

# RATIONAL BARGAINING THEORY AND CONTRACT: DEFAULT RULES, HYPOTHETICAL CONSENT, THE DUTY TO DISCLOSE, AND FRAUD

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In his forthcoming book, *Risks and Wrongs*,<sup>1</sup> Jules Coleman covers a lot of territory, ranging from political to moral philosophy, from tort theory to the theory of crimes. Along the way, he touches upon important issues of contract theory, including the question of how the default rules of contract ought to be chosen. The concept of default rules is of particular interest to me because it undermines the legal realist view that, because all of contract law fills gaps in consent, the substance of contract law has little to do with consent. Once it is acknowledged, however, that most of contract law consists of default rather than immutable rules, then consent plays a far larger role in contract theory than is often admitted. For when certain conditions obtain, the parties' silence in the face of a default rule could well constitute consent to its imposition.

In this paper, I begin by responding to Coleman's rational choice approach to choosing default rules. In Part I, I apply the expanded analysis of contractual consent and default rules I have recently presented elsewhere<sup>2</sup> to explain how rational bargaining, hypothetical consent, and actual consent figure in the determination of contractual default rules. Whereas Coleman advocates the centrality of rational bargaining analysis to this determination, I explain why rational bargaining theory's role must be subsidiary to that of consent.

I then turn my attention to Coleman's appraisal of contracting parties' duty to disclose information concerning the resources that are the subject of a contractual transfer. In Part II, I argue that both Coleman's and Anthony Kronman's analyses

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1. JULES L. COLEMAN, *RISKS AND WRONGS* (forthcoming 1992) (manuscript dated July 1991, on file with author; pages cited to manuscript).

2. See Randy E. Barnett, *The Sound of Silence: Default Rules and Contractual Consent*, 78 VA. L. REV. 821 (1992).

of John Marshall's opinion in the classic case of *Laidlaw v. Organ*<sup>3</sup> overlook an important function of his holding permitting nondisclosure. I conclude by proposing a conception of fraud that explains why trading on and profiting from certain types of undisclosed information is not properly deemed fraudulent.

## I. DEFAULT RULES AND HYPOTHETICAL CONSENT

### A. *Coleman's Analysis of Default Rules and Hypothetical Consent*

A default rule is a type of gap-filling background rule that is used by courts to interpret matters about which a contract is silent. What distinguishes default rules from other kinds of background rules is that they can be supplanted by the expressed consent of the parties, whereas "immutable" background rules will be enforced no matter what the parties may say on the matter.<sup>4</sup> An example of a default rule is the use by courts of the expectancy measure of damages for breach of contract.<sup>5</sup> An example of an immutable rule, which parties cannot contract around, is the implied duty of good faith performance of a contract.<sup>6</sup>

In his discussion of contract, Coleman addresses the question of how default rules should be chosen. As Coleman notes, many law-and-economics scholars have argued that default rules should reflect those rights and duties to which the parties would have agreed *ex ante*.

Thus, when transaction costs make an explicit agreement too costly *ex ante*, the court should apply a *default* or *gap-filling* rule that "mimics" the outcome of a hypothetical contract between them. The hypothetical contract is one the parties would have made had the transaction costs not made their doing so irrational.<sup>7</sup>

Coleman sees this approach as raising the following problem:

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3. 15 U.S. (2 Wheat.) 178 (1817).

4. See Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87 (1989) ("Default rules fill the gaps in incomplete contracts; they govern unless the parties contract around them. Immutable rules cannot be contracted around; they govern even if the parties attempt to contract around them.").

5. See RESTATEMENT (SECOND) OF CONTRACTS § 347 (1979).

6. Compare U.C.C. § 1-203 ("Every contract or duty within this Act imposes an obligation of good faith in its performance or enforcement.") with U.C.C. § 1-102(3) ("The effect of this Act may be varied by agreement, except as otherwise provided in this act and except that the obligations of good faith, diligence, reasonableness and care prescribed by this Act may not be disclaimed by agreement . . .").

7. COLEMAN, *supra* note 1, at 268 (footnotes omitted).

“Given the *ex post* nature of the obligations and rights it distributes, is there any reason to think that one default rule is any more justifiable than another? Is there, in particular, a case to be made for the *ex ante* contract as the default rule?”<sup>8</sup> Coleman contends that rational bargaining theory can both determine the content of counterfactual “majoritarian” default rules<sup>9</sup> and justify their imposition by a legal system.

Coleman argues, first, that rational bargaining theory is the best way to determine the scope and content of parties’ hypothetical consent. Then he attempts to connect his rational bargaining approach to hypothetical consent with actual consent.<sup>10</sup> Coleman’s project is ultimately to convince anyone who is already committed either to consent or to efficiency accounts of contractual obligation that a rational bargaining model must occupy a central place in their theories of obligation.

