acquired and need not be disclosed. However, such a view would be incorrect. Although the dichotomy between adventitiously acquired and deliberately acquired information is important, a variety of other dichotomies cut across it. As a result, there are classes of cases in which there should be a duty to disclose deliberately acquired information.

This is exactly the approach I will develop in the balance of this Article. More specifically, I treat adventitious acquisition as one element of a multi-stranded rule that should govern the disclosure problem, and then develop additional categories in which disclosure should be required even when the relevant information has been deliberately acquired. These categories center on the character of the information (Part III), whether the party who has the information is a seller (Part IV), whether the information was acquired through appropriate means (Part V), and the relationship between the parties (Part VI). Finally, I will develop exceptions that apply to most of these categories (Part VII).

III
FOREKNOWLEDGE

One way to look at Kronman's approach to the problem of disclosure is as a *process* approach. Under Kronman's analysis, whether disclosure is required depends upon the process by which the relevant information was acquired. If the information was acquired by a deliberative process, disclosure is not required; if the information was acquired by a casual or adventitious process, disclosure is required. This process approach works for casual or adventitious acquisition, but for reasons I will develop in this Part, this approach is too broad when it comes to deliberate acquisition.

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29. *Id.*

In contrast to Kronman's process approach, several leading economists have adopted a *substantive* approach to the disclosure problem, under which the permissibility of nondisclosure would turn on the character of the relevant information, rather than on the process through which the information was obtained.[30] The most notable contributions are Jack Hirshleifer's 1971 article, *The Private Value of Information and the Reward to Inventive Activity*[31]; Robert Cooter and Thomas Ulen's book, *Law and Economics*,[32] first published in 1987; and Steven Shavell's 1994 article, *Acquisition and Disclosure of Information Prior to Sale*.[33]

A. *Hirshleifer, Cooter and Ulen, and Shavell*

Hirshleifer's seminal contribution was to draw a critical distinction between "foreknowledge," on the one hand, and "discovery," on the other. *Discovery* is the "recognition of something that possibly already exists, though [it will be] hidden from view" unless and until the discovery is made.[34] Here, "Nature's secret will not be autonomously revealed but must be extracted by man."[35] Discovered knowledge can bring gains from allocating resources more efficiently. Such knowledge "makes the 'pie' larger."[36] Discovered information brings gains to an actor who has privately acquired the information, but more importantly it can increase social wealth—it "increases ex ante each person's potential share."[37]

In contrast, *foreknowledge* is knowledge that "will, in due time, be evident to all"; it is information that "Nature will . . . autonomously reveal."[38] Foreknowledge involves "only the value of *priority* in time of superior knowledge."[39] Foreknowledge of information can bring gains to an actor who privately acquires the information. As a result, actors may deliberately invest in acquiring foreknowledge. But the gains from foreknowledge are often only redistributive, not social. The information then "does not increase the pie's share, only the shares of those who have the

30. *See* Muriel Fabre-Magnan, *Duties of Disclosure and French Contract Law: Contribution to an Economic Analysis*, *in* GOOD FAITH AND FAULT IN CONTRACT LAW 99, 111 (Jack Beatson & Daniel Friedmann eds., 1995) ("the efficiency of duties of disclosure mainly depends . . . on the nature or content . . . of the information to be disclosed").

31. Jack Hirshleifer, *The Private and Social Value of Information and the Reward to Inventive Activity*, 61 AM. ECON. REV. 561 (1971).

32. ROBERT COOTER & THOMAS ULEN, LAW AND ECONOMICS 270-76 (3d ed. 2000).

33. Steven Shavell, *Acquisition and Disclosure of Information Prior to Sale*, 25 RAND J. ECON. 20 (1994).

34. Hirshleifer, *supra* note 31, at 562.

35. *Id.* at 569.

36. Jules L. Coleman et al., *A Bargaining Theory Approach to Default Provisions and Disclosure Rules in Contract Law*, 12 HARV. J.L. & PUB. POL'Y 639, 694 (1989) (describing Hirshleifer's analysis).

37. *Id.*

38. Hirshleifer, *supra* note 31, at 562.

39. *Id.*

relevant information."[40] The cost of acquiring such foreknowledge will exceed the social value of the foreknowledge. In such cases, the law should not provide incentives for the deliberate acquisition of information.

Hirshleifer did not specifically address the disclosure problem. His interest was in the general issue of whether and when an investment in acquiring information is inefficient, and in the specific issue of patent-law policy. Unlike Hirshleifer, Cooter and Ulen developed a principle that distinguishes between different kinds of information for the specific purpose of dealing with the disclosure problem. Their analysis is comparable in its nature to Hirshleifer's, but it differs in significant ways. Rather than distinguishing between foreknowledge and discovery, Cooter and Ulen distinguish between *productive* information and *redistributive* information:

> Productive information can be used to produce more wealth. To illustrate, the discovery of a vaccine for polio and the discovery of a water route between Europe and China were productive. . . . In contrast, redistributive information creates a bargaining advantage that can be used to redistribute wealth in favor of the informed party. To illustrate, knowing before anyone else where the state will locate a new highway conveys a powerful advantage in real-estate markets.[41]

Cooter and Ulen conclude that searching for redistributive information is socially wasteful, and therefore the law should discourage the expenditure of resources on this type of search. One important means to that end is to impose a duty of disclosure on an actor who has acquired such information:

> Efficiency demands giving people strong incentives to discover productive facts. Transmitting information is so easy that the person who discovers productive information seldom captures its full value. Consequently, the state must take special measures to reward people who discover productive information. . . .
>
> . . . Investment in discovering redistributive information wastes resources. In addition, investment in redistributive information induces defensive expenditures by people trying not to lose their wealth to better-informed people. Defensive expenditures prevent redistribution, rather than produce something. Thus, investment in redistributive information wastes resources directly and indirectly. The state should not create incentives to discover redistributive information. Instead, the state should discourage investment in discovering redistributive information. . . .

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40. Coleman et al., *supra* note 36, at 694.

41. COOTER & ULEN, *supra* note 32, at 273. Cooter and Ulen developed this approach in the first edition of their book, published in 1987. *See generally* ROBERT COOTER & THOMAS ULEN, LAW AND ECONOMICS (1987). However, the quotes from Cooter and Ulen in this Article are from the most recent (third) edition of their book, published in 2000.

> These considerations prompt . . . [the formulation of the following] economic principle . . . : *Contracts based upon one party's knowledge of productive information should be enforced, whereas contracts based upon one party's knowledge of purely redistributive information should not be enforced.* This principle rewards investment in discovering productive information and discourages investment in discovering redistributive information.[42]

Finally, Shavell, who also focuses on the disclosure problem, draws a distinction, comparable to those drawn by Hirshleifer and Cooter and Ulen, between information that is mere foreknowledge and information that is socially valuable because it allows action to be taken that will raise the value of a commodity to an actor who possesses the commodity and the information. Shavell concludes that an actor should be required to disclose private information that is mere foreknowledge, to reduce the incentive to wastefully acquire information that does not have social value.[43]

Although there are substantive differences between the formulations of Hirshleifer, Cooter and Ulen, and Shavell, the common theme is much stronger than the differences. The common theme is that certain kinds of information are not socially valuable; that the costs of acquiring the information therefore represent a social waste; and that accordingly the law should not provide incentives for the acquisition of such information. On the contrary, the law should provide disincentives, including a requirement of disclosure.

B. *Productive Efficiency and Allocative Efficiency*

Cooter and Ulen and Shavell published after Kronman, and therefore could not have influenced his thinking. But Hirshleifer published four years before Kronman, and we know that Kronman was familiar with Hirshleifer's article, because he discusses it in footnote 34 of his own article. That discussion, although brief, contains an extremely important passage, which can only be understood against the background of the relevant portion of Kronman's text. Here is the relevant portion of the text:

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42. *Id.* at 273-74. Cooter and Ulen suggest that if information has a mixed redistributive and productive quality, it should be treated as productive information. However, this seems to be inconsistent with their basic approach, because under this test information that had only a marginally productive aspect would be treated as productive. Accordingly, within the framework of their analysis a better test would be whether information is essentially redistributive or essentially productive.

43. Shavell states:

> [I]f information is not socially valuable, then effort to acquire it . . . is a social waste. Accordingly, a disclosure obligation is socially desirable because it will reduce . . . the incentive to acquire [such] information. In contrast, in the absence of an obligation to disclose, [all] information will have positive private expected value. . . . Thus, in the absence of a disclosure obligation, parties will be led to invest in acquisition of information even though that is socially undesirable.

