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SECURITIES AND SECRETS: INSIDER TRADING AND THE LAW OF CONTRACTS*

*Saul Levmore***

MUCH of the regulation of insider trading[1] is based on the premise that if an insider[2] or corporate entity possesses special information, but has a business reason for keeping it secret,[3] it

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* The author is appreciative of the suggestions of Michael Dooley, Charles Goetz, Douglas Leslie, and Robert E. Scott.

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[1] Most of the law in this area derives from Rule 10b-5. 17 C.F.R. § 240.10b-5 (1981). Rule 10b-5 provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

Id. Rule 10b-5 is promulgated pursuant to § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (1976). The rule deals with affirmative acts and has not been extended to abstention, so long as there is a corporate reason for nondisclosure. See, e.g., State Teachers Retirement Bd. v. Fluor Corp., 654 F.2d 843, 850-51 (2d Cir. 1981).

Although much of the analysis in this essay could be extended to other areas of securities law, the argument is more clearly developed if it is confined to issuing corporations regulated by the antifraud provisions of the Securities Exchange Act of 1934, as set forth in Rule 10b-5. The discussion and conclusions, for example, should not be applied, without further analysis, to tender offers or to registration and reporting requirements for new securities issues under the provisions of the Securities Act of 1933, §§ 7, 10, 15 U.S.C. §§ 77g, 77j (1976).

[2] Although the meaning of "insider" occasionally has been extended to include all persons with informational advantages, for the purposes of this essay the term refers to someone who owes a fiduciary duty to the corporation and its current and potential shareholders. For a slightly different distinction between insiders and outsiders, see Brudney, Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws, 93 Harv. L. Rev. 322, 354 (1979) (arguing that the element that makes an informational advantage unusable by those who possess it (insiders) is the inability of other traders (outsiders) to overcome the advantage lawfully).

[3] For a discussion of the expansion of the disclosure duty to those situations where there is no trading or prior misinformation, see Bauman, Rule 10b-5 and the Corporation's Affirmative Duty to Disclose, 67 Geo. L.J. 935 (1979). One of Bauman's limited exceptions to this affirmative duty is a situation in which it would be unfair to the corporation to disclose because a business purpose is at stake. Id. at 957. One purpose of this essay is to examine

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may withhold that information from the marketplace. The law builds on this premise that "silence is golden" in its instruction to "disclose-or-abstain": in the absence of disclosure, an insider may not trade on the basis of the withheld information and must also refrain from "tipping."[4] If the insider wishes to trade in securities that are affected by the secret to which he is privy, he must first disclose the information and continue to abstain from trading until it has disseminated.[5]

The disclose-or-abstain rule is but one of many legal schemes or "patterns," as they are called in this article, that might serve to promote various societal interests. Currently, the "free-market" pattern is the most popular alternative to the disclose-or-abstain rule.[6] Proponents of this scheme prefer to let insiders trade as they wish. The two alternatives represent different approaches to securities regulation: disclose-or-abstain rests primarily on fairness grounds; the free-market pattern rests on efficiency considerations and the role of the stock market as an allocator of capital. To the extent that markets function through the interaction of buyers and sellers who act on the basis of information about wants and about productive capabilities, more information is better than less. The free-market pattern allows markets to process this information by allowing secretive insiders to trade rather than requiring them to abstain.[7]

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the basis for this exception.

[4] Because trading by someone who learns of a corporate secret from an insider affects prices in the securities markets and the well-being of other shareholders about as much as does trading by the insider himself, this essay includes "tipping" in its concept of insider trading.

[5] Althougb the phrasing of the disclose-or-abstain rule seems to suggest that the insider has a choice, it is more accurate to say that his fiduciary obligation not to place obstacles in the way of the corporation's enterprises compels his decision whether or not to abstain. For example, if the secret concerns the existence of rich ore deposits in a certain region, the corporation's interests will be served by a period of silence until the corporation can purchase tracts of land in that region. See SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848, 850 n.12 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969). If the corporation's needs do not require that the insider refrain from disclosing material information, it is difficult to understand why an insider should be allowed to withhold it. See notes 48-74 infra and accompanying text for further discussion of the justifications for allowing corporate nondisclosure.

[6] Professor Manne has been a vigorous proponent of the free-market pattern. See generally H. Manne, Insider Trading and the Stock Market (1966); Manne, In Defense of Insider Trading, 44 Harv. Bus. Rev. 113 (Nov.-Dec. 1966).

[7] Insider trading on the basis of undisclosed information will drive stock prices in the

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Critics of the free-market pattern, however, find it unfair that insiders should enjoy trading advantages as a result of their managerial or controlling positions. Commentators have formulated moral arguments against insider trading[8] and have noted that the purpose of the Securities and Exchange Act of 1934[9] is "to place the buyer on the same plane, so far as available information is concerned, with the seller."[10] In response, courts have demanded "some degree of equalization of bargaining position"[11] between insiders and "outsiders," and have determined that if outsiders do not have equal access to information, fairness requires that insiders either disclose the information or refrain from acting on it.[12]

Unfortunately, the arguments against the free-market approach illustrate the proposition that fairness or "equality of trading positions" is a standard that has been supported more by dramatic pronouncements than by rigorous analysis. Closer examination of the disclose-or-abstain scheme, for example, suggests that requiring outsiders to take investment risks blindly—while knowledgeable insiders avoid these risks by abstention—may be as unfair as allowing insiders to trade as they wish. Thus, in many cases the disclose-or-abstain pattern scarcely does justice to the fairness goal.

Interestingly, the debate between proponents of free-market and disclose-or-abstain has been a narrow one; the fairness argument has been used primarily to counter the free-market approach and rarely to support patterns that are more regulatory in nature than disclose-or-abstain—although such patterns might come closer to realizing the fairness goal. Perhaps it is assumed that any "fairer" pattern—such as an "always-disclose"[13] scheme, which would man-

"proper" direction, i.e., in that direction in which stock prices presumably would move if the information were disclosed. See H. Manne, supra note 6; note 75 infra and accompanying text.

[8] Loss, The Fiduciary Concept as Applied to Trading by Corporate Insiders in the United States, 33 Mod. L. Rev. 34, 36 (1970).

[9] 15 U.S.C. §§ 78a-78jj (1976 & Supp. III 1979).

[10] 72 Cong. Rec. 2918 (1933) (remarks of Rep. Rayburn).

[11] Speed v. Transamerica Corp., 99 F. Supp. 808, 829 (D. Del. 1951).

[12] SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969). See also Brudney, supra note 2, at 354.