Coleman argues that a consent theorist could favor a rational bargaining approach to hypothetical contracts for two reasons. The first is that “[h]ypothetical consent is a proxy for actual consent,”<sup>11</sup> and a rational bargaining model can determine the content of hypothetical consent. A court searching for what the parties have agreed upon when they are silent will choose a hypothetical provision that, at the time of formation, appears to improve the lot of at least one of the parties and not worsen the situation of either. “From the fact that [such a solution] makes no one worse off . . . we are to infer that [the parties] would have consented. Consent follows as a matter of *logic* from considerations of rational self-interest.”<sup>12</sup>

The problem with this analytic connection between rational self-interest and hypothetical consent is patent, and Coleman is quick to note it: The concept of rational self-interest is doing all the work. Hypothetical “consent” becomes merely a label that is attached to the conclusion with no explanatory or justifi-

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8. *Id.* at 268.

9. Default rules conforming to a hypothetical bargain are commonly called “majoritarian” because they seek to identify the term to which *most* parties would have agreed. I call them “counterfactual” because they refer to what most parties would have but did not agree to. In contrast, what I call “conventionalist” default rules, discussed below, refer to what most parties do in fact mean by their silence.

10. Coleman also argues why an efficiency theorist might have use for the rational bargaining approach, but I leave this issue to others. See Richard Craswell, *Efficiency and Rational Bargaining in Contractual Settings*, 15 HARV. J.L. & PUB. POL’Y 805 (1992).

11. COLEMAN, *supra* note 1, at 269.

12. *Id.* at 272.

catory force of its own. "[I]n arguments of this sort," Coleman explains,

there appears to be nothing expressed by the concept of hypothetical consent that is not already captured in the idea of rational self-interest. The distinction between consent and rational self-interest central to moral theory apparently evaporates. The claim that imposing obligations *ex post* is justified because the parties would have consented to them *ex ante* adds nothing to a defense of such a proposal that is not already expressed by the argument that imposing obligations *ex post* is justified whenever such obligations would have been *rational* for the parties *ex ante*. Thus, one might say that the reliance on *ex ante* rational bargaining provides a rationality or welfarist defense of the default rule, not a consensualist one.<sup>13</sup>

Instead, Coleman recommends that the consent theorist view the relationship between hypothetical rational bargaining and hypothetical consent as epistemic, not analytic.

What it would have been rational for the parties to bargain to *ex ante* is not *equivalent* to, nor does it entail, anything about what they would have agreed to, but it is, nevertheless, *evidence*, perhaps the best evidence, of it. . . . In the absence of contradictory evidence, that is evidence contrary to that derived from the hypothetical rational bargain, it is legitimate to infer that the parties would have consented to that which would have been the outcome of a rational bargain between them.<sup>14</sup>

Having established an epistemic connection between the hypothetical rational bargain and the concept of hypothetical consent, however, this approach immediately confronts the following problem: What connection, if any, exists between hypothetical consent and actual consent? Why should one care about consent that by hypothesis is hypothetical?

Coleman considers the argument that, by consenting *ex ante* to legal enforcement, parties consent to the enforcement *ex post* of default rules chosen according to the rational bargaining method.

[B]y the very act of contracting the parties consent not only to a framework of explicitly created rights and duties, but to a jurisdiction for resolving conflicts that might arise in construing those rights and duties. Should the occasion arise,

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13. *Id.* I concur.

14. *Id.* at 273.

the jurisdiction to which the parties consent is authorized to impose rights and duties *ex post* that were not made explicit *ex ante*. To contract is, among other things, to consent to the relevant default provisions of a particular jurisdiction. Thus, the rights and responsibilities allocated by a default rule *ex post* are, in a suitable sense, consented to *ex ante*.<sup>15</sup>

According to Coleman, this approach avoids the need to specify the relationship between rational bargaining and hypothetical consent by positing the existence of actual consent to the terms determined by a rational bargaining model. "The importance of hypothetical consent simply disappears, and with it the need to establish an evidentiary or analytic connection between it and the *ex ante* rational bargain."<sup>16</sup>

Coleman makes two criticisms of this "consent to jurisdiction" approach. First, he argues that if this "argument for the default rule works at all, it works too well,"<sup>17</sup> because it would apparently justify *any* default rule, and even any *immutable* rule, a legal system may impose. "For if by consenting to a contract, one consents to a jurisdiction's default rule, then one consents to whatever rule the court applies: from those aimed at reconstructing a hypothetical bargain to those imposing obnoxious terms, and so on."<sup>18</sup> Second, Coleman questions "whether it works at all."<sup>19</sup> Representing parties' consent to legal enforcement as a consent to the entire take-it-or-leave-it set of default rules that will be applied is unrealistic because parties hardly have any choice among jurisdictions. As Coleman argues:

[T]he parties could be said to consent to a relevant authority's default rule only if they willingly, that is, noncoercively, choose it. This is not typically the case, however. The default rules of any jurisdiction are generally a nonnegotiable part of their bargain. Though the parties can often contract around them, they cannot substitute the default provisions

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15. *Id.* at 273-74. This argument is not entirely hypothetical. I originally offered it to Professor Coleman in private correspondence relating to his earlier incarnation of the subject in Jules L. Coleman, Douglas D. Heckathorn, & Steven M. Maser, *A Bargaining Theory Approach to Default Provisions and Disclosure Rules in Contract Law*, 12 HARV. J.L. & PUB. POL'Y 639 (1989). I develop the argument considerably in Barnett, *supra* note 2.

16. COLEMAN, *supra* note 1, at 274.

17. *Id.* at 275.

