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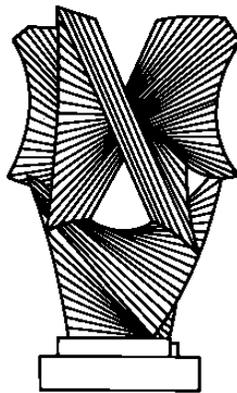
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Mistake under the Common European Sales Law

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Mistake under the Common European Sales Law

Ariel Porat*

The Common European Sales Law (CESL) sets the conditions in which the mistaken party is entitled to rescission and compensation from the other party. Some of the CESL's provisions, however, are inconsistent with efficiency.

First, under the CESL, as long as the mistake is essential, for the mistaken party to be allowed to rescind the contract, it is sufficient that the other party caused the mistake. From an efficiency perspective, however, causation is not enough to allow rescission for mistake. Second, the CESL permits rescission when one party failed to disclose information to the other party that would have revealed to the latter his essential mistake and the former party knew or could be expected to have known the mistake. In contrast, under efficiency, not all essential mistakes made by the one party that the other party knew or could have known about constitute grounds for rescission. Third, the CESL allows rescission for fraud, which includes non-disclosure of information. The CESL provides a list of considerations that should be taken into account in deciding whether a duty of disclosure arises. In contrast, under efficiency, there are far more concrete guidelines for determining whether a duty of disclosure arises, and in fact, under certain conditions, intentional ("fraudulent") misrepresentations are even permitted. Fourth, the CESL allows a contract to be rescinded when both parties made the same essential mistake. Yet efficiency considerations entail that this should not always be the case and that some mutual mistakes should not be grounds for rescission.

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Introduction

People create contracts in order to increase their welfare. Ideally, the positions of both parties to the contract after performance will be better than what their positions would have been had there been no contract. This, however, is not

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always the case. Numerous contingencies can arise before or after contracting that will affect the surplus the parties can derive from the contract. It is certainly not rare for one party to be left worse off from the contract while the other party is better off. This does not mean, of course, that the party who ended up worse-off made a mistake that will allow him to rescind the contract. In fact, in most such cases, the worse-off party, legally speaking, did not make a mistake: he simply took a risk that, unfortunately for him, materialized.

But there are cases in which a mistake was made, and the question that arises is whether the party made worse off is entitled to rescission or even compensation if he suffered harm. Contract law distinguishes between at least four types of mistake situations: unilateral mistake, mutual mistake, non-disclosure, and fraud. The Common European Sales Law (CESL) differentiates between “Mistake” and “Fraud” in two separate articles. Under their definitions in the Law, mistake includes both unilateral mistake and mutual mistake, whereas fraud refers to both active misrepresentation and non-disclosure. The CESL sets the conditions in which the mistaken party is entitled to rescission and compensation from the other party. Some of the CESL’s provisions, however, are inconsistent with efficiency. The aim of this Essay is to point out those inconsistencies.

First, under the CESL, as long as the mistake is essential,¹ for the mistaken party to be allowed to rescind the contract, it is sufficient that the other party caused the mistake.² From an efficiency perspective, however, causation is not enough to allow rescission for mistake.

Second, the CESL permits rescission when one party failed to disclose information to the other party that would have revealed to the latter his essential mistake and the former party knew or could be expected to have known the mistake. The question of whether a duty of disclosure arises should be answered, according to the CESL, by referring to principles of good faith and fair dealing.³ Efficiency,

¹ I interpret Art. 48, sec. 1(a), to condition rescission on the essentiality of the mistake. According to this section, a condition to rescission is that “the party, but for the mistake, would not have concluded the contract or would have done so only on fundamentally different contract terms and the other party knew or could be expected to have known this.”

² Art. 48, sec. 1(b)(i). The CESL adds in Art. 48, sec. 2, “A party may not avoid a contract for mistake if the risk of the mistake was assumed, or in the circumstances should be borne, by that party.”

³ Art. 48, sec. 1(b)(iii) of the CESL allows rescission if the other party “knew or could be expected to have known of the mistake and caused the contract to be concluded in mistake by not pointing out the relevant information, provided that good faith and fair dealing would have

however, sets different and much clearer conditions for rescission. In particular, under efficiency, not all essential mistakes made by the one party that the other party knew or could have known about constitute grounds for rescission. Independently of good faith and fair dealing principles, a party to a contract should often be entitled to withhold information from the other party concerning the latter's mistakes.

Third, the CESL allows rescission for fraud, which includes non-disclosure of information. The Law provides a list of considerations that should be taken into account in deciding whether a duty of disclosure arises.⁴ Although this list does include important considerations, some of them are vaguely formulated. Moreover, the CESL allows rescission whenever one party fraudulently misrepresented to the other party. In contrast, under efficiency, there are far more concrete guidelines for determining whether a duty of disclosure arises, and in fact, under certain conditions, intentional ("fraudulent") misrepresentations are even permitted.

Fourth, the CESL allows a contract to be rescinded when both parties made the same essential mistake.⁵ Yet efficiency considerations entail that this should not always be the case and that some mutual mistakes should not be grounds for rescission.

The Essay proceeds as follows. Part I analyzes the unilateral mistake and non-disclosure doctrines. Part II discusses the first three inconsistencies between efficiency and the CESL described above, all of which relate to unilateral mistake, non-disclosure, and fraud doctrines. Part III analyzes the mutual mistake doctrine and explains why the CESL's concept of the doctrine is incompatible with efficiency considerations. The Conclusion wraps up the discussion.