[13] The always-disclose pattern is not without its antecedents in the cases and literature. The United States Court of Appeals for the Tenth Circuit has wandered toward this pattern by indicating that absent a "business judgment rule" defense, a silent corporation may be liable to ignorant traders. Financial Indus. Fund, Inc. v. McDonnell Douglas Corp., 474 F.2d

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date disclosure—brings on unacceptable inefficiencies. As we shall see, this assumption may be a false one, but it is impossible to assess the efficiency costs of each of the possible patterns of insider-trading regulation without first examining the premise that silence is golden and that, in negotiating contracts, the corporation should be allowed to withhold some of what it knows.

Part I of this essay temporarily suspends consideration of economic efficiency in order to examine more closely the implications of the fairness goal for securities regulation. The analysis compares the ability of each of the patterns already mentioned—disclose-or-abstain, free-market, and always-disclose—to promote the fairness ideal. It considers two other patterns as well: "disclose-or-suspend," which requires a corporation to disclose material information or suspend all trading in its securities; and "blind-trust," which requires insiders to turn over the management of their own investments to an outsider in order to guarantee that insiders have no informational or trading advantage.

Although the comparison of patterns in Part I illustrates that, in the context of insider trading, fairness is a complex and elusive goal, the always-disclose pattern clearly is best able to neutralize the trading advantages of insiders. We must discover, therefore, whether the arguments underlying the silence-is-golden rule are sufficient justification for rejecting the "fairest" pattern of securities regulation. Part II begins that exploration by returning to the basic reasons underlying the corporation's desire to remain silent in a contractual context. The discussion is temporarily divorced from securities law and stands as an analysis of the propriety of disclosure, silence, and misinformation in contract law. The analysis also explores alternatives to the silence-is-golden rule that might satisfy the business needs of corporations.

Finally, Part III applies the understanding of the roles of silence and disclosure in contract law to an assessment of fairness and efficiency in the various patterns of securities regulation. It concludes that there are sources of inefficiency and misallocation that

514 (10th Cir. 1973). For the most part, however, fairness arguments have been used primarily to defend the disclose-or-abstain pattern against the free-market pattern. It has been observed only in passing that the fairness arguments might be used to push regulation beyond the disclose-or-abstain model. See Scott, Insider Trading: Rule 10b-5, Disclosure and Corporate Privacy, 9 J. Legal Stud. 801, 806 (1980). This essay develops the characteristics and effects of such a legal rule more carefully and discusses its possibility more seriously.

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have been overlooked in previous debates among the supporters of various regulatory patterns. As the implications of the various regulatory patterns for both securities and contract law become better understood, lawmakers will realize the expanded set of regulatory options available and will be able to make more informed choices among these alternatives.

I. Insider Advantages and Regulatory Patterns of Securities Law

Assessing the fairness of the various patterns of securities regulation requires a definition of "fairness." The current literature on insider trading uses the term in a confusing variety of ways. Often it is regarded as a means toward the goal of efficiency—first, because the less opportunity for insider trading, the less investors will spend to police the activity,[14] and, second, because the more protective the security rules are of investors' interests, the less likely they are to shy away from the capital market.[15] More frequently, however, commentators treat fairness as a distinct goal of securities law.[16] Yet, these commentators have not struggled with a definition of fairness, but have settled for general descriptions, such as "equal access to information"[17] between insiders and out-

[14] See Brudney, supra note 2, at 335-36. It has been argued that if the harm from insider trading had a significant adverse effect on the securities market, both private investors and corporate managers would expend their own resources to police insider trading. See Dooley, Enforcement of Insider Trading Restrictions, 66 Va. L. Rev. 1, 37-44 (1980). Investors, however, may wish that there were more policing, but expect or desire someone else to provide it at no charge. For instance, the fact that few citizens hire their own bodyguards and detectives hardly proves that society has employed the optimal number of law enforcers. If neither private investors nor the government provides the needed policing, tbe resulting lack of trust in the securities market will be inefficient because disgruntled investors will take their funds elsewhere, and mucb-needed projects will go untackled. Thus, the fairness goal can be recast as an efficiency concern.

[15] Brudney describes this possibility as follows: "If the market is thought to be systematically populated with such transactors [insider-traders] some investors will refrain from dealing altogether, and others will incur costs to avoid dealing with such transactors . . . . None of these responses is socially useful. All raise the cost of capital." Brudney, supra note 2, at 356.

[16] See, e.g., id. at 336 ("[F]ew would disagree that the antifraud provisions tend to focus more on the role of protection than on the role of efficiency."); Schotland, Unsafe At Any Price: A Reply to Manne, *Insider Trading and the Stock Market*, 53 Va. L. Rev. 1425, 1438 (1967).

[17] See, e.g., Brudney, supra note 2, at 354-55. See also Insider Trading: Some Questions and Some Answers, 1 Sec. Reg. L.J. 328, 335 (1974) (reprinting Comment Letter from the

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siders. Furthermore, they have defended the disclose-or-abstain pattern without confronting the implications of a scheme that allows insiders to be privy to material information while outsiders continue to trade in ignorance.

This article defines fairness more ambitiously: fairness is achieved when insiders and outsiders are in equal positions.[18] That is, a system is fair if we would not expect one group to envy the position of the other. The ambitious scope of this definition frees us from the narrow methodology that many promoters of the fairness objective appear to have followed—defending the disclose-or-abstain pattern from the attacks of the free-market supporters—and allows us to consider a wide array of regulatory patterns. On the other hand, such an ambitious definition of fairness contributes to the elusiveness of that ideal and suggests that it will serve better as a basis for comparing the various regulatory patterns than it will as a required goal. This elusive aspect of fairness will become more apparent as the patterns are developed, and the generous treatment accorded one group of shareholders continues to be at the expense of another.

A definition of fairness that seeks to equalize the positions of insiders and outsiders is also attractive because it recognizes that although the fairness goal reaches beyond fiduciary concerns, it takes off from the traditional concept of fiduciary duty.[19] The fiduciary obligation reflects the "golden rule" of interpersonal behav-

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Subcomm. on Broker-Dealer Matters and the Subcomm. on Rule 10b-5 of the Comm. on Federal Regulation of Securities of the Section of Corporation Banking and Business Law of the American Bar Association (Oct. 15, 1973)).

[18] This definition of fairness ascribes to Congress an additional intent in enacting the antifraud provisions into securities law, separate and distinct from its efficiency concerns. Although congressional rhetoric and post-Depression timing seem to turn in part on efficiency principles, this article resists recasting all of Congress's goals as efficiency considerations. It assumes that those goals have independent validity as efforts to achieve fairness in the securities market. It should be noted, however, that to the extent that Congress arguably sought only to prevent overreaching by corporate insiders, the fairness goal as used in this essay, goes somewhat further in that it considers as equally unfair any outsider advantage over insiders.