18. Coleman goes on to say: "This reconstruction of the consent theory of contractual obligation, in other words, provides no sense in which the *ex ante* rational contract is special. If the *ex ante* rational bargain as a default rule has a special attraction for this sort of consent theorist, this line of argument does not do a very good job of expressing or developing it." *Id.* at 274-75. But this assumes what must be shown—that a consent theorist does care about the *ex ante* bargain.

19. *Id.* at 275.

of other jurisdictions. For that reason, it is questionable whether by consenting to a framework of contractual rights and responsibilities the parties consent to the application of the operative default provisions.<sup>20</sup>

From the failure of this argument, Coleman concludes that rational bargaining theory, not consent, provides the justification for choosing default rules that reflect hypothetical consent. Far from consent being the basis of contract, consent is significant only because terms that are actually chosen are likely in practice to reflect what is rational for parties to have chosen. "Thus," according to Coleman, "one might say that the reliance on an *ex ante* rational bargaining provides a rationality or welfarist defense of the default rule, not a consensualist one."<sup>21</sup>

In the next section, I recast the "consent to jurisdiction" approach to avoid both these challenges. After clarifying the relationship between consent and the hypothetical rational bargain, I conclude that while the rational bargain model may play a role in a consent theory, it is hardly as central a role as Coleman contends.

### B. *Reconstructing the "Consent to Jurisdiction" Argument*

In a sense, we have joined a story in the middle. Whereas Coleman begins by assuming implicitly the validity of the hypothetical rational bargain and only then asks how a consent theorist might account for it, a consent theorist argues that consent is central to the creation of contractual obligation.<sup>22</sup> Thus, the issue is what, if any, relationship exists between consent and a rational bargain model. If there is no such relationship, then so much the worse for the rational hypothetical bargain.

Let me begin by offering a more complete presentation of

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20. *Id.*

21. *Id.* at 272.

22. I have explained briefly why consent is of central importance to contract in Randy E. Barnett, *A Consent Theory of Contract*, 86 COLUM. L. REV. 269 (1986) [hereinafter Barnett, *Consent Theory*], and at greater length in Barnett, *supra* note 2; see also Randy E. Barnett, *Contract Scholarship and the Reemergence of Legal Philosophy*, 97 HARV. L. REV. 1223 (1984); Randy E. Barnett, *The Internal and External Analysis of Concepts*, 11 CARDOZO L. REV. 525 (1990); Randy E. Barnett, *Conflicting Visions: A Critique of Ian Macneil's Relational Theory of Contract*, 78 VA. L. REV. 1175 (1992); Randy E. Barnett & Mary E. Becker, *Beyond Reliance: Promissory Estoppel, Contract Formalities, and Misrepresentations*, 15 HOFSTRA L. REV. 443 (1987). A condensed and revised account of this approach appears in Randy E. Barnett, *Rights and Remedies in a Consent Theory of Contract* in LIABILITY AND RESPONSIBILITY: ESSAYS IN LAW AND MORALS 135 (R.G. Frey & Christopher Morris eds., 1991).

the “consent to jurisdiction” argument that Coleman summarizes. In making a *legally* enforceable agreement, parties consent to more than the explicit terms in their agreement. To enter the realm of contract, and leave the realm of mere promise, the parties must signal or communicate their intention to be legally bound. This “manifested intention to be legally bound” is what I call “consent.”<sup>23</sup> By manifesting such an intention, parties consent to the jurisdiction of some (monopoly or competitive) adjudicative and enforcement mechanism. Their consent forms the basis for an adjudicator’s authority to render a binding judgment in a pure contracts case. Without this added implication, a consent to be legally bound means no more than any other commitment or promise.<sup>24</sup>

Thus, consent to be legally bound must entail both parties accepting one of two propositions:

- (a) When a dispute arises that is not covered by an explicit term of the contract, whatever court has jurisdiction to resolve the dispute *loses* its jurisdiction and any loss that may have resulted from the transaction remains where it happened to fall; or
- (b) When a dispute arises that is not covered by an explicit term of the contract, whatever court has jurisdiction to resolve the dispute *retains* its jurisdiction and may allocate the loss according to some set of principles.

While each of these propositions is logically consistent with a manifested intention to be legally bound, when parties are silent on this issue, the actual meaning of their expression of assent must be determined conventionally. Because the concept of consent is a communicative one, we must always seek the most plausible interpretation of the conduct of the parties within the relevant community of discourse.<sup>25</sup>

If the second of these propositions more accurately ex-

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23. I leave to one side the important issue of how *manifested* consent is related to *subjective* assent. As I explain elsewhere, a manifested consent can be “real” even when unaccompanied by subjective assent because *communicated* consent is the concept of consent that is at the root of contract theory. Admittedly, however, one reason for the centrality of communicated consent is its close empirical correspondence with subjective assent. See generally Barnett, *supra* note 2, at 898-902.

24. While adequate for present purposes, this statement of the principle is incomplete. *Prima facie* contractual obligation arises when a person “voluntarily performs acts that convey[] her intention to create a legally enforceable obligation by transferring alienable rights.” Barnett, *Consent Theory*, *supra* note 22, at 300. This refined version of the principle is needed to handle problems that are beyond the scope of this article.