Shavell, *supra* note 33, at 21.

> News of the treaty of Ghent affected the price of tobacco in New Orleans. Price measures the relative value of commodities: information regarding the treaty revealed a new state of affairs in which the value of tobacco—relative to other goods and to tobacco-substitutes in particular—had altered. An alteration of this sort is almost certain to affect the allocation of social resources.[44]

Here is footnote 34:

> This will not be true in a regime of "pure exchange," that is, in a regime where goods are only exchanged and not produced (the pool of exchanged goods remaining constant). In "the more realistic regime in which production and exchange both take place," however, information of the sort involved in *Laidlaw v. Organ* will have allocative consequences. Hirshleifer . . . at 566-67.[45]

There are two striking aspects to this passage. The first is that although the passage is tucked away in a footnote, it constitutes an important limit on the deliberate-acquisition rule. Kronman says in this passage that even if there is deliberate acquisition, there is no good economic reason to allow nondisclosure if the acquisition takes place in a regime of pure exchange. (*Pure exchange* essentially refers to an economic regime in which production does not take place, so that "[a]n individual dissatisfied with his endowment . . . can modify it only by trading."[46]) Perhaps Kronman tucked the passage into a footnote because he believed that the limit was trivial; he contrasts a regime of pure exchange with a "more realistic" regime in which production and exchange both take place. He concluded that in the latter regime, "information of the sort involved in *Laidlaw v. Organ* will have allocative consequences." However, far from being unrealistic or unusual, most information that consists of foreknowledge is acquired and utilized precisely in short-lived regimes of pure exchange. Indeed, that is just what occurred in Kronman's centerpiece case, *Laidlaw v. Organ*. As Robert Birmingham puts it:

> In *Laidlaw* . . . private gain was the difference between the price Organ paid and the price after the news that the war had ended was made public, or some $3000; the social gain was zero. *Laidlaw* contains only a transfer payment. Organ gets more money, Laidlaw gets less. The effect of the contract in *Laidlaw* is redistributive only, hence prima facie inconsequential.[47]

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44. Kronman, *supra* note 11, at 11.
45. *Id.* at 11 n.34 (quoting Hirshleifer, *supra* note 31, at 566-67).
46. Hirshleifer, *supra* note 31, at 563.
47. Robert L. Birmingham, *The Duty to Disclose and the Prisoner's Dilemma:* Laidlaw v. Organ, 29 WM. & MARY L. REV. 249, 270 (1988).

More generally, Kronman drastically underestimated the significance of regimes of pure exchange. It is true that long-run regimes of pure exchange will be relatively rare. However, foreknowledge typically has a very short shelf life—typically, days, hours, or at the most weeks—just because it is information that "Nature will . . . autonomously reveal."[48] During that short shelf life, a regime of pure exchange will normally prevail, because there will not be enough time to make investments in or reallocations of productive resources. Accordingly, Kronman's acknowledgement, in footnote 34, that in a regime of pure exchange a nondisclosure rule is unnecessary, even for deliberately acquired information, has a very wide ambit.

The second striking aspect of the passage in footnote 34 is that contrary to the implications of the passage, Hirshleifer's conclusion that the cost of acquiring foreknowledge is often socially wasteful is not limited to a regime of pure exchange, but can extend to a regime of production as well. Thus Hirshleifer states:

> Consider now the more realistic regime in which production and exchange both take place. . . .
>
> Suppose . . . that *one single* individual is given sure, prior, and private information that [a certain event will occur]. . . . [*A*]*s under the regime of pure exchange, private foreknowledge makes possible large private profit without leading to socially useful activity*. The individual would have just as much incentive as under pure exchange (even more, in fact) to expend real resources in generating soeially useless private information.
>
> . . . .
>
> . . . In a world of pure exchange, there will in general be private overinvestment in information: resources committed to acquisition and to dissemination are both wasted from the social point of view. In a world of production . . . the gains from productive rearrangements due to the information must be offset against the costs of acquisition and dissemination; there may or may not be private investment.[49]

In any event, Shavell, and Cooter and Ulen, writing after Hirshleifer and focusing specifically on disclosure, do not restrict their conclusions to a regime of pure exchange. Instead, they conclude that there should be a general duty to disclose redistributive information or foreknowledge, because the acquisition of such information is socially wasteful, and the expenditure of the costs of such acquisition therefore should be discouraged by a disclosure rule, rather than encouraged by a nondisclosure rule.

48. Hirshleifer, *supra* note 31, at 562.

49. *Id.* at 566, 567, 573.

Part of the difference between Kronman's approach and that taken by Hirshleifer, Cooter and Ulen, and Shavell is that, speaking very generally, the latter emphasize productive efficiency, while Kronman emphasizes allocative efficiency—that is, the importance of information in allocating social resources to their highest valued uses. This emphasis is reflected in a central passage in Kronman's analysis:

> From a social point of view, it is desirable that information which reveals a change in circumstances affecting the relative value of commodities reach the market as quickly as possible (or put differently, that the time between the change itself and its comprehension and assessment be minimized). If a farmer who would have planted tobacco had he known of the [peace treaty] plants peanuts instead, he will have to choose between either uprooting one crop and substituting another (which may be prohibitively expensive and will in any case be costly), or devoting his land to a nonoptimal use. In either case, both the individual farmer and society as a whole will be worse off than if he had planted tobacco to begin with. The sooner information of the change reaches the farmer, the less likely it is that social resources will bc wasted.
>
> . . . .
>
> Allocative efficiency is promoted by getting information of changed circumstances to the market as quickly as possible. Of course, the information doesn't just "get" there. Like everything else, it is supplied by individuals (either directly, by being publicized, or indirectly, when it is signalled by an individual's market behavior).[50]

One of the striking aspects of this passage is that Kronman has placed his bets on two very different horses. The first horse, *Incentives*, rides under the spur of giving incentives to invest in the acquisition of information where incentives are needed, but not otherwise. The second horse, *Allocation*, rides under the spur of allocating social resources efficiently by getting information to the marketplace. Kronman apparently thought that he had made only one bet because the two horses share the same colors. They do not. A bet on *Incentives* wins if the acquisition of information is deliberate, but loses if the acquisition is adventitious. A bet on *Allocation* wins whenever information is brought to the marketplace—even in an indirect and perhaps trivial way, as by the fact of a purchase or sale—regardless of how the information is acquired. Thus Randy Barnett, who bets only on *Allocation*, scolds Kronman for not putting all his money on that horse:

50. Kronman, *supra* note 11, at 12-13.

> Resource prices produced both by those who trade and those who decline to trade represent a summation of innumerable amounts of radically-dispersed information concerning the competing alternative uses of scarce resources and the relative subjective desirability of these uses. Therefore, a person in possession of [even] "windfall" information concerning a particular scarce resource still contributes importantly to the welfare of others by causing the price of that resource to move in an information-revealing direction, whether the direction is up, down, or unchanged. The price-effect of the decision to trade or refrain from trading results notwithstanding that the trader may neither have produced the information nor intentionally disclosed it. I do not claim that this informational process is perfect, but only that it is both vital and irreplaceable.
>
> Imposing a duty to disclose on those in possession of information concerning a future change in market demand for a resource eliminates the possibility of profiting from the information, and thereby greatly reduces any incentive for potential traders to engage in information-revealing transactions.[51]

Barnett's argument has two basic flaws.

First, Barnett implicitly assumes that more information is always good because of its allocational effect, but disregards the costs of producing this good. As Birmingham points out:

> "Judicial rules should encourage cows" does not follow from "cows are good." . . . We may already have too many cows in that the marginal cost of maintaining a cow exceeds a cow's marginal benefit. The same may bc true of information. Where should the encouragement stop? We are talking about social cost here. Maximizing the number of cows or the amount of information seldom optimizes . . . [because information is costly to produce and the] resources used to produce this information might have produced something else.[52]

Second, it is not the case, as Barnett claims, that there will always be a positive efficiency gain from getting information into the market through market behavior. In *Illustration 1*, Brown sells her income-producing apartment house on the basis of her private information that her septic tank is illegal, and the apartment house therefore is not a lawful income-producing property, but that market behavior does not have a positive efficiency effect.