[19] As various courts and commentators have noted, rules that prevent insiders from profiting at the expense of outsiders are not completely explained by, but draw heavily on, fiduciary principles. See, e.g., Brudney, supra note 2, at 326 n.22; Comment, A New Concept of Fraud On the Securities Exchange—A Comment on In re Cady Roberts & Co., 15 S.C.L. Rev. 557, 561-64 (1963); Note, Civil Liability Under Rule X-10b-5, 42 Va. L. Rev. 537, 546-54 (1956).

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ior—treating others as we would ourselves. Consequently, a regulatory system that seeks to ensure such a golden-rule result should be regarded as quintessentially fair.

A. Disclose-or-Abstain

The disclose-or-abstain system permits the insider to withhold material information as long as he abstains from trading. In such a system, the knowledgeable insider holds a substantial informational advantage over the corporation's other shareholders. The value of this informational advantage is most obvious in the now familiar example of a valuable ore discovery, much like the one at issue in *SEC v. Texas Gulf Sulphur Co.*,[20] where the insider gains information that indicates that his company stock is more valuable than the market supposes. The disclose-or-abstain rule will be of little comfort to the outsider who happens to sell shares of this company's stock during the period of abstention and silence. The outsider will envy the insider's knowledgeable position, thus destroying the fairness ideal.

It might be argued that abstention is not, *on average,* less friendly to an outsider than is disclosure. After all, it is just as likely that the outsider will purchase undervalued shares during the abstention period while the insider is forbidden from doing so. A more sophisticated version of this argument acknowledges that *someone* must be selling shares to this lucky outsider who purchases while the insider is dutifully abstaining, and reasons that abstention is as fair as disclosure because in both cases outsiders, as a group, break even. In the case of abstention, any harm to one outsider is offset by the benefit to the outsider on the other side of the transaction. The individual insider who refrains from trading is removed from the calculus, but insiders and outsiders, as a group, will be in equal positions, and the fairness goal will be met.

Although this "group" approach to the fairness standard has some appeal, fairness should encompass some concern for individuals. Moreover, the outsider group may be worse off than the insiders if we assume that individuals are generally risk averse.[21] The

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[20] 401 F.2d 833 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969).

[21] See, e.g., W. Klein, Business Organization & Finance 153 (1980).

insider who abstains does not risk the ups and downs of transactions in a misinformed market. Meanwhile, outsiders must trade in random fashion[22] because key information has been withheld, and the fact that they can prosper as easily as they can fail is, even on average, unpleasant for a group of risk averters.

The distinction between the fiduciary duty owed to existing shareholders and that owed to potential shareholders also points out the unfairness of abstention and the inadequacy of the group approach as a defense. The insider owes a fiduciary duty to existing—and not potential— shareholders at the moment he is deciding whether to disclose or to be silent. If the news that is withheld is good news, and some existing shareholders sell because they are unaware of the company's prospects, individual members of this "primary beneficiary group" are injured.[23] Although it is true that these members are benefited when the news that is withheld is bad—because the price of their stock remains high while the bad news is withheld—it is arguable that just as we should not average fairness among individuals, we also should not average fairness across events. Moreover, there is every reason to expect that silence is more often necessary to protect corporate pursuits when good news materializes than when bad news breaks.[24]

B. *Free-Market*

The injustices[25] that attend the free-market pattern, in which insiders may trade as they wish while withholding information for corporate purposes, are distinct from but comparable to those generated by the disclose-or-abstain scheme. Clearly, the free-market pattern misses the goal of fairness in the securities market by a

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[22] See H. Manne, supra note 6, at 93-103.

[23] Regardless of insider-trading rules, the insider owes a duty to the shareholders he represents not to benefit nonshareholders at the shareholders' expense. Thus, even given the fact that insider-trading rules expand the insider's duty to nonshareholder outsiders as well as to shareholders, see note 19 supra, it is at least instinctively appealing to urge that they have a stronger duty to the traditional beneficiaries of their fiduciary duty.

[24] When bad news breaks, there is often little left for the corporation to protect. For example, if the corporation discovers that there is no oil on the land they have just purchased and on which they have just set up oil rigs, there is little for the company to do but to sell the land and equipment. The bad news will have a minimal impact on the market prices of these assets.

[25] The term is meant as a refreshing alternative to "unfairness." No additional pejorative meaning is intended.

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wide margin. Here we need not analyze the circumstances for fiduciary responsibility to primary beneficiary groups, nor need we assume particular shareholder risk attitudes; it is quite clear that any sort of group approach yields the conclusion that these insiders are advantaged under the free-market pattern and have taken their profits from the ignorant parties with whom they have traded. As such, the pattern benefits insiders, disadvantages outsiders, and falls short of the fairness goal. The disclose-or-abstain rule has, in fact, developed as a remedial substitute for the free-market pattern.

On the other hand, as its proponents point out, the free-market rule is actually better for some individual outsiders than is insider abstention. If the withheld information is good news, for example, the knowledgeable insiders will buy and drive up the stock's price. Meanwhile, there may be some outsider who will sell stock during this period and, in fact, would sell at this time under any circumstances.[26] He will benefit from the increased price in the stock that results from insider trading. This outsider is clearly better off with insider trading than he would have been with insider abstention—although not as well off as he would have been if there had been full disclosure and the stock's price had more completely responded to the news before his sale.[27] This benefit to outsiders, however, does not qualify as "fair" in our quest to neutralize trading advantages because only some outsiders benefit from this accidental coincidence. Nevertheless, an accurate assessment of the free-market pattern should acknowledge that, although the pattern is unfair to outsiders as a group and harmful to most individual outsiders, like disclose-or-abstain, it may benefit other individual outsiders.[28]

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[26] It is, of course, very difficult to determine which shareholders would have sold even if the price had not risen. H. Manne, supra note 6, at 101-02.

[27] The theory of efficient capital markets assumes that because stock prices fully reflect all available information, investors cannot make a profit by competing for, and attempting to trade on, additional information. The theory does not apply, however, to insider trading on unavailable information. Studies have shown that insiders can indeed make a profit by trading on this undisclosed information. See Note, The Efficient Capital Market Hypothesis, Economic Theory and the Regulation of the Securities Industry, 29 Stan. L. Rev. 1031, 1050-54 (1977).

[28] Unlike the usual case, in which a benefit to one group occurs only at the expense of another, the benefit to those outsiders who happen to sell shares and receive a high price because of insider activity is not gained at any expense to the trading insiders.

