

An economic perspective on the doctrine of unilateral mistake in English contract law: a remedy-based approach

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Abstract

The key economic issues in implementing the law of unilateral mistake are twofold. First, it should avoid misallocation of resources; second, it ought to create a sufficient incentive for acquisition of information. However, the rule of unilateral mistake in English contract law does not serve these economic goals satisfactorily. The existing law and economics literature deals extensively with how to achieve these ends by designing the legal standards for a unilateral mistake which can nullify the contract, with little discussion of the function of legal remedy. This paper offers a remedy-based approach and argues that it has economic advantages over the current law.

Keywords: unilateral mistake; contractual mistake; legal remedy; law and economics.

1 Introduction

Assume, for example, that A is a rare-book collector who finds a first edition of *Wealth of Nations* personally autographed by Adam Smith in a second-hand bookshop. The book is exceptionally valuable, but the owner of the bookshop, B, misbelieves that it is an ordinary second-hand book, so offers to sell it for £5. After selling the book to A, the seller learns the truth. Can the seller claim the book back under English contract law? The answer depends on whether A, the buyer, is or is not aware that B, the seller, is mistaken. Arguably, the seller is entitled to the book only if A knows of the mistake. From an economic perspective, two interesting questions remain to be answered. First, does this rule improve allocative efficiency in moving the resource from a low value user to a higher value user? Second, can the rule create a sufficient incentive for A to search for information, for example by spending time and effort on looking for rare books in second-hand bookshops? The purpose of this paper is twofold. First, I seek to demonstrate that the current law can lead to misallocation of resources as well as undermining the incentive for acquisition of information. Second, I will offer a remedy-based approach to unilateral mistake. The paper proceeds as follows.

Section 2 sets out the legal background of unilateral mistake. Section 3 outlines the economic problems associated with the current law. Section 4 reviews the primary

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propositions in the law and economics literature to demonstrate why they are unsuitable for English contract law. Section 5 proposes a remedy-based approach to unilateral mistake. Section 6 concludes the arguments.

2 Legal background

A unilateral mistake is taken to refer to a mistake which is made by one contracting party but is not shared by another, for example the seller knows that the cow being offered for sale is barren, but the buyer misbelieves that the cow is fertile.¹ The English law of unilateral mistake is complicated, treating differently a mistake which is unknown to the non-mistaken party from one which is known to that party. In the current example, if the seller is not aware that the buyer misbelieves that the cow is fertile, the law provides no remedy to the buyer for the unilateral mistake, so the buyer must perform his or her obligations in accordance with the contract. If, however, the seller is aware that the buyer mistakenly believes the cow to be fertile and still contracts with seller, the contract is void *ab initio* and the buyer can request the seller to return the contract price paid in a claim of restitution. In this section, I will briefly outline the relevant legal rules concerning unilateral mistakes as a background to addressing the issue in Section 3: why the current law of unilateral mistake is economically problematic.

A THE UNILATERAL MISTAKE UNKNOWN TO THE NON-MISTAKEN PARTY

English contract law provides no legal remedy for a unilateral mistake which is unknown to the non-mistaken party. This rule is based on the old legal doctrine of *caveat emptor*, which means that each party bears their own risk; a person who is about to enter into a contract is under no duty to disclose material facts known to them but not to the other party, even facts which the person believes would be operative on the mind of the other.² If the seller of a barren cow is unaware that the buyer misbelieves that the cow is fertile, the contract is perfectly valid in law. The seller is not held liable for the buyer's unilateral mistake, unless the seller does something to deceive the buyer. Mere silence attracts no legal liability.³ This rule was made clear by Cockburn CJ in *Smith v Hughes*. He said:

I take the true rule to be, that where a specific article is offered for sale, without express warranty, or without circumstances from which the law will apply a warranty . . . and the buyer has full opportunity of inspecting and forming his own judgement, if he chooses to act on his own judgement, the rule *caveat emptor* applies. If he gets the article he contracted to buy, and that article corresponds with what it was sold as, he gets all he is entitled to, and is bound by the contract. Here the defendant agreed to buy a specific parcel of oats. The oats were what they were sold as, namely good oats according to the sample. The buyer persuaded himself they were old oats, when they were not so. But the seller neither said nor did anything to contribute to his deception. He has himself to blame.⁴