It is true that requiring disclosure of adventitiously acquired information may sometimes result in marginal efficiency costs. Under the

51. Randy E. Barnett, *Rational Bargaining Theory and Contract: Default Rules, Hypothetical Consent, the Duty to Disclose, and Fraud*, 15 HARV. J.L. & PUB. POL'Y 783, 797-98 (1992).

52. Birmingham, *supra* note 47, at 259.

Disclosure Principle, however, the fact that a requirement of nondisclosure may have *some* efficiency costs is not sufficient to justify nondisclosure. Instead, the efficiency costs must be significant. On average, the useful allocative effect of transactions based on foreknowledge or other redistributive information is likely to be either nil or extremely small—too small to justify a nondisclosure rule.

Begin with the case of homogenous commodities, as exemplified by *Laidlaw v. Organ*.[53] It is safe to assume that Organ purchased the tobacco at the then-market wartime price. (If Organ offered more than the market price, Laidlaw would have become suspicious that something was afoot.) It is therefore very hard to believe that Organ's purchase had a material effect on the price of tobacco, since Organ was almost certainly purchasing a relatively small amount of a homogeneous commodity in a market with many buyers and sellers. Furthermore, recall Kronman's conclusion that "information *of the sort* involved in *Laidlaw v. Organ* will have allocative consequences."[54] The phrase "of the sort" is telling. Kronman did not say that the actual information in the actual case had allocative consequences—and for good reason. It is inconceivable that the actual information in the actual case had allocative consequences. For all practical purposes, *Laidlaw v. Organ* took place in a regime of pure exchange. The information of which Organ had foreknowledge was to become public in an hour or two, and Organ must have known this. There is no way in which the price signal sent by Organ's purchase—which was probably a null signal in any event—could have affected the production of tobacco or the allocation of productive resources within that period of time.

Nor did Organ's contract with Laidlaw move the tobacco to a higher valued use. As Baird, Gertner, and Picker conclude:

> [I]n *Laidlaw v. Organ,* one of the parties [may have] spent a lot of money to become the first to know that the War of 1812 was over and that the British blockade of New Orleans was soon to be lifted. This information, however, only gave the person who gathered it the ability to profit at someone else's expense. There is no (or at least very little) social benefit in knowing a few hours earlier than anyone else that a peace treaty had been signed many weeks before. . . .
>
> When there is no obligation to disclose information . . . information about whether the war is over has value to the person who knows it even though it has little or no social value. Because of its value to the individual, that individual will spend resources acquiring it. . . .

53. 15 U.S. (2 Wheat.) 178 (1817).

54. Kronman, *supra* note 11, at 11 n.34 (emphasis added).

> On balance, [if disclosure is required] the informed person does no better than the uninformed one. Indeed, because the information is costly to acquire, the informed person does worse, and hence has no reason to gather the information in the first place. Because the information, by assumption, has no social value, a law requiring disclosure has a desirable effect. When information has no social value, a law requiring disclosure works better than one that imposes no disclosure requirement.[55]

Barnett's argument has even less traction in the more typical nondisclosure case, which involves differentiated rather than homogenous commodities. For example, assume that A purchases B's farm because A has foreknowledge that the Highway Department is about to construct a new highway adjacent to the property, while the public (including B) does not. Prices for differentiated commodities, like B's farm, are always negotiated within a zone. Accordingly, there is too much noise in any single price of this kind to provide a clear price signal for other transactions, since the exact price is based in part on a number of individualized variables, including negotiating ability. Certainly A's purchase will not send a signal that farms adjacent to the planned highway are now more valuable: no one else knows that the highway is planned, let alone where it will go. If A's purchase does send a signal, it will be that farmland generally is worth more than was previously thought. However, that would be precisely the wrong allocational signal. Farmland generally would not be worth more than was previously thought; only the farm of B, and other farms that are adjacent to the projected highway (whose location is secret, except to A), are worth more.

In short, trading on the basis of private information is highly unlikely to efficiently affect the price levels of homogeneous goods, like Laidlaw's tobacco, because the market price of a homogeneous good is unlikely to be shifted at all, or more than microscopically, by an individual transaction. The only case that comes readily to mind in which trading on the basis of private information might have a significant effect on the price of a homogeneous commodity is where there is very significant insider trading in publicly held stock, because in that case the insiders are confident about the reliability of their information and may purchase enough stock to drive the price up or down. But that kind of trading should be, and is, illegal.[56] Trading on the basis of private information is also highly unlikely to efficiently affect the price levels of differentiated commodities, like B's farm. Because each differentiated commodity is different, the prices paid in individual transactions are unlikely to send a readable signal, and in any event

55. Douglas G. Baird, Robert H. Gertner & Randal C. Picker, Game Theory and the Law 98 (1994); *see also* Birmingham, *supra* note 47, at 269; Cooter & Ulen, *supra* note 32, at 273.

56. *See* SEC Rule 10b-5, 17 C.F.R. § 240.10b-5 (2002).

transactions based on private information will often send the wrong signal. This is true in the highway hypothetical, where the actor with private information is the buyer. It is even truer where the actor with the private information is the seller. Thus in *Illustration 1* the sale is not at the right price, it is at the *wrong* price, and if the price sends a signal, it sends the *wrong* signal. More generally, because the private information of sellers will always be negative (or it would be disclosed), sales of differentiated commodities motivated by the seller's private information will always send the wrong price signal.

The limits on the force of Barnett's argument are also limits on the force of Kronman's argument that it is desirable to reward all deliberate investment in acquiring information. Kronman acknowledges, in footnote 34, that his argument doesn't apply in a regime of pure exchange. For most practical purposes, however, foreknowledge—including deliberately acquired foreknowledge—is relevant only in such a regime. As Hirshleifer states, "Foreknowledge . . . [involves] only the value of priority in time of superior knowledge."[57] Generally speaking, this priority is very short-lived. Again, *Laidlaw v. Organ* is a perfect example. No farmer was going to make an irrevocable decision—or indeed any decision—about planting or not planting tobacco between sunrise and 8:00 a.m.

Accordingly, Kronman's centerpiece example drastically undercuts his argument. As *Laidlaw* illustrates, while foreknowledge typically has a short shelf life, decisions about how to allocate funds to particular productive resources, or how to allocate productive resources to particular uses, typically are developed only over a significant period of time. Therefore, it is unlikely that important allocational decisions will be made between the time at which private foreknowledge of information is employed and the time at which the information becomes generally known. For practical purposes, during that period decisions as to which the foreknowledge is relevant typically will occur in a regime of pure exchange, will be redistributive rather than productive, and will not have allocational consequences; and all this is true even if the foreknowledge is deliberately acquired.[58]

To summarize, even information that is deliberately acquired should be subject to a disclosure requirement based on the substantive character of the information. In a perfect world, the Cooter and Ulen test, which centers on whether the information is redistributive or productive, might be

57. Hirshleifer, *supra* note 31, at 562.

58. Kronman advances examples where this won't be so. However, the two examples he provides are unrealistic—the first, self-admittedly; the second, close to self-admittedly. *See* Kronman, *supra* note 11, at 12-13.

preferable, because it speaks to the ultimate issue. In the real world, however, that test probably would be too difficult to administer. In contrast, the Hirschleifer-Shavell test, which centers on whether information is foreknowledge, would be easy to administer in the great majority of disclosure cases, and would probably pick up most of the cases covered by Cooter and Ulen's redistributive category.

Accordingly, another strand of the rule that should govern the disclosure problem is that an actor who has private information that consists of mere foreknowledge should be under a duty to disclose the information even if the information was deliberately acquired.

I will now turn, in Parts IV-VI, to three other categories of cases in which an actor should be under a duty to disclose information that is deliberately acquired.

IV
SELLERS

In terms of the disclosure problem, sellers as a class have four distinguishing characteristics: (1) Sellers have asymmetric access to information about the property they are selling. (2) This information is normally acquired adventitiously. (3) Nondisclosure by sellers entails losses to their unknowing counterparties rather than forgone gains. (4) Sellers typically will have an adequate incentive to deliberately acquire information about their property even if they are under a duty of disclosure. Given these characteristics, a seller should always be required to disclose material facts concerning the property that she is selling.[59]

A. *Asymmetric Access*

To begin with, the access of sellers and buyers to information is systematically and highly asymmetric, because sellers typically have special access to the characteristics of the property they are selling. Furthermore, normally the informational advantage of sellers concerning those characteristics is effectively unerodable by buyers.[60] This results from two factors. First, even if the buyer can investigate the commodity, the investigation

59. I assume in the following discussion that a seller owns the commodity that she is selling. I do not treat a sale through an agent as a case where the seller is not the owner, because the principal is the seller. A special problem arises in the sale of securities in publicly held corporations, because although the seller owns the securities, she does not own the corporate business. However, under the SEC's current disclosure rules, sellers of stock who have material private information about their corporations typically must make disclosure under Rule 10b-5. *See* SEC Regulation FD, 17 C.F.R. § 243.100-.103 (2002).