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C. *Always-Disclose*

In contrast to the first two patterns of securities regulation, a scheme that requires insiders always to disclose appears flawlessly fair. Once information is publicly available, insiders and outsiders are in equal positions. Thus, the always-disclose pattern comes closer to the fairness goal than either disclose-or-abstain, which is at least unfair to some individuals and to the primary beneficiary group, or the free-market pattern, which clearly puts insiders in a position superior to outsiders.

The always-disclose pattern is arguably somewhat less than fair to insiders, who always must wait a few days after disclosing and before trading to ensure that the new information has spread evenly throughout the investing world.[29] Clearly, disclosure followed by immediate trading would do little for the outsiders who were beyond earshot and electrified news releases. Yet, the argument goes, those outsiders who first receive the disclosed information and can trade without waiting for complete dissemination will enjoy an advantage over the disclosing insider, and their trades will mar the fairness ideal.[30]

This insider disadvantage, however, is much less important than it first appears. If there is a real benefit to being "quick" to trade after some information is disclosed, one would expect professional money managers under the current disclose-or-abstain regime to be sensitive to new information and to effect quick trades at the expense of slower outsiders. Yet, there is no evidence that professional investors can outperform the investing community as a whole.[31] Apparently, quick actors compete away available profits in their effort to garner additional information.[32] Thus, according to

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[29] See SEC v. Texas Gulf Sulphur Co., 401 F.2d at 853-54. Under the disclose-or-abstain pattern, insiders may choose whether to abstain or disclose and endure the delay; the always-disclose rule denies insiders this choice.

The efficient capital markets theory argues that tbe dissemination of such information will occur very rapidly, and thus, the duration of the insider's wait will not be long. See Note, supra note 27, at 1044-50.

[30] Of course, this argument points to an unfairness that occurs, albeit less frequently, in the disclose-or-abstain and disclose-or-suspend patterns as well: whenever an insider discloses, he must bear some disadvantage until the information has disseminated.

[31] See J. Lorie & M. Hamilton, Tbe Stock Market: Theories and Evidence 70-97 (1973).

[32] Analysts will compete for information until the cost of the competition equals the value of tbe information obtained. See Grossman & Stiglitz, On tbe Impossibility of Informationally Efficient Markets, 70 Am. Econ. Rev. 393, 393 (1980); Stigler, The Economics of Infor-

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the efficient capital market theory, the market assimilates available information so rapidly that investors who are first able to act on new information do no better than their slower competitors.[33] In sum, insiders who must wait for their disclosures to circulate suffer no practical disadvantage.[34]

Arguably, there may be some insiders who are talented analysts and who, because of their skill, would be able to act quickly without competing away their profits if given an equal start with outsiders. In that case, the pattern would seem unfair to insiders because, although they may be no worse off than the average outsider, they are worse off than they would be if allowed to use their investment talents (and *not* their insider advantage). The

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mation, 69 J. Pol. Econ. 213, 213-18 (1961); Note, supra note 27, at 1054.

[33] See Note, supra note 27, at 1044-50.

[34] Of course, if the information is disclosed in a way that enables only a select few outsiders to act on it quickly and without much cost, those outsiders will profit from this informational advantage in a way that neither other outsiders nor insiders who are forced to wait can. But that situation would represent a return to a free-market pattern, in which insiders may disclose to certain select outsiders. This article assumes that under an always-disclose rule, information will not be selectively disclosed.

The reality of information leakage, however, raises one of the major objections to any efforts to police disclosure—either through disclose-or-abstain or always-disclose. Even if corporate officers are required to disclose material information, the argument goes, some securities analysts will find ways to get information before it becomes generally available to the investment community. It is impossible for the SEC to police every possible source of investment information. See id. at 1064; Scott, supra note 13, at 818. Moreover, usually before the point of materiality is reached, much of the information has already reached the market in bits and pieces, and those who work hardest at it will get the bits and pieces first. See Note, supra note 27, at 1074-75.

In light of the impossibility of achieving truly equal access to information, free-market proponents argue that rules against insider trading do outsiders no good and should be abandoned. See, e.g., H. Manne, supra note 6, at 159-69; Note, supra note 27, at 1075-76. Fairness proponents argue in response that because the insiders' obligation to shareholders stems from fiduciary and equitable as well as efficiency considerations, rules against insider trading are justified by the proposition that insiders should not be allowed to profit from their positions, regardless of whether these rules actually benfit outsiders. Both camps seem to assume that there is no legitimate way to equalize the trading positions of insiders and outsiders. As we shall demonstrate below, although this goal is exceedingly difficult to reach, it may not be as unattainable as believed. If an always-disclose rule (currently rejected as unacceptable because of legitimate corporate interests in secrecy) were coupled with some way to make disclosure less costly to the corporation, insiders would have less incentive to resist disclosure, information would not leak out in bits and pieces, and it would be made more equally available to insiders, outsiders, and competitive analysts. In sum, the present realities concerning leakages and informational advantages are products of the reigning legal patterns that govern disclosure and would not necessarily continue under the rules of disclosure discussed in this article.

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problem, of course, is that it is impossible to tell at what point the enforced delay unfairly prevents insiders from using their superior investment skill and at what point it merely prevents them from profiting from an insider advantage. Moreover, we might expect such talented analysts to gravitate toward careers as professional investors and away from careers as corporate insiders. Thus, though there is little empirical data to support the argument that insiders are practically disadvantaged, it might be more accurate to conclude that the always-disclose pattern is more nearly fair (but not flawlessly so) than any other regulatory scheme.

D. Disclose-or-Suspend

Disclose-or-suspend may be characterized as a version of always-disclose that does not require rejection of the silence-is-golden maxim. Under this scheme, if insiders decide that business reasons require nondisclosure, trading in the company's securities will be suspended until the need for corporate secrecy ends. Like always-disclose, disclose-or-suspend appears flawlessly fair because it puts both insiders and outsiders in equal positions; when one group is prevented from trading because silence is golden and a corporate secret is being protected, the other is also estopped.[35]

In addition to recognizing the value of corporate secrecy, disclose-or-suspend appears even fairer than always-disclose because it sometimes eliminates the time-lag disadvantage imposed on disclosing insiders.[36] On the other hand, suspension may create unfairness, not between insiders and outsiders, but according to the shareholders' needs for liquidity. If the market for a company's shares is to be shut down until material information can be released, some capital will be frozen in place and will not be at the disposal of its owners.[37] Some shareholders—probably the wealth-

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[35] Suspension is a novel and, as we shall see, potentially costly idea, and this article does not attempt to detail the mechanics of effecting such a concept. Because considerations relevant to the decision whether to disclose or suspend include questions of liquidity and informational needs in the local market—matters that call for a weighing of societal rather than corporate interests—the insider may not be the proper one to choose between disclosure and suspension. The reader may wish to imagine an impartial suspender—perhaps some SEC-related committee—to which an insider could turn in confidence and relate the events that have transpired and the extent of the corporate interest in silence.