B THE UNILATERAL MISTAKE KNOWN TO THE NON-MISTAKEN PARTY

Turning now to a unilateral mistake known to the non-mistaken party, we find that the law becomes more complicated and confusing. This type of mistake may render the contract void *ab initio*, which simply means that the parties never entered into a legally binding

1 J Cartwright, *Misrepresentation Mistake and Non-Disclosure* (London: Sweet & Maxwell, 2007), p. 497.

2 G Treitel, *The Law of Contract* 10th edn (London: Sweet & Maxwell, 1990), p. 361; J Beatson, *Anson's Law of Contract* 28th edn (Oxford/New York: OUP, 2002), p. 323.

3 *Keates v Cadogan* (1851) 10 CB 591.

4 (1871) LR 6 QB 597 at 603.

contract. If a contract is held void *ab initio*, each party must return what he or she received from the other party, for example the seller returning the contract price to the buyer and the buyer returning the goods to the seller.

It is, however, less clear in what circumstances a “known unilateral mistake” can render the contract void *ab initio*. To date there has been no clear authoritative interpretation in case law and little agreement among scholars. Two versions of interpretation can be found in the academic literature.

The first version proposes that if one party makes a unilateral mistake which is known to the other party, the contract is void *ab initio*.⁵ This interpretation draws upon *Hartog v Colin & Shields*,⁶ where the plaintiff sued the defendant for breach of contract when the defendant failed to deliver 30,000 Argentine hare skins which were contracted for. The defendant argued that no contract had been entered into, because he made a mistake in offering to sell the hare skins at a price per pound when he had intended to sell them at a price per piece – and more importantly, he alleged that the plaintiff was aware of his mistake and had “fraudulently” accepted the offer. The court held that there was no contract between the plaintiff and the defendant because the defendant made a material mistake in the offer, which should have been and was known to the plaintiff.

The second version suggests that not every “known unilateral mistake” can render the contract void *ab initio*. Known unilateral mistakes can be divided into two types, viz. mistakes as to the subject-matter and those as to the promise. Only the latter type can make the contract void.⁷ To illustrate, consider the following examples given by Beatson. A sells X a piece of china. X thinks that it is Dresden china. A knows that X thinks so, and knows that it is not. X makes a mistake as to the subject-matter of the goods, so even though the mistake is known to the non-mistaken party, A, the contract is still legally valid. By contrast, if X thinks that it is Dresden china and also that A intends to sell it as Dresden china, and A knows that X misbelieves that A is selling Dresden china, then X’s mistake is as to the promise rather than the subject-matter; therefore, the contract is void *ab initio*.⁸ This proposition is based upon *Smith v Hughes*.⁹ In this case, the buyer believed that the oats which he bought were old, when in fact they were not. More importantly, the seller was aware of the buyer’s mistake. In deciding whether the buyer’s mistake could nullify the contract, the trial judge directed the jury to consider whether the word “old” had been used by the seller or the buyer in making the contract. If so, the contract was void *ab initio*. If it was not, the contract was valid even if the seller was clearly aware of the buyer’s mistake.

It is not the purpose of this paper to evaluate the merits and demerits of the two propositions. For the current purpose, we are more concerned with the judicial approach to unilateral mistakes. I will call the current approach taken by courts the standard-based approach. According to this approach, in deciding whether a unilateral mistake can make the contract void, the court will apply the standard test to investigate whether the non-mistaken party is aware or unaware of the mistake. The legal remedy can be granted for a unilateral mistake only if the non-mistaken party knows that the other party is mistaken. The availability of legal remedy depends upon whether the mistake can pass the test set by the law. Therefore, under the current rule, a unilateral mistake would either have no effect

5 G Treitel, *An Outline of the Law of Contract* 6th edn (Oxford: OUP, 2004), p. 137; R Stone, *The Modern Law of Contract* 7th edn (London: Routledge Cavendish, 2008), p. 388; P Richard, *Law of Contract* 7th edn (London: Pearson Longman, 2006), p. 225.

6 [1939] 3 All ER 566.

7 Beatson, *Anson’s* (n. 2 above), p. 323.

8 *Ibid.*, p. 324.