25. See Barnett, *supra* note 2, at 855-59.

presses the actual intentions of most contracting parties when they consent to be legally bound, then there is an implicit consent to resolve disputes not governed by explicit contract terms according to promulgated background rules and procedures. Thus, courts enforce background rules with actual, not hypothetical, consensual authorization. This is not to claim, however, that courts are always free to enforce any background rule whatsoever when parties consent to be legally bound. The next question is to determine the content of the background rules whose enforcement can be justified as consensual.

When the cost of learning the content of and contracting around contract law is sufficiently low, by remaining silent on a particular matter, parties can be said to have consented to *any* promulgated default rule.<sup>26</sup> That is, silence under these circumstances manifests a consent to the enforcement of those rules that one could have changed by one's express agreement but did not. When, however, these conditions do not obtain, it is no longer safe to conclude that silence means consent to whatever background rules may happen to exist.

In the absence of these circumstances, if the enforcement of particular default rules is to be justified as consensual, these default rules should be chosen (a) to reflect the probable tacit understandings of the parties, and (b) to reduce the likelihood of subjective disagreements arising between the parties.<sup>27</sup> These functions are best performed by default rules that reflect the common sense expectations in the community of discourse to which the parties belong.<sup>28</sup> I call these "conventionalist" default rules. In attempting to determine the content of conventionalist default rules, a possible relationship between actual consent and the hypothetical rational bargain emerges. Although this relationship is, as Coleman suggests, "epistemic, not analytic,"<sup>29</sup> the epistemic connection is different from what he describes.

How do we determine the content of the parties' tacit understandings given that it is generally difficult either to discern them directly or to determine the expectations that prevail in the relevant community of discourse? A rational bargaining

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26. *See id.* at 864-67.

27. *See id.* at 874-97.

28. *See id.*

29. COLEMAN, *supra* note 1, at 273.

model—if it can deliver what Coleman promises<sup>30</sup>—could provide a good method for legal theorists to determine what most parties' consent to jurisdiction means when their express agreement is silent. If most parties tacitly expect that "fair" default provisions will be supplied when gaps in their explicit consent are revealed, rational bargaining theory may help determine what terms most parties deem to be fair. A court may presume that the particular parties before it implicitly consented *ex ante* to the imposition of terms that would be in their rational self-interest. In this manner, rational bargaining theory may be able to capture the "common sense" meaning of the parties' silence.

Of course, a presumption that any given pair of parties would consider the "common sense" rules that result from a rational bargaining analysis to be a fair way of resolving their dispute could be factually mistaken in a particular case. Nonetheless, we may still be warranted in adopting a presumption in favor of the rational default term if so doing will reduce the incidence and severity of erroneous enforcement. In this way, hypothetical consent may be seen as *evidence* of actual consent on issues about which the parties are silent, and the rational bargain may be viewed as evidence of hypothetical consent. Or, perhaps more accurately, in the *absence* of empirical evidence of what actual parties in the relevant community of discourse mean when they consent in a particular situation, we may safely presume that they intended the default rule suggested by a rational bargaining analysis.

In sum, given a practical assessment that most contracting parties are rationally self-interested actors, we may adopt the rational bargain as the presumptive meaning of consent. Thus, a legal system would be morally justified in enforcing rational background terms, unless it believes that the normal assumption of rationality did not hold. According to this account, the rational bargaining model, although potentially useful, is merely an interpretive "half-way house" between an actual manifestation of consent and empirical evidence of what most persons actually mean by such manifestations.

This is not to deprecate the practical value of the rational

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30. I assume throughout this analysis that rational bargaining theory can actually determine the content of a person's rational choice. If this assumption proves inaccurate, then a rational bargaining model cannot perform the role I identify (or any other).

bargaining model to a legal system or to legal theorists. Despite decades of cries for more empirical research into contracting practice, such research is still rare. Moreover, as I discuss below, monopolistic legal regimes thwart the epistemic function of a free market in legal jurisdictions, necessitating some effective substitute for discovering the actual intentions of most parties. Therefore, if consent is to be given a meaning that corresponds to the actual meaning in the relevant community, some more abstract method of approximating this meaning without costly empirical research or market information would be invaluable.

We now may turn to Coleman's charge that because "[t]he default rules of any jurisdiction are generally a nonnegotiable part of [the parties'] bargain,"<sup>31</sup> the consent to jurisdiction approach is inapplicable in the absence of a competitive market in jurisdictions. Without free choice among jurisdictions and among packages of default rules that each jurisdiction provides, is not Coleman correct that we must still rely on hypothetical rather than actual consent in our choice of default rules? Coleman argues that if "the claim is that a default rule is justified to the extent that it *would be freely chosen* in a competitive market for authoritative jurisdiction, then the defense of [a] default rule itself relies upon arguments from hypothetical, not explicit consent."<sup>32</sup>

While this argument has some merit, it does not support any conclusions about a fundamental or necessary relationship between hypothetical and actual consent. Instead, it suggests only that we must rely on hypothetical consent where consumer choice is restricted.<sup>33</sup> Here, as elsewhere, the market is a unique source of otherwise unobtainable information.<sup>34</sup> Rational bargaining theory may attempt to "mimic the market," but even the best rational bargaining theorists will sometimes err in interpreting the meaning of the parties' consent to be legally bound. So long as consumers of legal systems are denied free choice among legal jurisdictions, we are deprived of

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31. COLEMAN, *supra* note 1, at 275.