60. TREBILCOCK, *supra* note 8, takes a generally comparable position. "On my analysis, sellers will generally have to disclose information they possess or material facts to buyers . . . unless disclosure is likely to discourage its acquisition." *Id.* at 114.

will involve costs of a magnitude that the seller will not confront.[61] Second, a buyer's normal investigation of a highly differentiated commodity, like a used machine or a home, will seldom produce all the information that the seller has acquired through the history of her ownership.

B. Acquisition of Information

A seller's private information concerning the characteristics of thc commodity that she is selling is almost invariably acquired without an investment in search. Instead, the information is usually an adventitious by-product of ownership. That would be the case, for example, in *Illustration 1*, in which the seller knows that the septic tank on her property is illegal. In general, therefore, requiring disclosure by sellers is in part a special case of requiring disclosure of adventitiously acquired information.

C. Losses versus Forgone Gains

Another difference between nondisclosure by sellers and by buyers is that typically nondisclosure by buyers results in forgone gains, while nondisclosure by sellers results in losses. Cognitive psychology has shown that actors are loss-averse; that is, the disutility of giving up what one has is greater than the utility of acquiring what one doesn't have.[62] To put this differently, an actor perceives the loss of existing endowments as a greater harm than a failed opportunity to augment his endowments by an equal amount. Accordingly, perceived losses, such as out-of-pocket costs, are more painful than forgone gains, such as potential profits. As Daniel Kahneman explains it, "There is an asymmetry between gains and losses, and it really is very dramatic and very easy to see. . . . People really discriminate sharply between gaining and losing and they don't like losing."[63]

The difference between losses and gains has a systematic impact in the case of nondisclosure by sellers. A buyer will always disclose private information that a relevant commodity is worth less than appears, because the information will drive down the price. Accordingly, a buyer will only withhold private information that the commodity is worth more than appears. Therefore, in the case of nondisclosure by a buyer, the seller forgoes a gain he might have made, but does not incur a loss in relation to the value he placed on the commodity.

61. *See* Kronman, *supra* note 11, at 17.

62. *See, e.g.*, RICHARD H. THALER, THE WINNER'S CURSE: PARADOXES AND ANAMOLIES OF ECONOMIC LIFE 63-78 (1992); Daniel Kahneman, Jack L. Knetsch & Richard H. Thaler, *Experimental Tests of the Endowment Effect and the Coase Theorem*, 98 J. POL. ECON. 1325 (1990); Amos Tversky & Daniel Kahneman, *Rational Choice and the Framing of Decisions*, *in* THE LIMITS OF RATIONALITY 60 (Karen Schweers Cook & Margaret Levi eds., 1990).

63. *See* Erica Goode, *A Conversation with Daniel Kahneman: On Profit, Loss and the Mysteries of Mind*, N.Y. TIMES, Nov. 5, 2002, at F1.

The position of a seller is much different. A seller will always disclose private information that a commodity is worth more than appears, because the information will drive up the price. Therefore, a seller will only withhold information that the commodity is worth less than appears (as in *Illustration 1*). Accordingly, nondisclosure by a seller usually results in a loss to the buyer, since the commodity is worth significantly less than he pays for it. Because a loss is felt more sharply than a forgone gain, there is extra reason to be solicitous about protecting buyers against nondisclosure sellers. As stated by Trebilcock, "Treating wipe-outs differently from windfalls may be justifiable on the grounds either that risk aversion . . . is more apposite to prospective losses than prospective gains or, on a related Rawlsian difference principle, that people generally would prefer a legal regime that shields them from catastrophic losses."[64]

D. *Incentives to Acquire Information*

Finally, a nondisclosure rule is most easily justified, and perhaps only justified, where such a rule provides a significant instrument for the production of socially useful information. However, an owner normally does not require special incentives to invest in information about her own property. Ownership already provides a sufficiently strong incentive for such an investment, because the information will maximize her utility while she owns the property, and allow her to set the correct price if she sells. Accordingly, a requirement of disclosure will not significantly diminish the incentive of sellers to invest in information about their property.[65] As Shavell points out,

> If sellers are deciding whether to acquire information, they will have an *excessive* incentive to obtain it in the absence of a disclosure requirement . . . . [S]ellers will make the socially desirable decision about acquisition of information [even] if there is a disclosure requirement. Sellers will have the correct, positive incentive to acquire information even when required to disclose it because they will be able to capture an increase in value due to information. . . .[66]

It is true that a rule requiring disclosure by sellers may slightly diminish the amount of investment that sellers make in information concerning their property. For example, although a homeowner has an incentive to get termite inspections because she wants to preserve thc value of her property, if she must disclose a bad termite report if and when she sells her house, her incentive to get termite inspections may be slightly diminished. However, under the Disclosure Principle it is not enough that disclosure would

64. TREBILCOCK, *supra* note 8, at 146.
65. Shavell, *supra* note 33, at 21.
66. *Id.* (emphasis added).

have *some* efficiency costs. The costs must be significant. A disclosure requirement will only infrequently diminish an owner's incentive to invest in information about her property, and even when such dimunition occurs it is likely to be marginal.[67] The possibility that requiring disclosure by sellers would marginally diminish the incentives of sellers to invest in information about their own property is not enough to overcome the presumption embodied in the Disclosure Principle.

E. *Market Information*

For some or all of the reasons discussed above, Kronman agrees that a seller should disclose material information concerning latent defects in the property she proposes to sell.[68] However, Kronman would not require a seller to disclose other private information concerning the property, such as market information—that is, information that bears on the value of the commodity but is external to the commodity. Market information is equivalent to what Justice Marshall characterized in *Laidlaw v. Organ* as "intelligence of extrinsic circumstances, which might influence the price of a eommodity,"[69] as opposed to the intrinsic characteristics of the commodity itself. *Laidlaw v. Organ* is an example of market information, although there a buyer rather than a seller had the information. Organ did not have any private information about the characteristics of the tobacco he wanted to purchase. Instead, he had private information about the market for tobacco.

It is true that two of the reasons for requiring disclosure by sellers do not apply to market information: sellcrs do not have asymmetric access to market information, and they may acquire market information deliberately rather than adventitiously. On the other hand, even market information held by a seller is information that will result in a loss to the unknowing buyer, rather than a forgone gain. Furthermore, in many and perhaps most cases a seller's private market information will consist merely of foreknowledge. That was true, for example, in *Laidlaw v. Organ.* Finally, an owner of property has an incentive, by virtue of her ownership alonc, to gather information about the property, regardless of the kind of information involved.

In theory, under current law the general principle is that there is no duty to disclose by either buyers or sellers. In fact, however, a rule that

67. *Cf.* Kronman, *supra* note 11, at 25 ("[T]he point is not that information regarding termites is costless (it isn't), but that a disclosure requirement would not be likely to reduce the production of sueh information.").

68. *See id.* at 26.

69. Laidlaw v. Organ, 15 U.S. (2 Wheat.) 178, 195 (1817); *see also* Barnett, *supra* note 51.

sellers have a duty to disclose would not cause a major change in law and practice.

To begin with, modern economic theory teaches that sellers will frequently disclose even if they have no legal obligation to do so, because nondisclosure will often unravel under competition. Baird, Gertner, and Picker illustrate the unraveling effect with an example involving sealed boxes of apples.[70] Assume the following: A box of apples can hold up to 100 apples. Sellers know how many apples are in a box, but buyers do not. If a seller lies about the number of apples in a box, the buyer can sue the seller at no cost and recover damages.

Begin with the base case of a 100-apple seller. If a seller does not disclose the number of apples in a box, buyers will assume that the box has less than 100 apples and will refuse to pay a 100-apple price. As a result, a 100-apple seller will disclose. Because a 100-apple seller will disclose, buyers will assume that silent sellers have less than 100 apples, and will refuse to pay the 100-apple price to silent sellers.