9 (1871) LR 6 QB 597.

on the validity of the contract or nullify it completely. As will be demonstrated in the next section, the standard-based approach combined with the “black and white” legal effect of unilateral mistake is not only economically inefficient, but also distorts the contracting parties’ incentive for acquisition of information.

3 Economic problems with the current law

The current law of unilateral mistake gives rise to two economic problems: (a) misallocation of resources; and (b) disincentive to acquisition of information.

A MISALLOCATION OF RESOURCES

Allocative efficiency requires resources to move from lower to higher value users. Efficiency is achieved when the resources move to the highest value user.¹⁰ From an economic perspective, a contract is a device for resource allocation and it can at least in theory achieve allocative efficiency, as well as ensuring that each step in the allocation process is a Pareto improvement, so that nobody is being made worse off by contracting.¹¹ A rational person will make a contract if and only if they believe that the value which they receive exceeds the value which they relinquish. Therefore, contracting is a mutual benefit activity. As long as there is a person who is willing to offer a price for the goods higher than the subjective value of the owner, a new contract will be made. The contracting process will continue until the goods go to their highest value user.

However, success in achieving allocative efficiency by contracting depends upon the prerequisite that each contracting party should perfectly realise their own subjective value on the goods, which is measured as the maximum price that the party requests for selling the goods. If the party is mistaken as to their own subjective value, so that the value received from the other party is less than the value the original party transfers, the mistake may lead to misallocation, moving the goods from a high value user to a lower value user. Assume, for example, that A sells a painting to B for £15,000 because A mistakenly thinks that it is a copy. If A had known that the painting was an original, A would not have been willing to sell it for less than £150,000. B knows the truth, but would have been willing to pay no more than £50,000 for an original painting. So, it is efficient for A rather than B to have the painting. But the consequence of A’s mistake – selling the painting to B for £15,000 – causes the misallocation of moving the painting from the high value user, A, to the lower value user, B.

It should also be admitted that not every mistake leads to misallocation. Some mistakes merely give rise to redistribution of wealth without affecting allocative efficiency. To illustrate, imagine that B in our example is willing to pay £200,000 for the original painting. In this case, A’s mistake does not cause misallocation, because the painting still moves to the higher value user, B. Although the mistake causes A to charge a lower price, thereby making A a loss of £135,000 (£150,000 - £15,000), that is only a private loss to A. From the standpoint of society, A’s mistake merely transfers £135,000 from A to B and the total social wealth does not diminish.

Therefore, a contractual mistake will cause a resource misallocation if and only if it leads the resource to move from a high to a low value user. Based upon this economic argument, an efficient law of unilateral mistake should allow the mistaken party to rescind

10 A Ogus, *Costs and Cautionary: Tales economic insights for the law* (Oxford: Hart Publishing, 2006), p. 27; for critical analysis of the definition of allocative efficiency, see e.g. M Trebilcock, “The value and limits of law and economics” in M Richardson and G Hadfield (eds), *The Second Wave of Law and Economics* (Sydney: Federation Press, 1999), pp. 17–22.

11 For elaboration of Pareto improvement and of its implications, see J Coleman, “Efficiency, exchange, and auction: philosophic aspects of the economic approach to law” (1980) 68 *California Law Review* 220.

the contract if that party's subjective value is higher than that of the non-mistaken party; for the same reason, if the subjective value of the mistaken party is lower than that of the non-mistaken party, the law should still enforce the contract, notwithstanding the mistake.

The current law of unilateral mistake is inconsistent with allocative efficiency. When deciding whether the contract is void on the ground of a unilateral mistake, the court does not take account of the allocative outcome caused by its judgment. The crucial factor which the court considers is whether the non-mistaken party is aware of the mistake. This approach can lead to misallocation of resources in two situations.

Firstly, misallocation occurs where the party makes a unilateral mistake unknown to the other party, but the former's subjective value for the goods is higher than that of the latter. According to allocative efficiency, the law should allow the mistaken party to rescind the contract in order for the goods to go to the higher value user. But, under the current legal rule, the contract cannot be voided, because the unilateral mistake is unknown to the non-mistaken party. Consequently, the law moves the goods from the high value user, the mistaken party, to the low value user, the non-mistaken party.