[36] See note 29 supra.

[37] Although liquidity is a familiar concept, it does not normally appear in discussions of

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ier ones—will be better able to meet emergencies by resorting to other components of their portfolios than will their less wealthy counterparts.

This fairness calculus is somewhat modified by the fact that a shareholder can use his frozen shares as collateral to borrow money to meet emergencies. As such, any unfairness results from a need for cash, an inability to borrow up to the full value of the untradable stock, and the transaction cost of borrowing.[38] This differential between real value and collateral value is just a preview of the imperfections that result from an interference with the functioning of the capital market. The effects of suspension and illiquidity are more fully discussed in the analysis of market misallocations presented in Part III.[39]

E. Blind-Trust

By placing a barrier between insiders and their investments in the corporate enterprise, the fifth pattern of securities regulation would guarantee that insiders could not profit from their informational advantage.[40] Under this scheme, an autonomous trustee

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portfolio theory. Liquidity refers to the investor's ability to convert an asset into cash. Typically, there is no need to quantify liquidity because it is subsumed in the concept of risk or variability. A house, for example, is not so much less liquid than a widely traded bond as it is more difficult to convert into an amount of cash that corresponds to its longer-term fair-market value. As such, liquidity might be defined as the ability to effect an immediate sale of an asset at a price that is close or equal to the price that could be obtained at a leisurely pace. Suspension, on the other hand, actually creates a situation in which it is impossihle to effect an immediate sale at any price.

[38] The collateral value of suspended shares could be increased in some circumstances by modifying this pattern to permit "good-news suspensions," under which the insider or corporation would disclose that an increase in the company's value is expected, but that its details must be kept secret for some time. This modification, which raises questions about the obligation to announce bad-news suspensions, is not pursued in this essay.

[39] See notes 104-08 infra and accompanying text.

[40] The same result could be achieved by simply forbidding insiders from owning or controlling securities of their own companies. Not only would insider trading be prohibited, but the market would likely benefit from increased information, because insiders would have no selfish incentive to refuse disclosure.

This "forbidden-ownership" pattern presumably would be unattractive to many observers because having a personal stake in his company is thought to increase an employee's productivity. See, e.g., W. Klein, supra note 21, at 14-16. Even if that were not the case, a pattern that prevented insiders from trading at all would hardly achieve our fairness goal, because it would disadvantage only one group. The blind-trust pattern discussed in the text at least allows the insider to continue with a direct stake in the corporate enterprise.

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would trade the securities the insider owned in the company. This "blind-trust" pattern is the philosophical opposite of the free-market scheme in that it both takes away the insider's ability to trade as he pleases and removes his right to refrain from trading.

In order to give this pattern some substance, imagine a trust that instructs the trustee to toss a coin on one randomly chosen day each month. If the coin turns up "heads," he is to invest one thousand of the insider's dollars in the company's stock. If "tails" is tossed, the trustee is to sell a sufficient number of currently-owned shares of the insider's company stock to yield $750, which sum will then be used to purchase shares in a broadly diversified mutual fund for the insider's portfolio. The insider may not otherwise trade in his company's securities. The key characteristic of the blind-trust pattern is that the insider cannot control the timing of "his" purchases and sales. The specifics of such a blind-trust plan are not important and are quite flexible,[41] but this particular illustration is attractive because, on average, the insider's net investment in his company's stock is a positive $250 every other month. Thus, it approximates the investment behavior we would attribute to the average insider, and the nonexploitive insider continues to be rewarded in the long run when fellow shareholders do well.

Quite clearly, this blind-trust pattern is unfair to an insider because it takes away his opportunity to profit from his own analysis of the market and his company's place in current affairs. But such unfairness is similar to the unfairness of a scheme in which outsiders trade while insiders abstain and keep important information secret. The outsider is then stuck with his luck and unable to reason effectively. He may be fortunate and purchase shares while the insider is guarding the secret of new copper mines. On the other hand, he may have sold shares, or the secret may be one of bad news.

In both the blind-trust and the disclose-or-abstain patterns, in-

[41] For example, the plan could be funded by the corporation as part of a compensation package, or the individual insider could be required to contribute the necessary funds. In the latter case, if the trustees tossed "heads" more than 50% of the time and thus required more investment in the corporation than the insider had agreed to fund, the corporation would ensure the success of the plan by lending the funds necessary to make up the difference between tbe insider's desired investment in the company and the investment actually required by the coin toss.

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siders and outsiders, as a group, are in relatively equal positions because neither may gain a trading advantage from undisclosed information—outsiders (and trustees) because they do not have the information and insiders because they cannot trade on the information. Disclose-or-abstain, however, does not offer the outsider much comfort with its assurance that, as a group, he and the other outsiders are no worse off then the silent insider. Similarly, the insider who is subjected to a blind trust derives little comfort from the assurance that the purchases and sales that are made on his behalf are determined in a random fashion,[42] and that, on average, he and all the insiders are no worse off as a group than the outsiders are as a whole when the information at their disposal is materially incomplete. Thus, the blind-trust pattern again demonstrates that group analysis is not an adequate defense to individual unfairness in securities regulation.[43]

There are, of course, distinctions between the blind-trust and disclose-or-abstain patterns. The disadvantages of the disclose-or-abstain scheme are inflicted on outsiders only during those periods in which an insider withholds material information. At other times, insiders and outsiders alike are free to match their wits against other investors and to put the future in their own hands. The blind-trust concoction, on the other hand, imposes its uncontrolled and unreasoned decisionmaking on all insiders at all times.

In sum, the several patterns of regulation examined above meet the fairness standard with varying degrees of success. Although fair on its surface, the familiar disclose-or-abstain pattern disadvantages outsiders when analyzed in terms of risk attitudes,[44] individualized effects,[45] and relative fiduciary obligations.[46] The free-market and the blind-trust patterns hardly achieve the fairness goal because each relegates one group to ignorance or inactivity while the other group trades knowledgeably (insiders in the free-market

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[42] Random investments, rather than investments by a trustee using his business judgment, are chosen for this pattern to ensure that the insider cannot leak information to the trustee. In addition, the investment decisions of the average outsider are not likely to outperform those made in the random fashion outlined in the text. See generally Note, supra note 27, at 1035 (capital market is so efficient at assimilating information that an average trader cannot outguess it).