32. *Id.* at 276.

33. See Randy E. Barnett, *Pursuing Justice in a Free Society: Part Two—Crime Prevention and the Legal Order*, 5 CRIM. JUST. ETHICS 30 (Winter/Spring 1986) (describing how a more competitive legal order could function). A recent and more elaborate treatment of this thesis can be found in BRUCE L. BENSON, *THE ENTERPRISE OF LAW* (1990).

34. See Barnett, *supra* note 2, at 902-05.

market information with which to correct the errors produced by rational choice or any other form of abstract theory.

Consider liquidated damages clauses, which reveal contracting parties' actual preference regarding the measure of recovery for breach of contract. When such provisions are known to be readily enforceable, parties who remain silent are presumably satisfied with the prevailing default rule, which measures damages by the expectancy interest. When courts refuse to enforce such provisions, however, we may be correct that by remaining silent most parties have implicitly chosen the expectancy measure of damages, but we are denied access to a pool of explicit choices to help confirm our interpretive hypothesis. In sum, the circumstantial evidence of consent by silence to the expectancy measure is greatly weakened. The parties' silence may have resulted not from consent but instead from the futility of negotiating an express clause that is unlikely to be enforced. Thus, to the extent that freedom of contract in any phase of contracting is absent,<sup>35</sup> the silence of the parties on any given issue is rendered considerably more ambiguous than necessary.

Still, where parties are protected from having contracts imposed upon them in the absence of their manifested intention to be legally bound, this consent can be viewed as a meaningful act. Under these conditions, if a rational bargaining approach is feasible, the default rules it recommends may well correspond to the actual meaning of such consent for most parties. In this way, while the nonexistence of a free market in legal jurisdictions deprives us of an extremely important source of knowledge about the meaning of a choice to be legally bound, it does not completely undermine our ability to discern the meaning of consent.

A consent theory, then, offers the following epistemic connection between consent and rational bargaining theory: When parties manifest their consent to be legally bound, courts often need to interpret the meaning of their silence with respect to "gaps" in their manifested assent. In such circumstances, silence is most likely to mean what the majority of similarly situated persons thinks it means. Since most people

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35. Even a consent theory of contract would limit freedom of contract in some ways, as, for example, with consent to transfer inalienable rights. See Randy E. Barnett, *Contract Remedies and Inalienable Rights*, 4 Soc. PHIL. & POL'Y 179 (1986).

are rational, silence most likely means what a rational person would think it means. Rational bargaining theory promises legal theorists seeking to determine the meaning of silence a substitute for the empirical information provided either by social scientific research or by the market.

Thus, while rational bargaining theory may prove to be a highly useful interpretive device in an informationally imperfect world, it has justificatory value only *within* a regime of actual consent. Absent a manifested intention to be legally bound, interpreters using a rational bargaining approach simply have nothing to interpret.<sup>36</sup>

## II. THE DUTY TO DISCLOSE AND THE LIBERAL CONCEPTION OF FRAUD

### A. *Coleman's Analysis of the Duty to Disclose*

Coleman's underestimation of the informational function of contractual consent is also evident in his discussion of *Laidlaw v. Organ*.<sup>37</sup> *Laidlaw* involved a tobacco purchase contract made during the War of 1812. At the time the contract was executed, the buyer had advance information that the treaty ending the war had been signed, promising an end to the naval blockade of New Orleans that had been suppressing the price of tobacco. When asked by the seller if he knew anything that might affect the price of tobacco, however, the buyer failed to disclose this information. The legal issue was whether the seller could avoid the contract because of this failure to disclose. Chief Justice John Marshall, speaking for the Supreme Court, endorsed a default rule of nondisclosure:

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 the opinion that he was not bound to communicate it.<sup>38</sup>

Anthony Kronman has defended this rule by focusing attention on the incentives it provides for the deliberate production

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36. See Barnett, *supra* note 2, at 859-73 (discussing the role of consent in justifying contractual enforcement of default rules).

37. *Laidlaw v. Organ*, 15 U.S. (2 Wheat.) 178 (1817).

38. *Id.* at 195 (quoted in COLEMAN, *supra* note 1, at 249).

of valuable information.<sup>39</sup> Consequently, Kronman believes that information that is casually obtained should have to be disclosed. In contrast, Coleman rejects the distinction between deliberately and casually obtained information and instead stresses that whether information is productive depends upon whether it is predominantly "technological" in nature or whether it is predominantly "redistributive."<sup>40</sup>

For Coleman, the crucial question is whether the value of the information at issue "derives from *technology*, gains from allocating information more efficiently," or from "*distribution*, wealth transfers that follow from price changes."<sup>41</sup> He maintains that

all information has a technological as well as a redistributive dimension. In many cases, investment in information will be socially efficient because the technological gains will outweigh the costs of investment. However, in some cases, the technological effects will be less significant than the redistributive ones. In these cases, private investment can exceed social return.<sup>42</sup>

Applying this distinction, Coleman concludes that imposing a duty to disclose is not always nonproductive or inefficient.