Secondly, misallocation also occurs where one party makes a unilateral mistake known to the other party, but the former's subjective value for the goods is lower than that of the latter. For the same reason as given above, if the subjective value of the non-mistaken party is higher than that of the mistaken party, the contract should be enforced, even though one party is mistaken. However, under the current law, the contract can be voided *ab initio* for a mistake known to the other party. This rule will cause misallocation when the subjective value of the non-mistaken party is higher than that of the mistaken party.

B DISINCENTIVE FOR ACQUISITION OF INFORMATION

A contractual mistake may lead to misallocation of resources, so that reducing the number of mistakes should diminish the probability of misallocation. Information is the antidote to mistake;¹² increasing the amount of information available to a contracting party reduces the level of uncertainty in the party's decision-making, thereby reducing the possibility of making a mistake. When there is an information asymmetry between the parties, it is desirable to create an incentive for the party with superior information to disclose it, where such information may prevent the other from making a mistake. It is, however, equally important to create an incentive for the former to acquire such information in the first place, otherwise there will be no valuable information to prevent the mistake. From an economic perspective, the law would ideally create both incentives.

Before considering the issue of incentive, it is necessary for us to appreciate how a legal rule can create different incentives for the actors. Economists see human behaviour as the result of a cost-benefit assessment in deciding whether or not to act.¹³ Legal rules can change the payoff of behaviour for an actor. In theory, the law can encourage an individual to do some socially desirable act by reducing the cost of this behaviour, for example exempting the person from legal liability for any harm incurred by it; it also can deter the individual from socially harmful behaviour by increasing its cost to the individual, for instance imposing a criminal sanction or increasing the amount of compensation payable for the harmful conduct.¹⁴

12 A Kronman, "Mistake, disclosure, information, and the law of contract" (1978) 7 *Journal of Legal Studies* 1, at 4.

13 G Becker, "Crime and punishment: an economic approach" (1968) 76 *Journal of Political Economy* 169.

14 For general discussions, see G Becker, *The Economic Approach to Human Behaviour* (Chicago: University of Chicago Press, 1976); D Baird, R Gertner and R Picker, *Game Theory and the Law* 6th edn (Cambridge, Mass: Harvard University Press, 2003).

To see how the current law of unilateral mistake affects the incentive for disclosure, the analysis should distinguish the situation where the information to be disclosed is favourable to the disclosing party from one where the information is unfavourable to the same party. In the first case, there is no need for the law to create an incentive for disclosure:¹⁵ a rational party will voluntarily disclose the information if the profit from the disclosure exceeds the cost. In other words, parties will have sufficient incentive to disclose the information which is favourable to them. For example, the seller will voluntarily disclose any information that would raise the contract price; and the buyer, by the same token, has the incentive to reveal any information which might lower the contract price. Therefore, the current law of unilateral mistake does not affect either party's incentive to disclose information favourable to him or herself.

In the second case, parties will not disclose unless the law creates sufficient incentives for them to do so, because a rational party has no incentive to disclose information which is unfavourable to him or her. If the law makes the cost of non-disclosure higher than the cost of disclosure, it will create an effective inducement for the party to disclose. The current law of unilateral mistake can do this. To appreciate this argument, we should consider the difference in the payoff to the party between disclosure and non-disclosure under the current law.

If a party with a piece of unfavourable information discloses this to the other party, there are two possible outcomes. First, the disclosing party may still contract with the other party, if the former is willing to adjust the contract price in favour of the latter. In this case, the disclosing party can still gain from making the contract, although obtaining less than under non-disclosure. But the disclosing party is certainly better off than if not contracting. Second, the other party may refuse to contract, believing that making the contract is not worthwhile. In this case, the disclosing party is unable to gain from contracting. In brief, under the current law, if a party discloses unfavourable information, that party may obtain either a lower profit or nothing.

Consider now the party's payoff for non-disclosure. Under the current law, the party can void the contract if that party has made a unilateral mistake known to the other party. Where the contract is void *ab initio*, the law will restore the parties to the position where no contract had been made: each party must return what he or she received from the other. Thus, when the contract is void, the non-mistaken party is deprived of the opportunity to gain from contracting.