[43] See text following note 23 supra.

[44] See notes 21-22 supra and accompanying text.

[45] See notes 23-24 supra and accompanying text.

[46] See id.

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pattern) or freely (outsiders in the blind-trust scheme). The third pattern (always-disclose), in which informed insiders always disclose material information and ignore the corporate interest in secrecy, and the fourth (disclose-or-suspend), in which they may withhold information and suspend everyone's trading in the relevant securities, come closest to meeting the fairness standard. Under these patterns, both groups act with equal access to information, or they do not act at all.

If fairness were the only consideration, it would be relatively easy to choose among the patterns of securities regulation: corporations would be required always to disclose material information, and insiders and outsiders would have an equal chance to act on it. As noted above, however, the general assumption is that the corporation's interest in silence is too great to consider always-disclose as an acceptable option. Unfortunately, as Part III demonstrates, disclose-or-suspend is hardly better at protecting the corporation's interest in silence.[47] The adoption of disclose-or-abstain therefore might be defended as the fairest option that respects the silence-is-golden rule. But this defense requires a closer look at the need for silence and its role in contractual relationships.

II. Disclosure and Dishonesty in Contract Law

One need not introduce subtleties concerning economic efficiency to understand that fairness has its costs. Although the always-disclose rule equalizes the positions of insiders and outsiders, it is quite clear that there are some situations in which silence is indeed golden and a corporation as a whole is better off if a secret can be kept.[48] Once again, in the traditional illustration concerning a large ore discovery, the corporation will fare much better if the farmer whose land surrounds the discovery site bargains to sell his land to the mining company without knowing about the discovery. If securities law forces the insider to disclose this information, and

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[47] See notes 105-06 infra and accompanying text.

[48] The fairness standard might legitimately be defined to allow for situations in which one group will be better off than another—but both will be better off than before. Such a standard would draw on efficiency notions and could be called a "Pareto-optimality fairness standard." This article does not adopt such a definition of fairness. It is fair to add that corporation law is hesitant to adopt a Pareto-optimality fairness standard, unless the fiduciary is willing to share a significant amount of his gain with the common sbareholders. See Fliegler v. Lawrence, 361 A.2d 218 (Del. 1976).

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does not allow mere abstention or suspension, the farmer will demand a premium for his land, forcing the corporation to pay a higher price or perhaps to forgo exploration for minerals altogether.[49] This, in turn, will hurt both present and future shareholders and, in some instances, society as a whole.[50]

Despite the costs, it is reasonable to wonder why the law has not imposed a duty on the buyer to tell the seller-farmer about the great mineral wealth that is the real subject of their impending transaction. In similar contexts, the law has imposed on parties to a sale a duty to disclose material information. Such a transactional disclosure requirement (as opposed to disclosure that benefits investors in securities) would shed a vastly different light on the subject of disclosure under the securities laws because there would be no further reason to keep corporate secrets. Thus, the case against any of the regulatory patterns that allowed nondisclosure would be subtantial. Assuming there is a principled reason for allowing corporate nondisclosure, a second question might be whether there are alternatives to corporate silence that would protect the corporation's business needs without exacting the same fairness cost in the securities market as do patterns that allow nondisclosure.

A. *Optimal Disclosure*

Proper evaluation of a rule that allows corporate silence in a transaction with a seller-farmer requires an analysis of basic contract law, independent of any concern for securities regulation. The question here is whether a buyer and a seller in a face-to-face transaction should be required to disclose information material to the sale. Contract law traditionally has held that there is no requirement of disclosure absent special circumstances imposing a

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[49] An expectation of profit is one of the most compelling incentives to exploration and information gathering that society can offer; absent sucb an expectation, we can expect a decline in such socially beneficial activity.

[50] The efficiency cost of tbis pattern is not greatly reduced by turning from always-disclose to a rule that permits suspension in lieu of disclosure. Suspension is a drastic and costly step. Moreover, suspension is itself a form of disclosure; some farmers will know that the announced suspension may be related to their land and will bargain accordingly. See notes 105-06 infra and accompanying text. In sum, the disclosure pattern, whether in its basic (always-disclose) or modified (disclose-or-suspend) form, succeeds in equalization only at great corporate expense. In what must now be a familiar conclusion, meticulous fairness within a class is accomplished only at a cost to the class as a whole.

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duty to speak, such as a confidential or fiduciary relationship.[51] Modern cases, however, can be read as signaling a trend toward increased disclosure requirements.

In *Obde v. Schlemeyer*,[52] for instance, defendants sold a termite-infested house to the Obdes, who had failed to ask about the possibility of termites. The Schlemeyers knew that the house had a termite problem and knew that they had taken insufficient steps to rid the structure of the insects. The court rejected the sellers' claim that, absent direct questioning, they had no duty to volunteer the information about termites to the buyers.[53] Instead, the court held that "justice, equity, and fair dealing" demanded that they inform the prospective purchasers of the condition.[54] Cases following *Obde* have imposed a similar disclosure requirement where the information concerned a leaking irrigation ditch, a contaminated well, and so on.[55]

Assuming that *Obde* was correctly decided, the question remains whether disclosure of information about termites by a homeowner-seller is distinguishable from disclosure of mineral discoveries by a corporate buyer. Professor Kronman distinguishes the two on grounds of economic efficiency.[56] According to his theory, disclosure should not be compelled when the disclosure would discourage exploration for socially useful information.[57]

Professor Kronman illustrates his principle by distinguishing *Obde* from *Laidlaw v. Organ*.[58] In *Laidlaw*, the Court held that the defendant (or, more accurately, a friend of the defendant) was not required to disclose material information he possessed regarding

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[51] See Vokes v. Arthur Murray, Inc., 212 So. 2d 906 (Fla. Dist. Ct. App. 1968); Swinton v. Whitinsville Savings Bank, 311 Mass. 677, 42 N.E.2d 808 (1942); D. Rice, Consumer Transactions 105 (1975).

[52] 56 Wash. 2d 449, 353 P.2d 672 (1960).

[53] Id. at 451-52, 353 P.2d at 674.

[54] Id. at 453, 353 P.2d at 675.

[55] See, e.g., Bethlahmy v. Bechtel, 91 Idaho 55, 415 P.2d 698 (1966) (leaking irrigation ditch); Janinda v. Lanning, 87 Idaho 91, 390 P.2d 826 (1964) (contaminated well); Posner v. Davis, 76 Ill. App. 3d 638, 395 N.E.2d 133 (1979) (leakage problems); Huling v. Vaux, 18 Wash. App. 222, 566 P.2d 1271 (1977) (true property boundary was 20 feet east of hedge that looked like boundary).