The efficiency of a property right in information depends upon whether the technological or the distributive dimensions of the information dominate. If the information is largely distributive in its impact, a property right in information may well be inefficient. So we should be reluctant to accept the conclusion that the best argument for a property right in information as such is that it encourages efficient investment in gathering information.<sup>43</sup>

Both Kronman's efficiency analysis, which distinguishes between casually and deliberately discovered information, and Coleman's efficiency analysis, which distinguishes between the technological and redistributive effects of information, miss the most important issue raised by mandating a duty to disclose such "extrinsic" information.

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39. See Anthony T. Kronman, *Mistake, Disclosure, Information, and the Law of Contracts*, 11 J. LEG. STUD. 1 (1978).

40. Coleman takes this distinction from Jack Hirshleifer, *The Private and Social Value of Information and the Reward to Inventive Activity*, 61 AM. ECON. REV. 651 (1977).

41. COLEMAN, *supra* note 1, at 250.

42. *Id.* at 251.

43. *Id.* at 254.

B. *The Paradox of a Right of Nondisclosure*

Once again the issue involves the meaning of silence. To fail to disclose some fact is to remain silent about it. Those who favor a duty to disclose contend that sometimes such silence can constitute a fraudulent misrepresentation. This implication of silence is graphically highlighted in the *Laidlaw* case by the buyer's silence in the face of the seller's direct question concerning whether the buyer had any information that would affect the price of tobacco. The buyer's silence conveyed a false representation that the buyer had no such information. Was this intentional misrepresentation fraudulent? I say no.

All speculative resource trading involves betting on price changes. Such speculation is impossible unless a legal system adheres to the liberal conception of freedom of contract. The liberal principle of freedom *from* contract requires that each party obtain the other's consent before a transaction may receive legal protection; the liberal principle of freedom *to* contract protects the enforceability of the parties' manifestation of consent from interference by others or from a change of mind by one of the parties that is not consented to by the other.<sup>44</sup>

Enforcing a right to speculate on changes in resource prices while permitting parties to withhold information concerning the potential demand or supply of the traded resource provides substantial social benefits that extend well beyond the parties to a particular transaction.<sup>45</sup> True, as Kronman has stressed, a right of nondisclosure creates incentives to generate useful information deliberately, but that is only one of its advantages. Both Kronman and Coleman overlook the incentive that this right creates to *disseminate* certain vital information, whether it is acquired casually or deliberately.

At first glance, a rule permitting those in possession of information relevant to demand for particular scarce resources—or

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44. For an extended account of the crucial social functions performed by these two aspects of contractual freedom, see Barnett, *supra* note 2, at 829-59; see also Randy E. Barnett, *The Function of Several Property and Freedom of Contract*, 9 Soc. PHIL. & POL'Y 62 (1992).

45. The analysis presented here does not apply to speculation on pure lotteries or other "nonproductive" games of chance. The case for a right to engage in such speculation or gambling is quite different than that which can be made for a right to make speculative resource transfers. I have offered this type of analysis of the right to consume intoxicating substances in Randy E. Barnett, *Curing the Drug Law Addiction: The Harmful Side-Effects of Legal Prohibition*, in *DEALING WITH DRUGS* 73 (Ronald Hamowy ed., 1987).

what Marshall called "intelligence of extrinsic circumstances which might influence the price of the commodity"<sup>46</sup>—to withhold it from their trading partners seems inimical to the dissemination of such information. Closer analysis, however, reveals that a nondisclosure rule does indeed promote that end. To put the matter paradoxically, permitting persons to conceal certain types of information best promotes the dissemination of that information.

The resolution of the paradox lies in the fact that, their verbal silence notwithstanding, the *actions* of persons in possession of Marshall's extrinsic intelligence disseminate more information than mere words ever could. Both consenting to trade and withholding one's consent importantly affect the market price of a resource.<sup>47</sup> The movement of resource prices that such decisions cause in the aggregate conveys invaluable and otherwise unobtainable<sup>48</sup> knowledge. 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 "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 po-

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46. *Laidlaw*, 15 U.S. (2 Wheat.) at 195.

47. Many, including economists, often seem to forget that the prevailing market price reflects the price at which the marginal seller is willing to transact with the marginal buyer. The market price of, for example, a house is as influenced by the decisions of all homeowners who prefer to hold on to their property rather than accept the prevailing market price as it is influenced by those at the margin who consent to such transfers.

48. See Barnett, *supra* note 2, at 831-35 (discussing the limited accessibility of personal and local knowledge).

tential traders to engage in information-revealing transactions. Consequently, a legal duty to disclose extrinsic intelligence to the other party would greatly reduce disclosures of this information to the society at large. Moreover, such a disclosure rule would cause countless persons to be misled. By eliminating the incentive to trade on information, enforcing a duty to disclose would induce persons in possession of extrinsic intelligence inadvertently to convey to the market by their silence the inaccurate impression that future demand will be lower or higher than they know it to be.