I. An Economic Analysis of Unilateral Mistakes and Non-Disclosure

Consider the following two examples:

Example 1. Air and Noise Pollution. A sells his residential apartment to B and fails to disclose to her information about the air and noise pollution emanating from a nearby factory. A knows that B, who has not seen the property before purchasing it, is unaware of the pollution and also that B

required a party aware of the mistake to point it out." Rescission, however, would not be allowed if the mistake was assumed by the mistaken party or "in the circumstances should be borne by him." For Art. 48, sec. 2, see *supra* note 2.

⁴ Art. 49, sec. 3.

⁵ Art. 48, sec. 1(b)(iv).

values clean air and quiet. Upon discovering the pollution, B wants to rescind the contract. Is she entitled to do so?

Example 2. Mineral Deposits. A enters into a contract to purchase a tract of land from B, after conducting an expensive investigation into the likelihood of mineral deposits on the land. The results indicated very high chances of finding minerals. A discloses nothing to B. The contract price for the land does not reflect a high likelihood of mineral deposits. B now wants to rescind the contract. Is she entitled to do so?

In both examples, A failed to disclose material information to B and that non-disclosure probably induced the creation of the contract. In both examples, A was aware of the importance of the information to B, as well as of the fact that she lacked this information. The two cases can be described as either unilateral mistake cases—when one party (A) knew about the other party's (B) mistake but failed to point it out to her—or fraudulent non-disclosure cases—when the non-disclosure was intended by one party (A) to induce the other (B) to make a mistake. Yet should the law treat these cases alike?

From an efficiency perspective, the answer is no: in Example 1, rescission should be allowed, but in Example 2, it should not. I will start by explaining why there should be no duty of disclosure in Example 2. If, in that case, A has a duty to disclose the results of his investigation to B, he might not conduct the investigation in the first place because he will not be able to reap the entirety of its benefits. His investigation, however, generates information that is socially beneficial or productive: this information can enable the efficient use of the land and increase social welfare. Therefore, in order to encourage A's investigation, he should be allowed to withhold its results from B.⁶

In fact, had the information from the investigation been negative (low likelihood of finding minerals), A would not have entered into the contract with B, thereby avoiding a possible loss. Even with a duty of disclosure, then, A has some incentive to conduct an investigation. If he discovers that the land is of low value (low likelihood of finding minerals) and decides not to purchase it, he may keep the information to himself (in which case, there is no social value to the information) or somehow sell it to B for a price. If, instead, he finds out that the land has a high value (high likelihood of finding minerals) and wants to purchase it, he must disclose the

⁶ Kronman, "Mistake, Disclosure, Information, and the Law of Contracts", 7 J. LEGAL STUD. (1978), 1.

information to B and will derive no benefit from it. Thus, under a duty of disclosure, from the outset, A has not much to profit from investigating the possibility of mineral deposits on the land. To provide him with strong incentives to do so, A should be allowed to reap all of its benefits, including the benefit of positive information (high likelihood of finding minerals). This can be achieved only if A has no duty to disclose the results of his investigation to B.

Example 1 is a completely different case. A acquired the information regarding the air and noise pollution at no cost to him: he learnt about these defects from simply living there. Therefore, a duty of disclosure would not affect the production of information of this type: with or without a duty of disclosure, A would acquire the information.⁷ At the same time, however, imposing a duty of disclosure on A in this Example would ensure that both he and B increase their welfare if they enter into the contract; non-disclosure might lead B to buy an apartment that she would not have bought had she been aware of its flaws.

It may very well be the case, then, that at the end of the day, a duty of disclosure in Example 1 would have mainly redistributive consequences: With disclosure, B might not have bought the apartment or would have bought it at a lower price. In the absence of disclosure however, she might have paid more than the apartment's value for her. Yet paying an excessive price does not mean that B must live in the apartment after discovering its defects immediately after moving in; indeed, she is free to resell the apartment, and while, at the end, she loses money, that loss would be close to A's gain from not disclosing the information to B. Still, the latter scenario would entail some social costs—the resale contracting costs—which would be saved if there were disclosure. Furthermore, disclosure in Example 1 could also save B the costs of acquiring information: with no duty of disclosure, she would have to incur costs to find out about possible defects in the apartment, whereas with a duty of disclosure, she would be able to trust A and avoid those costs. Note that for A, the costs of acquiring information regarding air and noise pollution are zero, while for B they are positive.⁸

To be sure, in Example 2, as well, non-disclosure could entail costs for B to acquire information about the land that would be saved were A subject to a duty of

⁷ *Id.*

⁸ Note also, that hiding information from one another could be more attractive to the parties when there is no duty of disclosure, while such hiding is often costly but has no social value.

disclosure. Thus, it is quite possible that with no duty of disclosure in this case, both A and B would conduct a costly investigation into the land's worth, and moreover, neither would be able to reap much benefit from their respective investigations since the other party acquired the same information.⁹ A possible solution is to impose on B (the seller), but not A (the buyer), a duty of disclosure.¹⁰ This would increase the buyer's incentive to carry out the investigation. But more importantly, only when the seller discloses no information to the buyer will the buyer proceed with an investigation since he will understand that the seller has not conducted any investigation himself.