If the party with unfavourable information, knowing that non-disclosure will lead the other party to make a mistake, actually fails to disclose, the payoff from non-disclosure is nil. In contrast, if disclosure is made, there is a possibility for the original party to obtain a positive payoff, since, after disclosure, the other party may choose either to make the contract subject to adjustment of the price or not to contract. If the other party chooses the second option, there will be a contract between them, so that the party with unfavourable information can still enjoy a positive return from contracting. Therefore, the current law creates an incentive for the party with superior information to disclose.

However, the major economic problem with the current law is that it undermines the incentive for information acquisition. Why should rational parties seek information? Their incentive is that they intend to profit from using the information which they have acquired. Under the current law, they are forbidden to profit from using such information and this discourages information-seeking. To illustrate, consider the following example.

15 C Wonnell "The structure of a general theory of non-disclosure" (1991) 41 *Case Western Reserve Law Review* 329 at 341.

The owner of land believes that there no mineral wealth under the land and therefore offers to sell it for £4m. The buyer is a mining firm, according to whose experts there is a one per cent chance that this piece of land contains a quantity of minerals worth £600m, so the *ex ante* value of the land to the firm is £6m (£600m × 1%). But the mining firm will incur a search cost of £1m to assess the mineral value of the land. Imagine further that, if it is discovered that the land contains minerals, the owner will not sell the land for less than £599.5m. The question which we need to answer is whether the firm will invest £1m in discovering the mineral capacity of the land under the current law.

If the law did not excuse the owner's mistake and enforced the contract strictly when it was discovered that the land was rich in minerals, the firm would purchase the land at the price of £4m and then spend another £1m on discovering the mineral capacity, because it could earn an *ex ante* profit of £1m (£6m - £4m - £1m = £1m).

In contrast, if the law excuses the owner's mistake and allows the contract to be rescinded when it is found that the land contains minerals, the firm will not invest £1m in exploration in the first place, because once the contract is rescinded, the firm is not only unable to profit from investing in the search, but cannot recover its search costs, so sustains a loss of £1m.

Under the current law, if the firm does discover minerals under the land without revealing this to the owner, the owner can void the contract on the ground of a unilateral mistake which is known to the non-mistaken party. In this case, the firm will sustain a loss of £1m. If, however, the firm discloses the information to the owner, the owner will raise the contract price to £599.5m. Given the search cost of £1m which has been spent by the firm, it will receive a negative payoff of £0.5m by purchasing the land at this price (£600m - £599.5m - £1m = -£0.5m). Therefore, the best strategy for the firm is not to invest £1m in discovering the mineral capacity. Because the current law will void the contract on the ground of a mistake known to the non-mistaken party, it forbids the party with superior information from capturing profit by using the information. Consequently, it undermines the party's incentive to search for information.

An economic approach to the law of unilateral mistake can generate insights essential for understanding how the law could affect allocation of resources and the incentive for acquisition of information. In this section, I have demonstrated that there are two economic problems associated with the English law of unilateral mistake: misallocation of resources and discouragement of the acquisition of information. There is an interesting question to be answered: could we propose a new rule to overcome these two economic problems? In the next section, I shall review two main solutions proposed in the law and economics literature, as well as pointing out their limitations. Then, in Section 5, I will propose a new solution – a remedy-based approach to unilateral mistake – and argue that the new approach has economic advantages over both the current law and the propositions in the literature.

4 Solutions in the current law and economics literature

The question of how the legal rule affects allocative efficiency and the contracting parties' incentives to disclose and search for information has been extensively researched in law and economics.¹⁶ Much of the literature in this field builds on the contributions of Kronman and of Cooter and Ulen.¹⁷

A KRONMAN'S APPROACH

Kronman addresses the issue by drawing a critical distinction between information which is acquired deliberately and that which is acquired casually. He proposes that if the non-mistaken party acquires the information casually, the law should rescind the contract for a unilateral mistake; in contrast, if the information is acquired deliberately, the law should enforce the contract even though one party is mistaken. For him, information is acquired casually if the party does not incur any cost in acquiring the information, for example a businessperson acquires a valuable piece of information when accidentally overhearing a conversation on a bus. By contrast, information is acquired deliberately if the party has purposely invested in searching for or producing information, for instance a securities analyst acquires information about a particular corporation in a deliberate fashion – by carefully studying evidence of its economic performance.¹⁸