[56] Kronman, Mistake, Disclosure, Information, and the Law of Contracts, 7 J. Legal Stud. 1, 9-18 (1978).

[57] Id. at 13-14.

[58] 15 U.S. (2 Wheat.) 178 (1817).

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the Treaty of Ghent and the eventual end of the War of 1812.[59] Inasmuch as the onset of peacetime would coincide with the resumption of trade, tobacco prices could be expected to rise. The defendant's profiteering therefore was accomplished by purchasing tobacco before any sellers knew of the imminent peace. As Professor Kronman points out, *Laidlaw* reaches a necessary result if we are to encourage the search for accurate information and benefit from the improved allocation of resources that results when actors in the marketplace are given the best available (price) signals.[60] In *Laidlaw,* for example, Organ's purchase of tobacco presumably raised the price of tobacco and thus indirectly signaled farmers to switch from the planting of other crops to the growing of tobacco.

Homeowners, on the other hand, need not be offered an incentive to inspect for termites. As soon as there is a fleeting rumor of a termite infestation in the neighborhood, every sensible owner calls in the experts and prepares to take corrective measures. Kronman might have added that if *Obde* had been decided for the defendants, future buyers would also inspect for termites at their own expense. Thus, not only is nothing gained, but much is wasted by a rule that permits nondisclosure. Buyers will duplicate inspection expenses and, when the seller does not disclose the results of the first inspection, termites will continue to damage the structure until the ignorant buyer uncovers the defect. To be sure, the inefficiency may be less dramatic; buyers may instead learn to ask sellers about termites, or resourceful entrepreneurs, such as real estate agents or lawyers, may hire themselves out to potential buyers and advise them to ask such questions. Nevertheless, the end result is a net loss to society if the ignorant Obdes allow the termites to continue their work, or if the Obdes must pay for another inspection of the structure.

This efficiency-based distinction is most compelling in the case of the ore discovery. Unlike the owner of an infested house, the farmer is not likely to drill in his fields for minerals. There will be a net societal loss if we do not encourage exploration, and there is no reason to think that the farmer will be inclined to explore unless he is privy to the buyer's information. The buyer, of course, will not explore if he must disclose the fruits of his efforts.

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[59] Id. at 193.

[60] See Kronman, supra note 56, at 11-12.

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An understanding that disclosure rules should be based both on the need to encourage the production of information in some cases and on the societal loss that would result from withholding information in others,[61] helps explain why in some situations nondisclosure is acceptable. For example, the *Obde* rule need not be followed (and, indeed, no cases suggest that it would) when information regarding noisy late-night neighbors, tire-slashing vandals, or cruel and illiterate local schoolteachers has been withheld by the seller of a home. In such situations, there is little concern that requiring disclosure would discourage exploration for socially useful information. Unless the Obdes or the Schlemeyers are the sort who will stay awake night after night, hiding behind the curtains, and waiting to pounce on the tire-slashing vandals as they appear, the effect of nondisclosure is only one of wealth distribution; the tires will continue to be slashed at the same rate regardless of whether the Schlemeyers or Obdes live in the neighborhood. Similarly, unless the Obdes are school-board veterans, have a particularly sensitive school-age child, or detest noisy neighbors *more* than the average person, there is no net societal gain to be had by forcing a transfer of the information from seller to buyer.[62] Pre-

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[61] The fact that the ongoing work of undisclosed termites would harm all concerned argues for disclosure. See text following note 60 supra.

The societal loss that results from the extra inspection that might be required is less important because latent defects are often discoverable after living in a home for a time, with no extra inspection. The discussion here searches for a rule that applies to many cases and does not depend on the buyer's cost of information gathering, which would be the subject of detailed litigation and would tempt dishonesty.

[62] The logic underlying this position predicts judicial decisions to the extent that when there is only a redistribution of wealth among the adversaries at stake, courts might be expected (or encouraged) to accept the bargained-for result. Courts are generally ill suited to direct wealth redistribution.

Courts have not yet articulated such a distinction, however, and one might distinguish cases like *Obde* and *Laidlaw* by arguing that information about termite infestation is just more material than information about neighborhood vandals, who will eventually either be arrested or mature. That explanation, however, would not explain why a buyer need not inform a seller-farmer about the mineral deposit that may lie beneath his land. Such information is at least as material to the average seller as information about termite infestation is to the average buyer. The above explanation therefore would insist on disclosure of all material information, and would make all but the always-disclose pattern unacceptable means of regulating insider trading. The integral role that efficiency considerations play in determining disclosure rules is attested to by the absence of a serious proposal requiring disclosure of the mineral deposit.

It seems, therefore, that courts implicitly may have adopted the suggested distinction between cases in which nondisclosure will impose a social cost and those in which it will effect

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sumably, if the Obdes do have a particular penchant for quiet evenings, they *will* ask about local noise, and an untruthful answer will constitute fraud on the part of the seller. The effect of nondisclosure is not the same in the case of termites. The undisclosed termites will continue their destruction until the Obdes discover the problem and call an exterminator. Thus, nondisclosure results in a net societal loss equal to the added damage to the house minus the cost of bringing in the exterminator earlier rather than later.[63]

B. *Optimal Dishonesty*

The silence-is-golden rule has thus far survived our scrutiny. Society's interest in encouraging the search for socially useful information, such as the location of a valuable mineral deposit, would appear sufficiently great to justify nondisclosure of that information. Moreover, it may seem only fair that the seller-farmer not be allowed to reap the benefit of a discovery for which the corporate purchaser bore the full risk. Silence, however, will protect the buyer only until the seller learns to ask questions that require the buyer either to reveal the information in question or to be affirmatively dishonest. Protection of the corporate purchaser in that case may bring us into conflict with the law against fraud.

The court in *Obde* and the Kronman analysis of *Laidlaw* seem to take for granted the proposition that if one party actually lied in response to the other's question, that fraudulent act would overwhelm other considerations, and the misinformed party would prevail. There are economic as well as moral reasons for such a result. For example, the buyer who idiosyncratically requires quiet evenings and learns that the law will permit the seller to be dishonest will no longer satisfy himself by asking the seller about the neighbors' behavior, but will hire his own inspector to visit the site of the seller's home on a few randomly chosen evenings in order to ascertain the true character of neighborhood noise. There then will

only a wealth redistribution. For instance, in all of the cases cited at note 55, supra, failure to warn the buyer would result in the defect worsening without the buyer's attention or in the needless expenditure of money by the buyer, or both.