Now consider a 99-apple seller. This seller does not want to be lumped together with those silent sellers whose boxes have less than 99 apples. In order to receive the 99-apple price, the 99-apple seller will also disclose. But now the 98-apple seller faces the same dilemma previously faced by the 99-apple seller. Because sellers with 99 or more apples are disclosing, by remaining silent the 98-apple seller will be lumped together with the silent sellers whose boxes have less than 98 apples. In order to receive the 98-apple price, the 98-apple seller will therefore disclose. This effect cascades all the way down to the 1-apple seller. Thus, all sellers will disclose the number of apples in their boxes.

Unraveling will occur only under certain conditions, which are not always satisfied. For example, unraveling may not occur if buyers know that one or more sellers do not themselves possess the relevant information. In that case, buyers cannot determine whether any given seller is silent because she does not wish to disclose or because she does not have the information. As a result, no inference can be drawn from the seller's silence. However, even where unraveling will not occur, a wide variety of statutes and regulations require disclosure by sellers. For example, the Securities Act of 1933 imposes extensive disclosure requirements on corporations and certain other persons who sell stock to the public,[71] and SEC Rule 10b-5 effectively requires disclosure of private information in most private sales.[72] The Food and Drug Act requires extensive disclosure about food, through labeling, and about drugs, through labeling and package

70. BAIRD, GERTNER & PICKER, *supra* note 55, at 89-90.

71. *See id.* at 95. 15 U.S.C. §§ 77a-77aa (2002).

72. 17 C.F.R. § 240.10b-5 (2002).

inserts.[73] The Uniform Commercial Code, adopted in every state except Louisiana, indirectly requires disclosure by sellers of goods through the imposition of extensive implied warranties.[74] (Warranty is a more powerful concept than disclosure. A duty to disclose usually applies only to facts that an actor knows, and therefore does not provide the actor with an incentive to investigate. In contrast, warranty is not dependent on the state of an actor's knowledge. Accordingly, warranty does provide actors with an incentive to investigate, so as not to give a warranty that cannot be supported.[75]) Sellers who want to avoid the impact of these warranties must either disclose the defects or disclaim or limit the warranty, which itself sends a signal about the quality of the goods. Various state statutes also require sellers of homes to make extensive disclosures. For example, California Civil Code § 1102 requires the seller of a home to disclose, among other things, significant defects or malfunctions in walls, ceilings, and plumbing; environmental problems; flooding problems; and neighborhood noise problems.[76] A number of other states have adopted comparable statutes.[77]

The courts have also begun to more aggressively require disclosure by sellers, particularly in the case of real property. For example, in *Hill v. Jones*[78] the seller of a home knew of, but did not disclose, termite infestation. The court held that if the infestation was material (an issue of fact for the jury), disclosure was required:

> The modern view is that a vendor has an affirmative duty to disclose material facts where:
>
> 1. Disclosure is necessary to prevent a previous assertion from being a misrepresentation or from being fraudulent or material;
>
> 2. Disclosure would correct a mistake of the other party as to a basic assumption on which that party is making the contract and if nondisclosure amounts to a failure to act in good faith and in accordance with reasonable standards of fair dealing;
>
> 3. Disclosure would correct a mistake of the other party as to the contents or effect of a writing, evidencing or embodying an agreement in whole or in part;
>
> 4. The other person is entitled to know the fact because of a relationship of trust and confidence between them.
>
> . . . .

73. 21 U.S.C. §§ 301-399 (2002).

74. U.C.C. §§ 2-314 to 2-316 (amended 2002).

75. *See* S.M. Waddams, *Pre-Contractual Duties of Disclosure*, *in* ESSAYS FOR PATRICK ATIYAH 237, 245-46 (Peter Cane & Jane Stapleton eds., 1991) (relation between warranties and disclosure).

76. CAL. CIV. CODE §§ 1102-1102.18 (2002).

77. *See, e.g.*, TEX. PROP. CODE § 5.008(b) (West 2003); VA. CODE ANN. § 55-519 (West 2003).

78. 725 P.2d 1115 (Ariz. Ct. App. 1986).

> Courts have formulated this "duty to disclose" in slightly different ways. For example, the Florida Supreme Court recently declared that "where the seller of a home knows of facts materially affecting the value of the property which are not readily observable and are not known to the buyer, the seller is under a duty to disclose them to the buyer."... We find that the Florida formulation of the disclosure rule properly balances the legitimate interests of the parties in a transaction for the sale of a private residence and accordingly adopt it for such cases.[79]

Similarly, in *Weintraub v. Krobatsch*,[80] the New Jersey Court held that the seller of a home had to disclose a cockroach infestation, and in *Reed v. King*,[81] a California court held that the seller of a home had to disclose that ten years earlier a woman and her four children had been murdered in the home, if that information would have a measurable effect on the home's market value.[82]

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79. *Id.* at 1118-19 (quoting RESTATEMENT (SECOND) OF CONTRACTS § 161 (1981) [hereinafter RESTATEMENT SECOND]); Johnson v. Davis, 480 So. 2d 625, 629 (Fla. 1985)). Modern law also imposes a warranty of habitability on landlords and sellers of new homes. *See* Javins v. First Nat'l Realty Corp., 428 F.2d 1071 (D.C. Cir. 1970); Conklin v. Hurley, 428 So. 2d 654 (Fla. 1983) (implied warrant of merchantibility extended from coverage of goods to coverage of newly constructed houses); UNIFORM RESIDENTIAL LANDLORD & TENANT ACT § 2.104 (amended 1972), 7B U.L.A. 123-24 (2000); JOHN P. DWYER & PETER S. MENELL, PROPERTY LAW AND POLICY: A COMPARATIVE INSTITUTIONAL PERSPECTIVE 64 (1998); Olin L. Browder, *The Taming of a Duty; The Tort Liability of Landlords*, 81 MICH. L. REV. 99, 113-14 (1982); Timothy Davis, *The Illusive Warranty of Workmanlike Performance: Constructing a Conceptual Framework*, 72 NEB. L. REV. 981, 1015 (1993); Michael Madison, *The Real Properties of Contract Law*, 82 B.U. L. REV. 405, 459-60 (2002). Similarly, "modern American courts have uniformly embraced the concept that [building] contractors and other service providers impliedly warrant to perform in a workmanlike manner." *Davis*, supra, at 1009. Although the relation between the two warranties is not always clear, generally speaking the warranty of habitability concerns the end result, while the warranty of good workmanship concerns the process by which the result is produced:

> The implied warranty of habitability has been defined "as a guarantee by the builder-vendor that the structure will have no defects of a nature that substantially impairs the enjoyment of the residence." Most courts construe the foregoing to mean that the warranty of habitability is breached only in those instances when defects are of such a nature that a home is rendered uninhabitable. Thus a fundamental difference between the implied warranty of habitability and the warranty of workmanlike performance emerges. The former is an "end result" concept where the conduct or the manner in which performance is conducted is irrelevant. As such, the warranty of habitability represents a form of strict liability since the adequacy of the completed structure and not the manner of performance by the builder governs liability.

Id. at 1015 (citations omitted). Thus in *Centex Homes v. Beucher*, 95 S.W.3d 266 (Tex. 2002), the Texas Supreme Court concluded that a builder can use good workmanship but nevertheless build an uninhabitable home if, for example, it builds the home over a toxic waste dump. Likewise, a poorly constructed home can nevertheless be habitable. Some states do not draw this distinction. Davis, *supra*, at 1015 (concluding that Arkansas, Illinois, and Rhode Island draw no distinction between habitability and good workmanship).

80. 317 A.2d 68 (N.J. 1974).

81. 193 Cal. Rptr. 130 (Cal. Ct. App. 1983).

82. *See also* Bethlahmy v. Bechtel, 415 P.2d 698 (Idaho 1966) (seller had to disclose that a buried water conduit ran under the attached garage); Cohen v. Blessing, 192 S.E.2d 204 (S.C. 1972) (duty to disclose termite infestation in house where this was not apparent upon reasonable inspection);

V
INFORMATION ACQUIRED THROUGH IMPROPER MEANS

Even if an actor acquires information deliberately, and even if the actor is a buyer and the information is not mere foreknowledge, disclosure should be required if the information was acquired through improper means, such as stealing, breaching a fiduciary duty, or tapping into someone's email. The major rationale for permitting nondisclosure in certain cases is to provide an incentive for the acquisition of information. This rationale does not hold, or is trumped, when the means used to acquire the information is socially undesirable. The use of such means should not be incentivized.