The rationale underlying this argument goes as follows. Rescinding a contract on the ground of unilateral mistake implicitly imposes a duty of disclosure on the party with superior information. If the information is acquired casually, imposing the duty to disclose is not likely to discourage the production of socially useful information, since the actor who acquires information casually makes no investment in its acquisition. But imposing the duty of disclosure on the party who acquires information by a deliberate investment would significantly reduce the incentive to make such an investment in the first place, thereby significantly diminishing production of valuable information.¹⁹

Kronman's proposition has a significant limitation. As Kronman's interest is in the issue of how the law of unilateral mistake can create the incentive for information production, he overlooks the issue of how the law affects allocation of resources. According to Kronman, the contract should be rescinded on the ground of unilateral mistake if the non-mistaken party acquires the information casually. But if the subjective value of the non-mistaken party is higher than that of the mistaken party, the rescission will result in misallocation of resources from the higher value user to the lower. Hence, Kronman's approach may also lead to misallocation of resources.

16 For general discussion, see Kronman, "Mistake, disclosure, information" (n. 12 above); J Hirshleifer "The private and social value of information and the reward to inventive activity" (1971) 61 *American Economic Review* 561; M Eisenberg, "Disclosure in contract law" (2003) 91 *California Law Review* 1645; R Craswell, "Taking information seriously: misrepresentation and nondisclosure in contract law and elsewhere" (2006) 92 *Virginia Law Review* 565; Wonnell, "The Structure" (n. 15 above); S Shavell, "Acquisition and disclosure of information prior to sale" (1994) 25 *RAND Journal of Economics* 20; M Trebilcock, *The Limits of Freedom of Contract* (London: Harvard University Press, 1997), pp. 102–27; O Grosskopf and B Medina, "A revised economic theory of disclosure duties and break-up fees in contract law", a working paper, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=935165; R Birmingham, "The duty to disclose and the prisoner's dilemma: *Laidlaw v Organ*" (1988) 29 *William and Mary Law Review* 249; H Kötz, "Precontractual duties of disclosure: a comparative and economic perspective" (2000) 9 *European Journal of Law and Economics* 5.

17 Kronman, "Mistake, disclosure, information" (n. 12 above); R Cooter and T Ulen, *Law and Economics* 4th edn (London: Pearson Addison Wesley, 2003), pp. 281–4.

18 Kronman, "Mistake, disclosure, information" (n. 12 above), p. 13.

19 *Ibid.*

B COOTER AND ULEN'S APPROACH

Unlike Kronman, Cooter and Ulen distinguish productive from redistributive information. For them, productive information can be used to produce more wealth, for example the discovery of a vaccine for polio and the discovery of a shipping route between Europe and China. In contrast, redistributive information creates a bargaining advantage that can be used to redistribute wealth in favour of the informed party. For instance, knowing before anyone else where the state will locate a new highway conveys a powerful advantage in real-estate markets. Searching for redistributive information is socially wasteful. Therefore, they conclude that the law should discourage expenditure of resources on searching for redistributive information.²⁰ One device to this end is to rescind the contract when one contracting party makes a unilateral mistake which is caused by the non-mistaken party's non-disclosure of redistributive information.

The argument of Cooter and Ulen appears to be based on the earlier work of Hirshleifer,²¹ who made a distinction between "foreknowledge" and "discovery". Foreknowledge is knowledge that "will in due time, be evident to all"; it is information that "Nature will autonomously reveal, it involves only the value of priority in time of superior knowledge."²² This type of information leads only to redistribution of wealth, without increasing social welfare. Discovery, by contrast, is "the recognition of something that possibly already exists, though [it will remain] hidden from view unless and until the discovery is made".²³ Discovered information can generate both private gains to the owner of information and social wealth. Although Cooter and Ulen use different terminology, the theme of their argument is much the same as that of Hirshleifer, in that both seek to distinguish socially valuable from socially valueless information and suggest that the law should provide disincentives for acquisition of the latter.