Furthermore, in Example 2, with no duty of disclosure, there is the risk that A (the buyer) will invest excessively, from a social perspective, in acquiring the information about the land, because the information could be partly distributive, and not just productive. That would be the case, for example, if there is high likelihood that the information about the land would transpire soon after the conclusion of the contract, even without any investigation by the parties. Finally, non-disclosure could result – exactly as in Example 1 – in inefficient allocation of resources: given the information about the land, it may occur that the land is more valuable at B's, rather than A's hands, while non-disclosure would result in A purchasing the land. This latter point is further analyzed below.¹¹

In Example 3, below, which is a variation on Example 1, the case for disclosure is stronger, since even though, as in Example 1, the information is acquired by A at no cost to him, it is mainly productive rather than redistributive.¹²

Example 3. Termites. A sells his residential apartment to B, without disclosing to her that the apartment is infested with termites. A lived in the apartment for five years prior to selling it and is aware of the termite

⁹ Cf. Shavell, *Foundations of Economic Analysis of Law*, (Cambridge, 2004), p. 333 & n.15. (explaining that with no duty of disclosure, private incentives to acquire information will be excessive, but with such a duty, incentives will be insufficient). See also Harrison, "Rethinking Mistake and Nondisclosure in Contract Law", 17 *GEO. MASON L. REV.* (2010), 335 (discussing the inefficiency that could result from non-disclosure of information even if costly acquired and suggesting that allowing the party who acquired the information first only part of its benefit could often be the efficient solution); Kull, "Unilateral Mistake: The Baseball Card Case", 70 *WASH. ULQ.* (1991), 78 (arguing that non-disclosure incentivizes both parties to engage in a redundant search for the same information).

¹⁰ For the argument that the case for disclosure by the seller is typically stronger than the case for disclosure by the buyer, see *infra* note 16 and accompanying text.

¹¹ *Infra* text accompanying notes 17-18.

¹² On the distinction between redistributive and productive information, see Cooter & Ulen, *Law & Economics*, 5th ed. (Harlow, 2007), pp. 292-98. See also Shavell, *supra* note 9, at 334 (distinguishing between information that has social value (i.e., that is productive) and information that has only private value (i.e., that is redistributive)).

problem. He also knows that B is unaware of the termites. Assume that anyone living in the apartment for a year or more would in any event discover the infestation. B wants to rescind the contract. Is she entitled to do so?

The reason why Example 3 presents a stronger case for disclosure than Example 1 is that the information with respect to the termite infestation is valuable to B not just in deciding whether to buy the apartment or what price to pay, but also in terms of taking precautions and preventing more serious harm to the apartment *if she does buy it*.¹³ If B buys the apartment without being aware of the termites, it will take her a year to discover them, and in this year, additional harm will be caused. A duty of disclosure for A would prevent this added harm.¹⁴

The question of whether the relevant information is redistributive or productive in nature is a central consideration in setting disclosure duties, not only when acquiring the information is costless for the non-mistaken party, as in Examples 1 (Air and Noise Pollution) and 3 (Termites), but even more so when it is costly. Example 2 (Mineral Deposits) represents cases in which acquiring the information is costly and the information is productive. The next example, below, illustrates cases in which acquiring the information is costly but the information is redistributive.

Example 4. Permission to Mine for Minerals. A buys a tract of land from B, after conducting an expensive investigation into the likelihood of zoning authorities granting him a permit to mine the land for minerals. The investigation results indicate that likelihood to be very high. A discloses nothing to B. The contract sets a price for the land that does not reflect the high chances of receiving a mining permit. B wants to rescind the contract. Is she entitled to do so?

In contrast to Example 2, the information in this example is redistributive rather than productive. If A bears no duty of disclosure, he will invest in acquiring the information. From a social perspective, however, this investment is a waste of resources, since it will not produce any social value. Or at least this is the case if we assume that nothing productive could be done with the land in light of the information

¹³ Cf., Cooter & Ulen, *supra* note 12, pp. 297-98 (calling this type of information “safety information”).

¹⁴ One can imagine a duty of disclosure arising after the contract has been concluded. See *infra* note 18 and accompanying text. For a discussion of the termites case, see Posner, *Economics Analysis of Law*, 8th ed. (New York, 2003), p. 111.

in the interim between the acquisition of the information by A and the public release of the information.¹⁵

The nature of the information, as either productive or redistributive, is thus a critical factor in setting duties of disclosure. This does not mean that it always tips the scales in the same direction: sometimes the productivity of the information justifies not imposing a duty of disclosure (as in Example 2, Mineral Deposits), and sometimes it works the other way around (as in Example 3, Termites). Thus, in Example 2, the buyer who acquired the information can make productive use of it, whereas the seller in Example 3 must transfer the information he acquired to the buyer so that the latter can make productive use of it.¹⁶ This difference between the two cases creates no dilemma as to how to reach the efficient solution. In Example 2, the information is costly, and to incentivize its production, the beneficiary of the information must be the party that produces it (A). Non-disclosure would retain the information with that party, and at the same time would allow him to use it productively. In contrast, in Example 3, the information is costless, and it will be produced regardless of the identity of its beneficiary. Disclosure would therefore not affect the production of the information, but at the same time would allow its productive use.

Things are not as simple if the information must be productively used by the party who does not acquire it and the information is costly. Thus, assume that in Example 3, it is costly for the seller to inspect the apartment for termites. On the one hand, if he has a duty to disclose the information he acquires to the buyer, he might refrain from inspecting the apartment so as to avoid the potential costs entailed by the duty of disclosure if termites are found.¹⁷ On the other hand, in the absence of a duty

¹⁵ Otherwise, the information could have productive consequences. Perhaps, however, the zoning authority would still have good reasons for not releasing the information to the public.