This category of cases is exemplified by Illustration 11 to *Restatement (Second) of Contracts* § 161:

> [A, seeking to induce B to make a contract to sell land to A, learns that the land contains valuable mineral deposits. A knows that B does not know this, but does not disclose this to B. B makes the contract.] A learns of the valuable mineral deposits from trespassing on B's land . . . . A's non-disclosure is equivalent to an assertion that the land does not contain valuable mineral deposits, and this assertion is a misrepresentation.[83]

(Notice that for reasons that are obscure, the *Restatement* comes to the right result through a rickety back door, by labeling the nondisclosure a misrepresentation rather than an improper nondisclosure.)

This category is also illustrated by the law of insider trading, which generally makes it improper to trade securities on the basis of misappropriated information.[84]

VI
RELATIONSHIPS OF TRUST AND CONFIDENCE

There are a number of exceptions to the common law rule that transacting parties are not under a duty to disclose. Some of these exceptions have already been discussed, such as the exception—clearly in force, though not well articulated—for information that is acquired through

Thacker v. Tyree, 297 S.E.2d 885 (W. Va. 1982) (duty to disclose that the house had been built on filled ground, causing structural problems). In some states, however, the seller of a home is not required to make disclosure. *See* Stevens v. Bouchard, 532 A.2d 1028 (Me. 1987) (absent a special relationship between buyer and seller, seller has no duty to disclose defects in the premises); London v. Courduff, 141 A.D.2d 803 (N.Y. App. Div. 1988) (seller of real property is under no duty to disclose); Layman v. Binns, 519 N.E.2d 642, 643 (Ohio 1988) (caveat emptor remains a viable rule of law in real estate sales). The courts also may be less willing to require disclosure by purchasers of commercial property than by purchasers of residential property.

83. RESTATEMENT SECOND, *supra* note 79, § 161 cmt. d, illus. 11.

84. *See* United States v. O'Hagan, 521 U.S. 642 (1997); United States v. Falcone, 257 F.3d 226 (2d Cir. 2001); SEC Rule 10b-5, 17 C.F.R. § 240.10b-5 (2002); Security Act of 1933 Release No. 33-7881, 73 SEC Docket 3 (Aug. 15, 2000), *available at* http://www.sec.gov/rules/final/33-7881.htm.

improper means. Another well-established exception is that an actor who stands in a fiduciary relationship to a beneficiary has a duty of full disclosure when dealing with the beneficiary. Judge Posner set out an economic justification for that exception in *United States v. Dial*:

> Fraud in the common law sense of deceit is committed by deliberately misleading another by words, by acts, or, in some instances—notably where there is a fiduciary relationship, which creates a duty to disclose all material facts—by silence. . . . The essence of a fiduciary relationship is that the fiduciary agrees to act as his principal's alter ego rather than to assume the standard arm's length stance of traders in a market. Hence the principal is not armed with the usual wariness that one has in dealing with strangers; he trusts the fiduciary to deal with him as frankly as he would deal with himself—he has bought candor.[85]

In addition to the economic justification for requiring candor by fiduciaries, there is a moral justification: As a matter of social norms, if A owes B a fiduciary obligation, B will have an expectation of candor by A that is justified by conventional social understandings. The moral norm of relationship-based candor is not limited to fiduciary relationships. Rather, it applies to any ongoing relationship in which as a matter of either the social conventions that apply to the relationship, or the understandings that are implicit in the relationship, one or both parties have a justified expectation that the other will exercise candor in transactions between them. In contract law, such relationships are referred to as relationships of trust and confidence. As stated in *Restatement (Second)* § 161:

> A person's non-disclosure of a fact known to him is equivalent to an assertion that the fact does not exist . . .
>
> . . . .
>
> (d) where the other person is entitled to know the fact because of a relation of trust and confidence between them.[86]

Comment *f* to section 161 states:

> The rule stated in Clause (d) supplements [the rule] with respect to contracts between parties in a fiduciary relation. . . . Even where a party is not, strictly speaking, a fidueiary, he may stand in such a relation of trust and confidence to the other as to give the other the right to expect disclosure. Such a relationship normally exists between members of the same family and may arise, in other situations as, for example, between physician and patient.[87]
>
> . . .

85. United States v. Dial, 757 F.2d 163, 168 (7th Cir. 1985) (citations omitted).

86. RESTATEMENT SECOND, *supra* note 79, § 161.

87. *Id.* § 161 cmt. f.

> [Illustration] 13. A, who is experienced in business, has raised B, a young man, in his household, and B has habitually followed his advice, although A is neither his parent nor his guardian. A, seeking to induce B to make a contract to sell land to A, knows that the land has appreciably increased in value because of a planned shopping center but does not disclose this to B. B makes the contract. A's non-disclosure is equivalent to an assertion that the value of the land has not appreciably increased, and this assertion is a misrepresentation.[88]

As Comment *f* suggests, many relationships of trust and confidence fall into well-established and well-defined social patterns, such as physician-patient or parent-child. As Illustration 13 suggests, however, any ongoing relationship should be treated as one of trust and confidence for purposes of disclosure if the relationship gives rise to a justified expectation of candor. So, for example, long-term close friends would have a justified expectation of candor if one buys something from the other. Even some commercial relationships might give rise to a justified expectation of candor, as where one of the parties is an expert, the other is not, and the nonexpert has put himself in the expert's hands. An example would be a relationship between a stamp dealer and a regular customer who has relied on the stamp dealer in building his collection. The basic question is whether the parties were in an ongoing relationship and, as a matter of the social conventions that apply to such a relationship, or of the understandings that are implicit in such a relationship, the unknowing party had a justified expectation of candor in the kind of transaction that they entered into.[89]

VII
EXCEPTIONS

Some of the strands developed in Parts II-VI are subject to three exceptions. Under the first exception, disclosure should not be required if the risk that the unknowing party held a mistaken assumption was allocated to that party. Under the second exception, disclosure should not be required if the unknowing party was on notice or failed to conduct a reasonable search. Under the third exception, disclosure should not be required if the social context in which the transaction occurred is a game in which buyers troll for mistakes by sellers.

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88. *Id.* § 161 cmt. f, illus. 13.

89. *Cf.* RESTATEMENT (SECOND) OF TORTS § 551(2) (1976) ("One party to a business transaction is under a duty to exercise reasonable care to disclose to the other before the transaction is consummated . . . facts basic to the transaction, if he knows that the other is about to enter into it under a mistake as to them, and that the other, because of the relationship between them, the customs of the trade or other objective circumstances, would reasonably expect a disclosure of those facts.").

A. *The Risk that the Unknowing Party Held a Mistaken Assumption Was Allocated to that Party*

In the case of a shared assumption, the risk that the assumption is mistaken may be contractually allocated to the adversely affected party.[90] Similarly, the risk that an unshared assumption is mistaken may be allocated to the unknowing party by a valid contractual provision or a trade practice. For example, it may be a usage in the commercial real estate business that when both the buyer and the seller are in the business, each is strictly on its own and disclosures will neither be made nor expected. In that case, even information that was adventitiously acquired, or mere foreknowledge, would not need to be disclosed, assuming the information was properly acquired, because those who participate in the commercial real estate business would impliedly consent to the usages of the business.

B. *The Unknowing Party Was on Notice or Failed to Conduct a Reasonable Search*

The risk that an unshared tacit assumption is mistaken should be allocated to the unknowing party where under the circumstances a reasonable person in that party's position would have been put on notice that his tacit assumption was incorrect, would have conducted a search that would have corrected his assumption, or both. For example, in *Illustration 1* (the septic-tank case), if the buyer had seen raw sewage seeping out of the ground prior to making the contract, the seller should not have been obliged to disclose, because a reasonable person in the buyer's position would have been on notice that the sewage system was defective and would have discovered the defect through a reasonable search.