But the shortcoming of Cooter and Ulen's approach is also obvious. In the context of contract law, it is impossible to draw a clear-cut distinction between productive and redistributive information. In most cases, the information is both productive and redistributive. Recall their earlier example: they argue that information on the discovery of a shipping route from Europe to China is productive. But this information can also be redistributive. Imagine a contractual relation between a Chinese exporter and a European importer. Assume now that the Chinese exporter knows of a new route; this information could reduce the transportation costs of the goods substantially. If the European company learns of this information, it will not purchase the goods unless the Chinese firm agrees to lower the price. But if the Chinese exporter conceals this information from the European buyer, the former can charge the original price and make a higher profit. Thus, the information on the new route redistributes wealth in the form of contract price from the European firm to the Chinese firm.

Conversely, the redistributive information may be of a productive kind. Cooter and Ulen take the information concerning the intended building of a new road as an example of redistributive information. But it may be productive as well. If the owner of land adjacent to the road uses the land for a purely residential purpose, the new highway will reduce the owner's subjective value on the land because of noise generated by passing vehicles. The sooner the owner has the information, the sooner that person will be able to sell the land to

20 Cooter and Ulen, *Law and Economics* (n. 17 above), pp. 281–4.

21 Hirshleifer "The private and social value" (n. 16 above).

22 *Ibid.*, p. 562.

23 *Ibid.*

someone who values it more highly and buy a new home elsewhere. Thus, information of this kind can speed up the process of resource allocation to the highest value user.²⁴

Because Cooter and Ulen's distinction between productive and redistributive information is ambiguous, it cannot be used as a criterion in contract law to determine when the contract should be voided for a unilateral mistake. If the law followed Cooter and Ulen's suggestion to discourage searching for redistributive information, it would lead to inefficient allocation of resources when the information had both redistributive and productive features.

From an economic perspective, the crucial issues in implementing the law of unilateral mistake are improving allocative efficiency as well as creating incentives for acquiring information. In this section, I have demonstrated that neither of the two main propositions in the law and economics literature provides an optimal solution, sharing as they do the characteristic that they seek to provide guidance on determining when the contract is void for a unilateral mistake by classification of mistakes in terms of certain economic features. But there is almost no discussion of how the legal remedy could contribute to solving this problem. In the next section, I will offer a new perspective, the remedy-based approach to the unilateral mistake, arguing that this has advantages over the existing propositions.

5 A remedy-based approach

The legal remedy, as argued by Ogus, is

an external inducement which can be envisaged as imposing cost or conferring benefits on actors. When integrated into the actor's cost-benefit assessment of the different available behavioural options, they may significantly change preferences, and therefore demand, like any other increase or reduction of price.²⁵

From the actor's perspective, the legal remedy is the price which the actor pays for the act. An increase in the price will undermine or overcome the actor's incentive for that act and a decrease in the price will stimulate it.²⁶

Based upon this argument, I propose a new approach to unilateral mistake, the remedy-based approach, according to which four suggestions are made: (1) the law should abolish the distinction between the unilateral mistake known to the non-mistaken party and that unknown to the non-mistaken party; (2) the unilateral mistake should not render the contract void *ab initio*; (3) if one party makes a unilateral mistake, whether known or unknown to the other party, the contract is voidable – the law should give discretion to the mistaken party to decide whether or not to rescind the contract; (4) if the mistaken party chooses to rescind the contract, that party should pay the other party for the expectation loss in order to put the latter into the position he or she would have been in if the contract had been perfectly performed. The expectation loss is measured in the same way as damages for breach of contract.

To see how this proposition works, recall our earlier mineralogical example. According to the new approach, if the landowner is mistaken as to the fact that the land is rich in minerals, the owner has the right to decide whether or not to rescind the contract. If the decision to rescind is made, the landowner should compensate the firm for its expectation loss of

24 Similar arguments were made by Kronman and Eisenberg, see Kronman, "Mistake, disclosure, information" (n. 12 above), p. 12; Eisenberg, "Disclosure in contract law" (n. 16 above), pp. 1666–73.

25 Ogus, *Costs and Cautionary Tales* (n. 10 above), p. 101.

26 For general discussion on legal remedy and incentives, see J Barton "The economic basis of damages for breach of contract" (1972) 1 *Journal of Legal Studies* 277; S Shavell, "Damage measures for breach of contract" (1980) 11 *Bell Journal of Economics* 466; Ogus, *Costs and Cautionary Tales* (n. 10 above), pp. 101–5.