¹⁶ For the argument that the case for disclosure by the seller is typically stronger than the case for disclosure by the buyer since "it is the buyer who typically can make socially valuable use of the information," see SHAVELL, *supra* note 9, at 333. Shavell also explains that the seller has incentives to acquire information about the land even with a duty of disclosure, since if that information is positive, he will be able to raise the price accordingly. Shavell, "Acquisition and Disclosure of Information Prior to Sale", 25 RAND J. ECON. (1994), 20, 21. See also Wonnell, "The Structure of a General Theory of Nondisclosure", 41 CASE W. RES. L. REV. (1991), 329, 343-44, 377 (arguing that efficiency requires the merger of information and resources and that that should be one of the rationales of the law of non-disclosure).

¹⁷ Although he may find the apartment to be termite-free, and if he can prove this to the buyer, he may get a higher price. Proving this to the buyer however could be hard, and therefore the seller is well aware, that if he sells the apartment, with a duty of disclosure, knowing less is better than knowing more. Furthermore, if the buyer assumes with high probability that the apartment is termite-free, while the seller, who possesses more information about the apartment, knows that that probability is in fact low, his willingness to investigate about the presence of termite, with a duty of disclosure, would be clearly too low.

of disclosure, the seller might still inspect for termites, and the information he acquires might be productive. For example, the owner of an apartment who is still undecided about selling his apartment, without a duty of disclosure, might inspect for termites and, if he decides not to sell, will use the information he acquires to prevent additional harm to his apartment. Yet bound by a duty of disclosure, the same owner might prefer ignorance and avoid the risk of finding termites and the subsequent costs of disclosing the information if he does decide to sell the apartment later on.

An innovative solution to the case when the information is productive to the party who does not acquire it and that information is costly is to impose a duty of disclosure on the party in possession of the information, *but only after the contract has been made or even performed*. Thus, using the variation on Example 3, the seller would be allowed to withhold from the buyer the information about the termite infestation prior to contracting and, thereby get a better deal, but after contracting, he would be obliged to disclose the information so that the buyer can use it and prevent further harm to the apartment. Although at first glance, this solution may seem odd to some readers, it could lead to efficient results in many cases.¹⁸

Let me summarize the discussion thus far with four propositions:

1. When information is *redistributive* and *costless*,¹⁹ it should be disclosed (Example 1, Air and Noise Pollution). At the very least, disclosure saves the other party's costs of acquiring the information herself.

2. When information is *redistributive* and *costly*, it should be disclosed (Example 4, Permission to Mine for Minerals). Disclosure discourages investments that are socially wasteful.

3. When information is *productive* and *costless*, it should be disclosed if the other party could make productive use of it (Example 3, Termites). Disclosure enables the productive use of the information, as well as saving the other party's costs of acquiring the information herself.

4. (1) When information is *productive* and *costly*, it should not be disclosed if the party who acquires it can make productive use of it (Example 2, Mineral

¹⁸ A duty of disclosure arises under the law mostly prior to contracting; it can also, however, arise at some point during performance. See Porat, "Comparative Fault Defense in Contract Law", 107 MICH. L. REV. (2009), 1397, 1399-1400. Here, I make the argument that in some circumstances, it could arise even after performance has been completed.

¹⁹ Here and elsewhere, "costless" means costless to the party who acquired the information.

Deposits). Non-disclosure encourages the production of the information from the outset. (2) If, however, only the other party can make productive use of the information (as in the termites case, where inspection is costly), it is unclear whether a duty of disclosure is better or worse than non-disclosure.

These are, of course, only general guidelines for setting a duty of disclosure. *First*, there are cases where information is partly redistributive and partly productive, as well as cases in which the information is costly but not excessively so. This, of course, could change the analysis. *Second*, the guidelines are intended as a basis for setting duties of disclosure in categories of cases and not for ad-hoc determinations in each individual case according to its particular features. Otherwise, they would guide contractual parties poorly on how to behave and inefficiently increase litigation costs. *Third*, the analysis in this part of the Essay did not distinguish between unilateral mistakes and non-disclosure, for the same analysis applies to both cases. I address this distinction in the next part of the Essay.

II. Unilateral Mistakes and Non-Disclosure under the CESL

Article 48 of the CESL stipulates that given that the mistake is essential,²⁰ the mistaken party may rescind the contract if “the other party ... caused the mistake.”²¹ The Article further provides that “[a] party may not avoid a contract for mistake if the risk of the mistake was assumed, or in the circumstances should be borne, by that party.”²² The latter provision applies to all situations in which there is a prima-facie case for rescission due to mistake.

It emerged from the analysis in Part I that in some cases of mistake, even if caused by the other party, rescission should not be allowed. Consider Example 2 (Mineral Deposits) again, but with a new twist (in italics):

Example 2A. Mineral Deposits—Causing the Mistake. A enters into a contract to purchase a tract of land from B, *without* conducting an investigation into the likelihood of mineral deposits on the land. *A says to B that he is certain that the chances of finding minerals are low. B believes that A is basing this on information he has acquired and that A is being honest with her.* The contract price for the land does not reflect a high likelihood of mineral deposits. *Later on, it becomes apparent that there are mineral deposits on the land.* B now wants to rescind the contract. Is she entitled to do so?

²⁰ *Supra* note 1 and accompanying text.

²¹ Art. 48, sec. 1(b)(i).

²² Art. 48, sec. 2.

In this Example, A caused B's mistake. Should this, in itself, be reason to allow rescission of the contract? Let's assume first that A was expressing his sincere and genuine opinion when he said to B that he was certain that the chances of finding minerals on the land were low. A may have been negligent in expressing such an opinion without knowing anything for certain, or he may have been non-negligent—after all he may have some positive information regarding the likelihood of finding minerals even without conducting an investigation. Literally speaking, however, in either event, A caused B's mistake. This is even more the case, if we assume that A did not express a sincere opinion, that he was completely ignorant of the facts, and that this "opinion" was intended as a means of reducing the price of the land he sought to purchase. In these circumstances, should B be entitled to rescission? The prima-facie answer under the CESL is yes, since A caused B's mistake.