Much the same is true of the actual transaction that gave rise to *Illustration 2*, the purchase of farmland by Beta. The illustration is based on facts related to the famous insider-trading case of *SEC v. Texas Gulf Sulfur Co.*[91] However, the facts of the actual transaction differ in several relevant respects from the facts set forth in *Illustration 1.* In the actual transaction, the purchaser was Texas Gulf Sulphur Company, and the seller—or more accurately, the optionor—was the Royal Trust Bank of Canada, as executor of the Hendrie Estate, a sizeable estate that included the relevant parcel of land. This parcel was not a farm, nor was it in a farm area. Instead, it was located in the Timmins region of the Canadian Shield, a vast and relatively barren area valuable principally for timber and minerals. Furthermore, Texas Gulf did not purchase the Hendrie parcel. Instead, it purchased, for $500, an option that would allow it to explore the property for two years and gave it the right, during that period, to acquire mining

90. Eisenberg, *supra* note 1, at 1620-41.

91. 401 F.2d 833 (2d Cir. 1968) (en banc).

rights on the property for $18,000. If Texas Gulf exercised the option and then discovered a commercial body of ore, the Estate would get 10% of the profits, which was the standard term in the industry. Prior to securing the option, Texas Gulf had written the Bank, as executor, that "[our] mining exploration department . . . has performed extensive work in the Timmins area on [adjacent public] lands. To complete our assessment of the area we are considering possible groundwork on lands held by private individuals or companies."[92]

Each of the elements in this transaction put the Estate on notice that Texas Gulf had private information that there was significant prospect of a mineable body of ore under the Hendrie land. Because the Canadian Shield is relatively barren, the Hendrie property was likely to have value to a buyer only for timber or minerals—and Texas Gulf Sulphur was not a timber company. Moreover, Texas Gulf specifically informed the Estate that it was interested in exploring for minerals on the Hendrie property. Pretty clearly, Texas Gulf did not plan to explore for minerals on every property in the vast Canadian Shield, and the Estate must have known that Texas Gulf selected the Hendrie property for a special reason. Finally, Texas Gulf specifically informed the Estate that it had performed extensive mining-exploration work in the region. Obviously, that exploration work had led Texas Gulf to believe that there was a significant prospect that a mineable ore body was located on the Hendrie property.

Of course, Texas Gulf did not disclose its specific findings. Nor did it need to, because it was a buyer rather than a seller; its information was not acquired either adventitiously or improperly (let us assume, although there was a little doubt here, because Texas Gulf might have unlawfully entered on the Estate's land), and the information was not mere foreknowledge. But beyond those elements, Texas Gulf did more than enough to put the Estate on notice that it had acquired material favorable information about the possibility of mineral deposits in the Hendrie property. Accordingly, even if Texas Gulf Sulphur had been under an obligation to disclose, it satisfied that obligation by putting the Estate on notice. At that point, it was the Estate's burden to make further inquiries about what Texas Gulf knew or might know. If Texas Gulf declined to provide further information, then the Estate had a choice of not doing business with Texas Gulf, or rolling the dice and making the deal that Texas Gulf proposed, knowing that Texas Gulf had material favorable information concerning the Hendrie property that it would not share. The Estate, having chosen to roll the dice, made a fair bet and could not complain that it lost.

92. MORTON SHULMAN, THE BILLION DOLLAR WINDFALL 1-11, 75-86 (1970).

C. The Social Context in Which the Transaction Occurred Is a Game in Which Buyers Troll for Mistakes by Sellers

An actor who has been put on notice in effect assumes the risk that he is mistaken. An actor may also assume the risk of a mistake by virtue of the social context in which a transaction occurs. For example, suppose that A, an amateur but well-trained bibliophile, finds a significantly underpriced book in a used-book store owned and managed by B, and it is clear from the price that B does not know the character or value of the book. A is under no obligation to make disclosure, for the reasons considered so far in this Part: A's determination that the book is rare and valuable is more than foreknowledge, because it is a discovery that might never have been made but for A's knowledge and skill. A's information was neither adventitiously nor improperly acquired.

But there is still another reason why A should not be required to make disclosure. The social context in which A's discovery occurred is the rare-book game, in which buyers with knowledge and skill about rare books regularly troll used-book stores, hoping to find a rare book that the dealer failed to recognize. Every used-book dealer benefits from the game, because it brings more used-book traffic into stores, and buyers who come to a used-book store hoping to come away with a bargain will often buy a book even if they do not find a bargain. On average, therefore, the game benefits dealers even if they occasionally lose on particular transactions. Used-book dealers all know that there is an ongoing rare-book game. Accordingly, the responsibility is on a dealer, if he doesn't want to lose the game, to make himself knowledgeable about rare books and to scrutinize his inventory with care. Of course, a high-volume used-book dealer might conclude that it isn't efficient for him to carefully examine the rarity of every book that he takes into stock, but that is the dealer's choice, and he should stand behind it.

The same point holds in certain other social contexts. Take, for example, garage sales. People who hold garage sales know that there is a garage-sale game, in which buyers troll garage sales on weekends in the hope of making a strike. This game benefits sellers, beeause it increases the volume of buyers. A seller who stands to benefit from this game cannot fairly complain when he loses rather than wins.

The exceptions discussed in this Part are not applicable in every case. They would usually fail to justify nondisclosure by an actor who acquired material information by improper means, or nondisclosure in the context of a relationship of trust and confidence. Where applicable, however, these exceptions would permit nondisclosure by actors who acquired information adventitiously, by actors whose private information is mere foreknowledge, and by sellers.

VIII
SUMMARY

Under the Disclosure Principle, the law should require disclosure except in those classes of cases in which a requirement of disclosure would entail significant efficiency costs. The Disclosure Principle is not intended to apply to individual cases. Instead, the principle is a guide to the formulation of a more specific, multi-stranded rule concerning when disclosure is or is not required in given classes of cases. The strands of this rule have been developed in Parts II-VII. Putting these strands together, the rule is as follows:

An actor should be required to make disclosure to correct a counterparty's mistaken tacit assumption unless:

- the actor is a buyer,
- the information is more than mere foreknowledge,
- the information was not acquired adventitiously or improperly, and
- the actor and her counterparty are not in a relation of trust and confidence such that a reasonable person in the counterparty's position would have a justified expectation of candor,

except that if the parties are not in a relationship of trust and confidence and the information was properly acquired, disclosure is not required if either (1) the risk that the unknowing party held a mistaken assumption was allocated to that party by a valid contractual provision or trade practice; (2) the unknowing party was on notice that his mistaken assumption was unfounded, failed to conduct a reasonable search, or both; or (3) the social context in which the transaction occurred is a game in which buyers troll for mistakes by sellers.

IX
EXCURSUS

It is often explicit or implicit in scholarly discussion of the disclosure problem that a right not to make disclosure is a crucial engine for a prosperous economy, because much less productive information would be developed under a thoroughgoing disclosure regime than under a nondisclosure regime. It is true that *less* productive information would be developed under a thoroughgoing disclosure regime, and therefore something would be lost in the way of efficiency if such a regime was adopted. However, it is speculative whether *much less* productive information would be developed. Consider, for this purpose, five basic paradigms under the disclosure problem—paradigms that regularly recur in the scholarly discussion and, to varying extents, in the case law. These are:

> *Paradigm 1.* Cases, like *Illustration 1*, in which a seller knows there is a latent defect in her property.
>
> *Paradigm 2.* Insider-trading cases.
>
> *Paradigm 3.* Cases, like *Laidlaw v. Organ*, in which a party's private information consists of mere foreknowledge.
>
> *Paradigm 4.* Cases, like *Illustration 2*, in which a buyer has determined that there may be valuable mineral or petroleum rights under the property of an unaware seller.
>
> *Paradigm 5.* Cases in which the buyer knows, and the seller does not know, that an artwork the seller owns is very valuable.

In *Paradigm 1*, *2*, and *3* cases (latent defects, insider-trading, and foreknowledge) disclosure should be required. I will therefore put those three cases aside.

In *Paradigm 4* cases (mineral and petroleum rights) disclosure should not be required, assuming the information was properly acquired and there was not a relationship of trust and confidence between the buyer and the seller. Nevertheless, the economic significance of *Paradigm 4* cases is not clear. Today, at least, it seems that most new petroleum and mineral deposits lie in areas in which the prospect of such deposits is public information. Often these areas are owned by a government, which sells petroleum and mineral rights at auction, so the disclosure issue is typically moot. In other cases, petroleum or mineral deposits are discovered by prospecting on public lands in areas where the possibility of petroleum or mineral deposits is public knowledge and the prospector goes on the land to stake it out for those purposes. In still other cases, potential petroleum or mineral deposits are located under private lands in areas that are known to be petroleum- or mineral-bearing, so that sellers are on notice that buyers may be acquiring the land (or, much more typically, acquiring petroleum or mineral-rights options or leases) for that purpose. Even when petroleum or mineral deposits are found under private lands located in areas where such deposits were completely unsuspected, it seems likely that in many or most cases the petroleum or mineral company will do something, like taking an option in its own name, or giving the optionor or seller a percentage in profits or a royalty interest, that effectively puts the seller on notice that the buyer believes there are valuable deposits under the land. In all these cases too the disclosure issue is moot.[93]

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93. At my request, Howard Tony Loo, my Research Assistant, sent the following message to a number of professors who teach in the area of oil and gas law:

> We are interested in what the industry practice is when a petroleum or mineral mining company buys private land that the company thinks has oil or valuable minerals underneath it. Specifically, we are interested in whether the private owner of the land is usually on notice

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> that the company believes that the land has oil or minerals on it. Do petroleum and mineral mining companies commonly put sellers on notice by purchasing or taking options or rights in their own names, or sharing profits with the seller? In other words, we are wondering whether industry practices make it the case that the private land owner knows (because the company tells them so) or should know (by virtue of the fact that the company wanting to purchase the land is an oil company) why the company wants the land. Or, do mining companies sometimes use third parties to buy the land so that the private owner is not tipped off to the fact that a mining company is interested in the land? What's the industry practice?