What makes *Laidlaw v. Organ* a “hard case” worthy of including in casebooks is the fact that the extrinsic information in question would have reached the market (and society at large) within hours no matter what the buyer did, thus obscuring the pervasive informational benefits of a general nondisclosure rule. In this regard, *Laidlaw* resembles the proverbial bar exam question that asks whether it is murder to shoot and kill a man who is falling from the top of Sears Tower as he passes the 50th floor. After all, you are supposed to think, he was just seconds away from death anyway. But the desired answer is that *every* murder involves cutting short the life of someone who is going to die anyway—in principle, the amount of time that the murder takes from the victim is immaterial. So too, the principle of *Laidlaw* is that persons have a right to profit by trading on secret information that one day may reach the market by other means.

Of course, if every murder cut only seconds from a person’s life, the doctrine of murder would probably be much different than it is. Similarly, if all information bearing on the supply or demand for resources would inevitably reach everyone within hours even if persons in possession of new information withheld it, the social function performed by a right to withhold such information from one’s trading partner would be greatly diminished. Indeed, the need for speculative commodity and other exchanges would also be diminished. Any such scenario is, however, pernicious fantasy.

What holds true for Kronman’s distinction between deliberately and casually acquired information applies with equal force for Coleman’s application of Hirshleifer’s distinction between the distributional and technological effects of information. Like Kronman, Coleman misses the fact that virtually all information

concerning existing relative scarcity is hidden and only a regime of private property and freedom of contract is capable of producing the price signals and movements that aggregate and disseminate this information to society at large. To my mind, the social function performed by private actors participating in commodities markets using undisclosed information is crucial whether or not the information also has a technological or a redistributive effect.

C. *Squaring Nondisclosure with the Prohibition Against Fraud*

None of the foregoing analysis directly addresses the issue of whether the failure to disclose extrinsic information is fraudulent. After all, a free market presupposes the illegality of both forcibly and fraudulently induced rights transfers. I conclude that although the buyer's silence in *Laidlaw v. Organ* was certainly intentionally misleading, it was not fraudulent. The root of the problem stems not from the misleading nature of the buyer Organ's answer but from the unfairness of the seller Laidlaw's question. When viewed in the proper context, Laidlaw's question can be seen to be inappropriate and, therefore, he is simply not entitled to a truthful answer.

To understand why, suppose that before each exchange every commodities trader asked every other trader whether she was in possession of any information that would affect the future demand for or supply of the commodity in question. An entitlement to a truthful answer to such a question—that is, a duty to disclose—would virtually eliminate the institution within which both buyer and seller are operating. Therefore, in this bargaining context, such questions should not be asked and, if asked, need not be answered truthfully. Silence, however misleading, is the appropriate response.<sup>49</sup>

This insight highlights a more general and widely neglected feature of legal theory that I call the “nonpervasiveness principle.” Defenses to consensual obligation must describe *exceptional* circumstances that undermine the *normal* significance of consent.<sup>50</sup> Any purported defense that would potentially apply to every transaction cannot be legitimate, so long as consent is deemed to justify contractual obligation.

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49. An affirmative misrepresentation not offered in response to such an inquiry would be quite another matter, however.

50. See Barnett, *Consent Theory*, *supra* note 22, at 318-19.

This nonpervasiveness principle is not limited to contract defenses. It applies as well to every defense that purports to rebut any form of *prima facie* legal obligation however grounded. No legal defense that would work potentially in every case can be permitted because, no matter how plausible such a purported defense may appear, to allow it would be to undermine the *prima facie* legal obligation it opposes. If the legal obligation at issue is morally justified, no legal defense can be accepted which entirely eliminates its operation.<sup>51</sup>

Suppose in *Laidlaw* that instead of asking indirectly about the blockade, the seller asked the following: "Would you be prepared to pay more for the tobacco than you are offering?" Suppose further that the buyer lied and said, "No, this is my top offer," when in fact he would be willing to double his offer. Is this lie a fraud on the seller? According to the nonpervasiveness principle the answer must be no, because to hold otherwise would undermine virtually every such transaction. As I discussed in the context of situations where persons conceal the fact that they are acting as the agent of an "undisclosed" principal:

In reality, every seller who agrees to a price necessarily assumes the risk that the buyer might have been willing and able to pay more, just as every buyer assumes the risk that a seller would have been willing or able to accept less. Because such ignorance, whether conscious or not, is pervasive, it cannot undermine the normal significance of consent.<sup>52</sup>

To be fraudulent, then, a misstatement of fact must concern some "intrinsic" (to borrow Justice Marshall's terminology) characteristic of the resource itself as opposed to some knowledge relevant only to the "extrinsic" demand for the resource in question. For example, it would be fraud to stand mute in the face of a buyer's statement that "I assume that these eggs are Grade A" when the seller knows them to be of an inferior grade. It would not be fraudulent for the buyer to conceal her knowledge of an important new study pronouncing eggs to be far more healthful than previously thought. Although both

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51. This principle can also be reversed: When a legal defense that invariably undermines a given legal obligation is found to be morally justified, then that legal obligation is illegitimate.

52. Randy E. Barnett, *Squaring Undisclosed Agency With Contract Theory*, 75 CALIF. L. REV. 1969, 1991 (1988).

facts could, if disclosed, potentially affect the price of the eggs, only the first involves the description of the eggs themselves.