At first glance, the analysis in Part I of the essay also seems to point to an affirmative answer: A acquired no information about the land (certainly not costly information), and therefore there is no special reason to exempt him from a duty to disclose to B the fact that he has no such (at least reliable) information. Thus, Example 2A seems to be a case in which *the information that A lacks any information* about the land is *redistributive* and *costless* (Proposition 1) and thus should be disclosed. But this would be too hasty a conclusion. If the law were to impose on A a duty of disclosure that he lacks information, his silence in any case would be interpreted as indication that he has information that he prefers not to disclose. There would then be no efficient incentives for A to acquire costly information to begin with. Therefore, when the *nature* of the information about the land is of the type that is often costly and better not to be disclosed (Proposition 4(1)), the lack of such information should not be subject to a duty of disclosure.

Furthermore, even if one holds the view that the information that A has no information about the land should be disclosed to B *in principle*, it is at least unclear as to whether B should be allowed to rescind the contract when A innocently, or even negligently, failed to comply with his disclosure duty.²³ This is even more the case if

²³ Under the *Restatement (Second) of Contracts* at § 153, in unilateral mistake cases, the mistaken party is entitled to rescind the contract if the other party "had reason to know of the mistake or his fault caused the mistake." In addition, rescission is allowed when enforcement of the contract would be unconscionable. In both cases, rescission would not be allowed if the mistaken party "bear[s] the risk of the mistake under the rule stated in § 154." Thus, under the

B herself was negligent in making the mistake. Thus, when there is a mistake caused by *both* A and B, and if that mistake would ideally be avoided by A's disclosure, the efficient allocation of the risk of the mistake between the two parties is a question that should be dealt with separately from the question of whether A should have prevented B's mistake *if he were actually aware of it*. I return to this point in Part III of the Essay.

In Example 2A, A did not really know whether the chances of finding minerals were low or high, and he might also have been unaware of B's relying on his statement about the chances being low. In contrast, in Example 2B, also a variation on Example 2, A clearly knows about B's mistake regarding the likelihood of mineral deposits on the land but intentionally refrains from correcting this crucial misconception.

Example 2B. Mineral Deposits—Knowledge of the Other Party's Mistake. A enters into a contract to purchase a tract of land from B, after conducting an expensive investigation into the likelihood of mineral deposits on the land. The results indicated very high chances of finding minerals. A discloses nothing to B. *B says to A that she knows that the chances of finding minerals to be very low. A says nothing.* The contract price for the land does not reflect a high likelihood of mineral deposits. B now wants to rescind the contract. Is she entitled to do so?

In this Example, A did not cause B's mistake; he just failed to correct it. Nevertheless, under Article 48 of the CESL, B is entitled to rescind the contract if A "knew or could be expected to have known of the mistake and caused the contract to be concluded in mistake by not pointing out the relevant information, provided that good faith and fair dealing would have required a party aware of the mistake to point it out."²⁴

Under the CESL, then, Example 2B represents, *prima facie*, a case for rescission. Efficiency, however, would mandate no rescission in such a case. If A were under a duty to disclose B's mistake, he would have inefficient incentives to acquire costly and productive information. Indeed, the analysis in Part I pointed to non-disclosure under the (implicit) assumption that A has no knowledge of B's belief or perceptions regarding the chances of finding minerals on the land, but the

Restatement, causing the mistaken party's mistake without fault will not entitle her to rescind the contract.

²⁴ Art. 48, sec. 1(b)(iii). Rescission, however, would not be allowed here either if the mistake was assumed by the mistaken party or "in the circumstances should be borne by him." See *supra* text accompanying note 22.

relaxation of this assumption does not change either the analysis or its outcomes. Thus, if in (the original) Example 2, A bears no duty of disclosure because B says nothing about the chances of finding minerals, but in Example 2B, he does have such a duty because the issue was clearly raised by B, A would probably avoid acquiring costly information in the first place since he would understand that he has low chances of being able to reap its benefits in their entirety. Indeed, his ability to reap the full benefit of the costly information would be a matter of pure coincidence: it would depend on whether the issue was somehow raised by B or not.

Things become more complex in the circumstances of a third variation on Example 2, where B straightforwardly inquires about the results of B's investigation.

Example 2C. Mineral Deposits—Lying. A enters into a contract to purchase a tract of land from B, after conducting an expensive investigation into the likelihood of mineral deposits on the land. The results indicated very high chances of finding minerals. A discloses nothing to B. *B says to A that she knows that A conducted an investigation and wants to know whether the results showed a high likelihood of finding minerals. A responds that the results indicated the chances to be low.* The contract price for the land does not reflect a high likelihood of mineral deposits. B now wants to rescind the contract. Is she entitled to do so?

In Example 2C, A lied. By lying, he caused B's mistake as in Example 2A, and he was also aware of B's mistake as in Example 2B. But more importantly, A's behavior also falls under the CESL definition of fraud in Article 49: "A party may avoid a contract if the other party has induced the conclusion of the contract by fraudulent misrepresentation ... or fraudulent non-disclosure of any information which good faith and fair dealing, or any precontractual information duty, required that party to disclose."²⁵ The Article clarifies that "[n]on-disclosure is fraudulent if it is intended to induce the person from whom the information is withheld to make a mistake,"²⁶ adding that "[i]n determining whether good faith and fair dealing require a party to disclose particular information, regard should be had to all the circumstances."²⁷ Typical circumstances are listed in Article 49, but all are related to non-disclosure that constitutes fraud.²⁸ Thus, as it becomes apparent from the wording

²⁵ Art. 49, sec. 1.