E.g., Email from Howard Tony Loo, research assistant to Professor Melvin A. Eisenberg, to John S. Lowe, George W. Hutchison Professor of Energy Law, Southern Methodist University (Jan. 30, 2003, 2:44 pm) (on file with author).

The replies made clear that in this area, sellers are almost invariably on notice. For example, Ernest Smith, of the University of Texas at Austin, replied:

> The vast majority of acquisitions by oil companies are through an instrument labeled an oil and gas lease (although it has more eharacteristics of a deed than a lease). The effect of the typical "lease" is to transfer rights in the oil and gas beneath the described tract for a specified period of years—perhaps 5—and for so long thereafter as oil or gas is produced in paying quantities. . . .
>
> In the typical transaction the landowner receives three financial benefits. The first, which is called the bonus, is the consideration for the lease. It is typically a lump sum paid at closing. The second is a series of annual rentals that are paid annually throughout the initial term. The third is the royalty, which is a right to a specified fraction of gross production or—more likely—a specified fraction of the oil company's sale proceeds or the market value of the royalty fraction. The size of the fraction varies with local custom and the landowner's skill at negotiation. One-eighth is (or should be) the absolute minimum. 1/6 and 3/16 are also common royalty fractions.
>
> The form of the transaction clearly alerts the landowner to the purchaser's interest in oil and gas beneath the land; but unless there has been prior development on nearby land, the landowner is unlikely to know how good the prospects for production actually are. The oil company, on the other hand, almost certainly has geological and seismic information that it is relying on in negotiating the agreement. 30 or more [years ago], when the typical landowner was a farmer or rancher and likely to be relatively unsophisticated, the oil eompany's possession of such information gave it an enormous advantage in negotiating the oil and gas lease. Most landowners today use attorneys in negotiating their side of the agreement and an experienced attorney should be able to obtain access to geological information; for there are specialized consultants who provide such information—at a considerable fee, of course.
>
> There are very few instances in which an oil company buys the land outright. One principal reason for this is that a purchase of the surface estate significantly increases the cost of the transaction to the oil company. This was true even 50 years ago and is certainly true today, when surface rights are not uncommonly far more valuable than mineral rights.

Email from Ernest Smith, Rex G. Baker Centennial Chair in Natural Resources Law, University of Texas at Austin, to Howard Tony Loo, Research Assistant to Professor Melvin A. Eisenberg (Mar. 30, 2003, 1:20 p.m.) (on file with author).

Similarly, Bruce Kramer, of Texas Technical University stated:

> In the modern world before an oil and gas lease will be negotiated in an unproven area, the oil and gas development company will negotiate an exploration agreement with the owner of the mineral estate, obviously . . . not hiding the fact that the exploration activities are designed to discover the existence or non-existence of oil and gas. To my knowledge there is little deception in the leasing transaetion and little evidence of widespread attempts to hide the fact that Exxon or Chevron is seeking to develop the premises for oil and gas.

Email from Bruce Kramer, Maddox Professor of Law, Texas Technical University, to Howard Tony Loo, Research Assistant to Professor Melvin A. Eisenberg (Mar. 30, 2003, 1:20 p.m.) (on file with author).

John Lowe, of Southern Methodist University, added:

> [G]enerally, oil companies do not buy the land outright, they just lease it. And often they lease it through brokers who do not disclose the name of the principal. There is often a lot of competition too; i.e., groups of competing leasing agents and independent entrepreneurs. I do not think that it is much different from the commercial real estate market. If the market works as it is supposed to, one who approaches it prudently should get a deal in a "fair" range.

In *Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information,* Frank Easterbrook stated that "[T]here would have been no discoveries of ore in Timmons, Ontario, by the Texas Gulf Sulfur Corp. unless the discoverer were allowed to use its hard-won information to appropriate much of the value of the deposits."[94] This statement is somewhat hyperbolic. It is true that Texas Gulf might not have made the discovery if it knew that it would have to disclose to the landowner the exact nature of its findings. However, no one advocates that kind of detailed disclosure where the landowner is put on notice that the acquiror is in possession of such information, and can either ask for more information, decline to go forward, or proceed at its peril. Therefore, a more realistic question is, would Texas Gulf have made its investment if it knew that it would be required to put a landowner on notice that it had discovered promising information about his land? We know the answer to that question—Texas Gulf was willing to and did put the Hendrie Estate on notice. Moreover, petroleum and mineral companies commonly put landowners on notice, by purchasing mineral or petroleum leases or options to acquire such leases, and paying partly by giving the landowner royalties or an interest in profit or production.

But why would a petroleum or mineral company think that it could make use of information it discovered even if it put the landowner on notice that it had made a discovery that affected the value of the land? To be specific, why did Texas Gulf not think that the Hendrie Estate would start an auction once it had been put on notice that it might well own a mineable body of ore?

There are several possible answers to that question. First, Texas Gulf offered the Estate the standard royalty terms that were being offered in the industry, so an auction might not have materially improved the terms the Hendrie Estate got. Second, Texas Gulf did keep something to itself—namely, its exact findings—and without access to those findings, other bidders would be bidding blind. Indeed, any winning bidder other than Texas Gulf would almost certainly have bid too high, because presumably

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Email from John S. Lowe, George W. Hutchison Professor of Energy Law, Southern Methodist University, to Howard Tony Loo, Research Assistant to Professor Melvin A. Eisenberg (Feb. 5, 2003, 7:44 p.m.) (on file with author).

The practice in the hard-mineral area is generally comparable for present purposes. Mineral companies usually deal through "landmen." A landman who wants to acquire mineral rights from a private fee owner (as opposed to staking a mining claim on federal land) normally acquires a mineral lease in exchange for royalties and a nonrefundable advance against royalties, rather than the entire fee interest. Telephone Interview with David Phillips, Director, Rocky Mountain Mineral Law Foundation (Oct. 21, 2003); Telephone Interview with Bill Van Bebber (Oct. 21, 2003). Accordingly, by the nature of the proposed contract the fee owner is on notice that the prospective lessee has reason to believe that there are minerals under the land.

94. Frank H. Easterbrook, *Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information*, 1981 SUP. CT. REV. 309, 328.

Texas Gulf would bid up to, but only up to, the point at which a bid was economically justified given the relevant information. Finally, although auctions are romantic, most property is sold by negotiation, and indeed auctions do not always produce a higher price than would be obtained by negotiation.

A right to not even put the seller on notice in *Paradigm 4* cases may be an instrument of efficiency, even if seldom employed in the real world. A right to not disclose might also be an instrument of efficiency in *Paradigm 5* (artwork) cases because, as Muriel Fabre-Mignon has written, otherwise "there is no incentive"—or perhaps more accurately, no economic incentive—"for the buyer to acquire that information as his efforts to in doing so will only benefit the seller. . . . [M]asterpieces would stay unknown, and therefore most probably in the wrong hands."[95] There are also categories of cases lying outside *Paradigms 4* and *5* where a right to not disclose is an instrument of efficiency. Accordingly, a thoroughgoing disclosure regime would not be justified, because there are categories of cases in which disclosure would have efficiency costs and the likelihood that these costs would be significant is sufficiently high that disclosure should not be required. Nevertheless, in the end the macroeconomic effect of a right to not disclose in those cases is unknown and probably unknowable. Maybe a right to not disclose in those cases is a mighty engine of economic development. Maybe it is just a two-cylinder putt-putter.

95. Fabre-Magnan, *supra* note 30, at 114.