£600m. As will be shown, this new approach effectively ends misallocation of resources caused by the current law, while creating a sufficient incentive for acquisition of information.

In the first place, the remedy-based approach is more allocatively efficient than the current law. Allocative efficiency requires goods to move from the lower to the higher value user. Therefore the contract should be rescinded for a unilateral mistake when the subjective value of the mistaken party is higher than that of the non-mistaken party and should not be rescinded when the reverse is true. As outlined already, the current law may lead to inefficient allocation of resources by moving goods from the higher to the lower value user, a problem which the remedy-based approach can alleviate.

In the light of this approach, if the mistaken party rescinds the contract, that party should compensate the non-mistaken party for his or her expectation loss. This is just equal to the non-mistaken party's subjective value – the price the non-mistaken party would request for selling the goods. A rational party will have the incentive to rescind the contract for the mistake only if that party's subjective value exceeds the other party's expectation losses; otherwise, the former will choose not to rescind. Consequently, other things being equal, it can be ensured that as long as the mistaken party rescinds the contract, his or her subjective value will be higher than that of the non-mistaken party and the rescission is allocatively efficient. If the mistaken party waives the right of rescission, it is implied that the mistaken party's subjective value is lower than that of the non-mistaken party, so that it is now enforcement of the contract which is allocatively efficient. Therefore, theoretically speaking, the remedy-based approach does not result in misallocation of resources.

Nonetheless, it is by no means possible to claim that the remedy-based approach can completely eliminate misallocation of resources. The above argument assumes that rescinding the contract generates no cost to the mistaken party and that the mistaken party can discover his or her mistake *ex post*. Obviously, neither assumption is always true in practice. Rescinding the contract will generate a high litigation cost to the mistaken party. If the mistaken party's subjective value on the goods is outweighed by the litigation cost and the expectation damages payable to the non-mistaken party, the party will not rescind the contract, in which case the misallocation cannot be rectified. Thus, the remedy-based approach can be allocatively efficient only if the litigation cost to the mistaken party is low. In addition, not every mistaken party can discover *ex post* that a mistake has been made. It has been widely recognised that individuals have only a limited capacity to digest information.²⁷ If the mistaken party fails to discover the mistake *ex post*, the remedy-based approach again cannot correct the misallocation caused by the mistake.

Despite the demerits outlined above, the remedy approach is more allocatively efficient than the current law. First, the problems of litigation cost and *ex post* ignorance of the mistake also apply to the current legal regime; it cannot be said that they are more serious under the rule proposed. Second, the remedy approach can correct more misallocations resulting from unilateral mistakes than the current law, under which, once a mistake leads to misallocation, it can be corrected only if the non-mistaken party knows of the mistake. In contrast, the remedy-based approach allows the party to rescind the contract for the mistake, no matter whether the non-mistaken party is aware of it. Thus, more misallocations can be rectified under the remedy-based rule than under the current one.

The second merit of the remedy-based approach is that it can create a sufficient incentive for acquisition of information, which is insufficient under the current law because once the contract is rescinded for the unilateral mistake, the contract is void *ab initio* and each party must return what they have received from the other party. This prohibits parties

27 C Sunstein (ed), *Behavioural Law and Economics* (Cambridge: CUP, 2000).

from capturing any profit derived from the information which they privately own. Therefore, they will lack the incentive to acquire the information in the first place. By contrast, under the remedy-based rule, if the contract is rescinded for a unilateral mistake, the non-mistaken party can claim the expectation loss from the mistaken party. Hence, after receiving compensation from the latter, the former would be put into the position in which he or she would have been had the contract been perfectly performed. The new rule allows the party to capture all of the profits derived from that party's own private information, thereby creating a sufficient incentive to acquire information.

6 Conclusion

The key economic issues in implementing the law of unilateral mistake are to facilitate efficient allocation and to create a sufficient incentive for acquisition of information. In this paper, I have demonstrated that the current English law may both lead to misallocation of resources and discourage parties from acquiring information. In addition, we have recognised that the propositions in the current law and economics literature do not offer an optimal solution. Finally, I have proposed a remedy-based approach to the unilateral mistake problem. As illustrated by this paper, the new approach has economic advantages over the current law. Not only can it create an incentive for acquisition of information, but it also rectifies more misallocation resulting from unilateral mistakes.