²⁶ Art. 49, sec. 2.

²⁷ Art. 49, sec. 3.

²⁸ These circumstances include: "(a) whether the party had special expertise; (b) the cost to the party of acquiring the relevant information; (c) the ease with which the other party could have acquired the information by other means; (d) the nature of the information; (e) the apparent

of the CESL, when A lies to B—and does not simply fail to disclose information to her—his behavior will be considered “fraudulent misrepresentation,” and B will be entitled to rescission.

Does efficiency require that A be allowed to lie to B in Example 2C without being exposed to the risk of rescission? The somewhat surprising answer is yes.²⁹ For if not, A’s investment in acquiring the costly information would be inefficient. In particular, A would not tend to take the risk of acquiring the information and later reveal its contents to B just because B explicitly asked about it. Thus, from an efficiency perspective, non-disclosure when A did not know (or was not expected to know) about B’s mistake, non-disclosure when A knew (or was expected to know) about B’s mistake, and lying about the contents of the information should have a similar outcome so long as the information A acquired is costly and of productive use to A (Proposition 4(1)).³⁰

Interestingly, all legal systems apparently prohibit inducing contract by lying, which is considered to be fraud. The question, then, is whether the gap can be bridged between the efficiency argument and the prevailing approach of the law, which is supported by conventional fairness intuitions. Indeed, even the efficiency argument for lying is not “clean”: A’s lying to B in Example 2C may prevent B from conducting an independent investigation into the potential of mineral deposits on her land. On the one hand, preventing such an investigation could be efficient, since if B were to conduct it herself, the information she would acquire would be mostly redistributive rather than productive; therefore, from a social perspective, an investigation by B would be a waste. On the other hand, the investigation results could convince B that it is better for her not to sell the land because she is in a better

importance of the information to the other party; and (f) in contracts between traders, good commercial practice in the situation concerned.” Art. 49, sec. 3.

²⁹ See Levmore, “Securities and Secrets: Insider Trading and the Law of Contracts”, 68 VA. L. REV. (1982), 139-40, who has argued for an “optimal dishonesty” rule that would allow lies in cases analogical to Example 2C. See also Sherwin, “Nonmaterial Misrepresentation: Damages, Rescission, and the Possibility of Efficient Fraud”, 36 LOY. LA. L. REV. (2003), 1023-4 (arguing that low level fraud should not result in markedly inefficient exchanges, and it may help overcoming bargaining impasses); Borden, “Mistake and Disclosure in a Model of Two-Sided Information Inputs”, 73 Mo. L. Rev. (2008), 667 (discussing both Kronman’s and Levmore’s arguments and proposing a rule which requires minimal truthful disclosure in response to generalized questions from sellers).

³⁰ In most of the law and economics literature, fraud is considered to be inefficient. See, e.g. Shavell., *supra* note 9, pp. 329-30, 334-35; Cooter & Ulen *supra* note 12, pp. 298-99. In the typical cases of fraud analyzed in the law and economics literature, however, the information is redistributive rather than productive. See, e.g., Posner, *supra* note 14, pp. 111, 113. But see Levmore, *supra* note 29, pp. 139-40 (arguing that dishonesty could be efficient).

position than the buyer to utilize it; in such case, the information would have social, not just private, value. Indeed, once B realizes that lying is allowed, she would distrust A's statements about the low likelihood of finding minerals on the land and would proceed as though she has no information about the land's potential. But a more plausible assumption is that lying—as opposed to mere non-disclosure—increases the chances of B's being misled by A after all, especially if A is allowed not just to make false statements but also to “support” them with deceptive evidence.

Is there a way out of this loop? Ideally, A would simply say to B that he refuses to answer her question about the land's mineral potential, and B would interpret this answer as “no information.” But as it should be clear by now, such an answer would signal to B the high potential of finding minerals on the land, so it does not solve the problem. A theoretical solution is that the law would prohibit disclosure in cases represented by Example 2C. A would then be able to respond to B's request for information about the land that he is barred by law from providing any such information, and B would not draw any conclusions from the statement (this legal solution makes more sense when disclosure could affect identified third parties or when A is a public authority³¹). More practically, if, but only if, A is a repeat player—for example, a large corporation acquiring land across the country—A might adopt a policy, known to all potential sellers, that it does not reveal any information about land it is seeking to purchase. Such a policy could be beneficial to A, and once B becomes aware of it, she would not take an explicit refusal on the part of A to answer questions about the land as indication of its qualities.³²

In other cases, prohibiting lying is clearly efficient. As we saw in Part I, there are plenty of cases in which it is better to incentivize the party who acquired the information to disclose it to the other party. In all such cases, it could make a difference if the non-mistaken party failed either innocently, negligently, or fraudulently to disclose the information that ideally should have been conveyed to the mistaken party. I revisit this issue in the next part of the Essay.

³¹ Public officials would be taken more seriously by the other party to the contract if they state that they are not allowed by law to reveal the relevant information. Note that the public authority would typically be a repeat player, see *infra* text accompanying note 32.

³² The mere decision to purchase the land has a certain signaling effect, but there seems to be no way to avoid this.

III. Mutual Mistakes

A. Economic Analysis

In cases of mutual mistake, both parties make the same mistake. In the well-known *Sherwood v. Walker* case,³³ for example, a seller sold a cow to a buyer for \$80, believing it to be barren, when in fact, the cow was pregnant and worth about ten times the agreed-upon price. The court allowed the seller to avoid the contract because of the parties' mutual mistake.