The nonpervasiveness principle accounts for Justice Marshall's distinction between intelligence of extrinsic and intrinsic circumstances. Still, a complete understanding of the rationale for this distinction requires that we consider the different functions performed by the prohibitions of duress and fraud.

#### D. *The Functional Difference Between Duress and Fraud*

A fundamental tenet of the liberal conception of justice is that resources rightfully belonging to another may not be taken without the manifested consent of the rights-holder. This tenet bars the use or threat of force to obtain such consent; thus, a contract signed or "consented to" under duress is void. In addition to this prohibition of force to obtain consent, liberalism has always barred persons from obtaining consent by means of fraud. Although the equating of force with fraud is both long-asserted and well-accepted by liberals, its theoretical basis remains obscure. This is because these two doctrines perform distinct functions.

Force is prohibited as a means of obtaining consent in important part because its use would legitimate transfers of resources that do not reflect the knowledge of the rights-holder regarding the potential uses and value of the resource in question. Permitting forcible transfers disrupts the complex, but vital, mechanism of information dispersal that only consensual transfers can make possible. The prohibition on the use of force reflects an effort to handle what I call the "first-order problem of knowledge," which consists of permitting persons and associations to act on the basis of their diverse local and personal knowledge while taking into account the knowledge of others about which they are pervasively ignorant.<sup>53</sup>

The function of the prohibition against fraud is related, but nonetheless different. This prohibition reflects an effort to handle a problem of interpersonal communication. Unlike the case of force or duress, a manifestation of consent that is fraudulently induced *does* reflect the knowledge of the person consenting, but the resources actually received by the defrauded

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53. The analysis presented in this paragraph is merely a summary of that presented in Barnett, *supra* note 2, and in Barnett, *supra* note 44.

transferee do not conform to the description communicated by the transferor.<sup>54</sup> Due to the transferor's failure to deliver resources conforming to the rights he communicated and conveyed by his manifestation of consent, a legal remedy is needed to close the unjust gap that has arisen between the distribution of resources and the distribution of rights.

In sum, when a seller uses duress to obtain the buyer's manifestation of consent, the transfer may not reflect the buyer's knowledge; with fraud, the buyer's manifestation of consent *does* reflect her knowledge but the resulting distribution of resources does not reflect the consent that was communicated. This type of gap arises when there is a discrepancy between the description of a resource's "intrinsic" qualities and the resources actually delivered. No such discrepancy occurs when intelligence concerning extrinsic circumstances affecting the supply of or demand for the resource is concealed.

Does this analysis of fraud, which accounts for the prohibition on transfers of rights induced by knowingly communicating false information, extend to the *failure* to convey true information that, if known, would influence the decision of the other party to consent to a transfer? The foregoing analysis suggests that a duty to disclose should exist when the failure to disclose creates a disparity between the rights transferred and the resources received. This may occur, for instance, when (a) an item, as it appears, would normally have certain intrinsic characteristics, (b) a reasonable inspection will not reveal the absence of these characteristics, (c) the seller knows that these characteristics are absent, and (d) the seller has reason to know that knowledge of this fact is "material," that is, it would likely influence the manifestation of assent by the buyer. An example of this is a product with a latent defect. When these circumstances obtain, the resources conveyed to the buyer do not conform to the substance of the rights conveyed by the seller.

On the other hand, a duty to disclose is not warranted by this analysis of fraud when the seller remains silent about a fact that does not concern the substance of the rights being transferred. In such a case, the seller does not deliver resources that fail to

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54. For example, a defrauded buyer may know that she values the use of the resources she is obtaining from the seller more than those she is transferring to the seller, but the resources she actually receives do not conform to the description that was communicated to her by the deceiving party.

conform to the rights that were represented as being transferred. For example (to vary the facts of *Laidlaw v. Organ*), suppose a seller sells grain at a price that has been greatly increased due to the shortages caused by a war. Although the seller fails to communicate his knowledge that the war has ended and consequently that prices are about to fall, he commits no fraud provided that he delivers grain of a quality and quantity conforming to the rights that were communicated and transferred.

#### IV. CONCLUSION

In this article, I have applied my recently-expanded account of a consent theory of contract to Jules Coleman's analyses of contractual default rules and the duty of contracting parties to disclose information to each other. First, I showed how, when determining conventionalist default rules that reflect the common-sense meaning prevailing in a particular community of discourse, a rational bargaining approach may usefully supplement or substitute for the information provided by market choices or empirical research. At least in contract theory, however, a rational bargaining model has justificatory value, not as an alternative to consent, but within an overall consensual framework.

Second, I explained how both Anthony Kronman's distinction between deliberately and casually obtained information, and Coleman's distinction between the technological and redistributive effects of information miss the more fundamental informational function of a right of nondisclosure. I showed that the refusal of one contracting party to disclose information to the other, even when asked, is not fraudulent when the information relates only to the supply or demand for the resources that are the subject of the contract. My account involved both the "nonpervasiveness principle" that applies to any defense to *prima facie* legal obligation and an analysis of the distinct social functions performed by the prohibitions on force and fraud.

Significantly, the analysis of both the role of hypothetical consent and the legitimacy of a duty to disclose turned on the informational functions that contractual consent uniquely performs.