Mutual mistakes are analogical to tortuous accidents, and a similar logic applies to them.³⁴ With mutual mistakes, the main efficiency consideration is how to incentivize the parties to efficiently avoid those mistakes (or insure against them). Four main scenarios of mutual mistake can be described: in two of the scenarios, either A or B is the cheapest cost-avoider of the mistake (i.e., either one of them is negligent), in a third scenario, both A and B are the cheapest cost avoiders (i.e., both are negligent³⁵), and in a fourth scenario, neither of the parties is the cheapest cost avoider (i.e., neither is negligent). If a contract is concluded by mutual mistake and, before any reliance occurs, one of the parties wants to avoid the contract, letting him rescind should not raise much objections, regardless of which party is the cheapest cost avoider. Not permitting rescission would result in a windfall for the one party and a loss to the other, with no clear social gain.³⁶ Specifically, with mutual mistakes there is often a risk that the trade between the parties did not create a social gain: the one party's gain did not necessarily exceed the other party's loss.³⁷ Furthermore, rescinding the contract would lead to an assignment of rights that symmetrically

³³ *Sherwood v. Walker*, [1887], 33 N.W. 919.

³⁴ See generally Cohen, "How Fault Shapes Contract Law", in Ben Shahaar & Porat (eds.), *Fault in American Contract Law* (Cambridge, New York, 2010), p.53.

³⁵ It is often the case that the parties can take precautions that are alternatives to one another, and efficiency-wise, it is preferable that only one of them take precautions to prevent the mistake. In such cases, it could be argued, only one party is the cheapest cost avoider, and he alone should be considered negligent. In other cases, however, just as in accidental tort cases, precautions are not alternative to one another, but complementary in nature, in the sense that efficiency-wise, it is preferable that both parties take precautions to prevent the mistake. In such situations, just as in the tort counterpart situations, if a mistake occurs, it could be the result of negligence on the part of both parties.

³⁶ For a critical account of the traditional economic analysis of the law of mutual mistakes and for the argument that the parties to a contract would not like one of them to enjoy a windfall while the other suffers loss, see Procaccia, "Revisiting the Economic Theory of Mutual Mistake and Unforeseen Contingencies in Contract Law", (2012) (on file with author).

³⁷ See Rasmusen & Ayres, "Mutual and Unilateral Mistake in Contract Law", 22 J. LEGAL STUD. (1993), 325. Rasmusen and Ayres justify the decision in *Sherwood v. Walker*, [1887], 33 N.W. 919, *supra* note 33.

informed parties would have agreed upon but for the mistake.³⁸ Thus, in cases like *Sherwood v. Walker*, assuming no reliance (and that the seller did not assume the risk of the mistake), rescission makes economic sense.³⁹ Finally, with mutual mistakes, the consideration of incentivizing parties to invest in acquiring productive information by upholding the contract—as with some unilateral mistakes—lose force, since it is assumed that the parties simply failed to acquire any information.⁴⁰

Things become trickier when one party wants to avoid the contract but the other party relied on the contract, so that rescission would leave the latter with loss. In such cases, if the contract is rescinded, efficiency would require that the loss be allocated to the cheapest cost avoider (the negligent party).⁴¹ Alternatively, rescission should not be allowed if the party seeking to rescind the contract is the cheapest cost avoider. There could be intermediate cases, where both parties are the cheapest cost avoiders or neither is the cheapest cost avoider, and then the question of whether to allow rescission is more challenging. A possible solution is to allow rescission in such cases but split the loss between the parties according to their relative fault (if they both were the cheapest cost avoiders)⁴² or to leave each party with his own losses.

Note that even in the absence of proven reliance, it could still be argued that rescission should not be allowed if the party who wants to rescind the contract is the cheapest cost avoider. This argument could be compelling if we assume that even with no proven reliance by the party opposing the rescission, he might suffer some

³⁸ See Smith & Smith, "Contract Law, Mutual Mistake, and Incentives to Produce and Disclose Information", 19 J. LEGAL STUD. (1990), 477: "The mutual mistake doctrine leads to an assignment of rights that is fully consistent with the contract terms that would have been agreed to had it occurred to the transacting parties to include a warranty-like provision." The authors also support the current doctrine in its effect on the parties' incentives to reveal their private information, thereby preventing mutual mistakes, as well as their incentives to produce information to begin with. *Id.*

³⁹ Cf. Cooter & Ulen, *supra* note 12, pp. 291-92. Things would be different if the mistake was assumed by the parties, but here I assume it was not.

⁴⁰ The fact that the contract could be avoided could provide parties with incentives to take precautions to avoid mutual mistakes, which could be either efficient or not. See Smith & Smith, *supra* note 38.

⁴¹ Or the cheapest insurer. See Posner & Rosenfield, "Impossibility and Related Doctrines in Contract Law: An Economic Analysis", 6 J. LEGAL STUD. (1977), 83; Cooter & Ulen, *supra* note 12, pp. 291-92. For a critical account of Posner's and Rosenfield's arguments, see Smith & Smith, *supra* note 38, pp. 487-88. The authors argue that it is often difficult to determine who the cheapest cost avoider is, and in particular, courts are often unable "to distinguish cases of true mutual mistake from those involving asymmetrically held information". *Id.*, p. 487. The authors support the current doctrine, which generally allows rescission in mutual mistake cases, see *supra* note 38.

⁴² Cf. Porat, *supra* note 18.

loss after all.⁴³ However, it would still be dubious – mainly for a non-efficiency considerations – whether the mere possibility of suffering loss if rescission is granted warrants letting one party enjoy a clear windfall that he did not bargain for just because the other party should have discovered the mistake before the contract was concluded.

B. The CESL

Under the CESL, in mutual mistake cases, the party who was adversely affected by the mistake is entitled to rescind the contract.⁴⁴ As with unilateral mistake, the CESL provides regarding mutual mistake as well that “[a] party may not avoid a contract for mistake if the risk of the mistake was assumed, or in the circumstances should be borne, by that party.”⁴⁵ The CESL also allows damages to the rescinding party: “A party who has the right to avoid a contract ... is entitled ... to damages from the other party for loss suffered as a result of the mistake ... provided that the other party knew or could be expected to have known of the relevant circumstances.”⁴⁶

The law of mutual mistake under the CESL is inefficient in several respects. First, it allows rescission even if there is reliance, without taking into consideration who is the cheapest cost avoider. Second, it imposes liability for loss suffered by the rescinding party even if she is the cheapest cost avoider and does not allow liability for any loss suffered by the other party. In contrast, under efficiency, when rescission would end up in losses, the question of both whether to allow rescission and who should bear the losses should be resolved according to the cheapest cost avoider criterion.

The following example, which is a variation of the *Sherwood v. Walker* case, illustrates the divergence between the CESL and the efficiency solutions to situations of mutual mistake.

Example 5. The Cow. B sells her cow to A for \$80, with both A and B assuming the cow to be barren. In fact, however, the cow is pregnant and worth \$800. A spent \$20 to transport the cow. B spent \$10 preparing the cow for delivery. B could have checked the cow a day prior to delivering her at a very low cost and verified whether she is barren. B wants to rescind the contract. Is she entitled to do so?

⁴³ He may have lost opportunities, which is hard to prove. See Fuller & Perdue, "The Reliance Interest in Contract Damages: 1", 46 YALE L.J. (1936), 52.

⁴⁴ Art. 48, sec. 1(b)(iv).

⁴⁵ Art. 48, sec. 2.

⁴⁶ Art. 55.

Under the CESL, B is *prima facie* entitled to rescind the contract. Moreover, B could recover \$10 for her expenses if A “could be expected to have known of the relevant circumstances,” whereas A cannot recover \$20 for his expenses. As noted, the CESL stipulates that “[a] party may not avoid a contract for mistake if the risk of the mistake was assumed, or in the circumstances should be borne, by that party.”⁴⁷ Although in Example 5, the risk of the mistake was not assumed, the argument could easily be made that the risk “should be borne” by B, who was at fault.

What is mandated by efficiency is quite clear in the circumstances of Example 5. B is the cheapest cost avoider of the mistake: she was negligent in not discovering the mistake before concluding the contract and, therefore, should be held responsible for the outcome. One possible solution could be for B to simply be barred from rescinding the contract. Alternatively, she could be entitled to rescind but required to cover A’s losses. It seems that both solutions would provide incentives to sellers like B to take precautions in order to avoid mistakes, including cases in which the same mistake is made by both parties. Yet the first solution, however, could be problematic: if B is not allowed to rescind the contract, she will have no reason to disclose to A the information she acquires after the creation of the contract that the cow is pregnant. This would lead to severe inefficiency: A would use the cow for meat and would derive a much lower value from the cow than would have been the case had he been aware of the cow’s pregnancy. This could be one reason to prefer the second solution (rescission but reliance damages) to the first one (no rescission) in situations—represented by Example 5—where disallowing rescission even to a negligent party would lead to the withholding of productive information from the party who could use it.

C. A Note on Other Accidental Mistakes

Mutual mistakes are not the only kind of accidental mistakes. There are also unilateral mistake cases where one party failed to disclose information that he should have disclosed, and one of the parties, or both, were the cheapest cost avoider of the mistake. Thus, in Example 1 (Air and Noise Pollution), A should have informed B about the pollution and noise emanating from the factory. Suppose, however, that while A negligently failed to disclose this information to B, B also negligently failed

⁴⁷ Art. 48, sec. 2.

to ask about the noise and air quality or to indicate to A that he values clean air and peace and quiet. Here, too, the non-disclosure is accidental, and the question of how to allocate the risk could be answered by reference to the cheapest cost avoider criterion.

Conclusion

The CESL regulates mistakes in a way that is not always consistent with economic efficiency. Indeed, the Law's formulation leaves enough leeway for courts to incorporate efficiency considerations if they want to. Thus, while allowing the mistaken party to rescind if the mistake was caused by the other party or when one party knew, or was expected to know, of the other party's mistake, the CESL adds that "if the risk of the mistake was assumed, or in the circumstances should be borne, by [the mistaken] party," rescission should not be allowed. With respect to the latter type of mistake cases, the CESL also alludes to "good faith and fair dealing" when it defines the conditions for rescission. The "assumption of the risk" condition applies to all mistakes, including mutual mistakes. Finally, for determining whether a duty of disclosure arises in a given case, the CESL provides a long list of considerations for courts to weigh, including the nature of the information and the costliness and relative ease of acquiring it. All of the conditions for rescission can easily be given an economic interpretation and enable courts to reach efficient outcomes.

Still the question that remains is why—assuming efficiency to be the goal—use broad, ambiguous, and often unclear terms, instead of being more precise and alluding explicitly to efficiency considerations of the type discussed in this Essay? Incorporating "good faith and fair dealing" and similar terms just adds uncertainty, which is particularly problematic for a law that is intended to apply to contractual parties across different nations and cultures.

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