[63] This conclusion assumes, of course, that it would have been rational for the Schlemeyers to call in the exterminator but for the fact that they thought they could pass on the loss to the ignorant Obdes.

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be a societal loss to the extent that the buyer incurs substantial investigation costs for information that the seller already possesses.[64]

The law's strong distaste for misstatements coupled, however, with its general willingness to tolerate silence in cases that do not fit the *Obde* mold leave a number of tangential questions unanswered. A buyer who is not idiosyncratic, but still would prefer the purchase price of his new home to reflect the existence of roving vandals, noisy neighbors, and sadistic local schoolteachers, might cleverly ask the seller a general question in order to gain protection from the law's abhorrence of affirmative dishonesty. If it is silence that protects the seller (except in the termite case), the buyer might ask, "Is there anything I should know about this house or neighborhood that would annoy the typical buyer?" Whether or not such a general question can successfully shift the costs of the numerous possible drawbacks that go along with a property is not of much concern. After all, we have already seen that there is only a wealth effect at stake; presumably, if a general question can shift these burdens and call forth future damages, this shift will be reflected in the sale price.

On the other hand, if the information concerned an ore discovery, the resolution of the problem might be more difficult. We have already discussed the hypothetical ore discovery in terms of the incentives that are necessary for exploration and innovation.[65] Our conceptual framework allowed for nondisclosure on the part of the buyer (thereby preserving the possibility of adopting any of the patterns regulating securities trading that allow an insider to choose between disclosure and nondisclosure) in order to maintain a socially beneficial incentive structure. In essence, the seller-farmer could not capitalize on the buyer's silence and thereby upset society's development by free riding on the buyer's search and drilling costs.

Like the home buyer, however, the seller-farmer might learn to shift the burden of disclosure to the corporate purchaser. After one

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[64] This discussion assumes some frictional costs associated with resales of the property. Otherwise, even buyers who cared about noise would not investigate, but merely would resell the house after the first sleepless night. Eventually, some purchaser would not really care and the chain of sales would come to an end.

[65] See note 49 supra; text following note 60 supra.

well-publicized case in which a seller unknowingly sold vast mineral rights to a buyer who was better informed, we might expect future sellers always to ask, "Do you have any information about properties or developments in this area of the world such that if I shared your knowledge, I would be likely to raise my sale price by ten percent or more?" Society's interest in preserving the incentives for exploration might be protected in this case by allowing the corporation to give a dishonest answer to the seller's general question.

The same conclusion holds if the buyer's dishonesty is in response to a more specific question, as long as the seller would not, without the corporation's information, bear the risk of exploration on his own. Although under existing law such affirmative misrepresentation likely would be called fraud, there are both fairness and efficiency reasons in this situation for allowing a dishonest answer to the specific question. The value of a mineral or oil discovery is so great that in some regions sellers could easily (and costlessly) modify their questions so as to convince courts that there had been affirmative misrepresentation. Thus, a seller of a tract of land ought to ask, "Do you have any information about natural resources such as gas, oil, and minerals, proposed legislation, nearby construction, or the like, such that if I shared your knowledge, I would be likely to increase my sale price by ten percent or more?" If the buyer must be honest, the seller will share in the buyer's discovery, and future exploration will be discouraged. In fact, by asking a specific question, the seller-farmer is putting himself in a position superior to that of the explorer. Before the sale, the buyer-explorer has only a strong suspicion that there is mineral wealth under the ground, and the seller-farmer may withhold his objection to the dishonesty until *after* the buyer's venture is completed. Thus, when the explorer is successful, the seller-farmer will assert his claim of fraud and benefit from the explorer's discovery without sharing his exploration risks or costs. When the explorer's suspicion proves wrong, the seller-farmer will remain silent and enjoy the sale proceeds while the buyer-explorer swallows his exploration costs.

If, however, the law allows the buyer-explorer dishonestly to answer "no" to the seller's general or specific inquiries, the seller will be unable to free ride on the buyer's exploration efforts, nor will he be tempted anymore to duplicate the buyer's efforts by hiring ge-

ologists or investigators than he was tempted to poke for these needles in his haystacks throughout the period in which he farmed the land. Unlike the case of the idiosyncratic buyer who desperately needs his quiet evenings, and unlike the case of the typical homeowner who has a keen interest in inspecting for termites, neither nondisclosure nor dishonesty will result in a duplication of efforts because the expected return from a clueless and unguided search is insufficient to prompt a hunt.[66] Yet, both nondisclosure and dishonesty will prevent free riding and encourage the socially-beneficial quest for information. One might argue, however, that the buyer-explorer can circumvent a legal rule that disallows affirmative dishonesty by employing an agent to purchase the land and by not disclosing the ore discovery to his agent. According to this plan, the agent will be able to answer the seller-farmer's questions honestly. This solution, however, creates unnecessary transactions costs and does not protect the buyer from the seller-farmer who learns to ask a second specific question such as, "On whose behalf are you purchasing this land?" An honest answer will, at the very least, give the seller-farmer an undeserved clue regarding the nature of any missing information.

The unfairness and inefficiencies of the buyer-explorer's dilemma suggest that the law ought to allow dishonest disclosure in cases in which the misinformation would only cause the misinformed party to behave as he would have without the information, and in which it would be unfair—because of the cost and risk of extortion—to require disclosure of the informed party.[67] In these situations, we might label the corporation's response "optimal dishonesty."

[66] The seller-farmer will be in about the same situation that he was in before the offer to purchase was made.

[67] Note that the "optimal-dishonesty" rule, suggested in the text, is meant to encourage one exploration without a duplication of effort. If, for example, *X* has drilled in the area and strongly suspects that there is valuable ore beneath the land of *A*, *B*, and *C*, *X* may answer their exploitive questions with dishonest answers. In a typical case, *Y* might follow the real estate market in the area or might spy on *X* and suspect that *X* suspects the existence of valuable minerals. Should *Y* be permitted to purchase land from *A*, *B*, and *C* with dishonest statements? It might be argued that *Y* ought to be allowed such behavior because *Y's* actions (and later resale to *X* or *X's* competitors) hasten the arrival of new information to the marketplace. But this argument overlooks the fact that the real purpose of the optimal-dishonesty rule is to preserve sufficient incentives for *X's* continued exploration. The optimal-dishonesty rule should not be extended to *Y's* transactions.

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An optimal-dishonesty rule, however, is not free from imperfections. Our legal system demands that courts police fraud, and, as with any policing activity, there will be times that courts err in that task. Such errors generate inefficiency to the extent that they deter parties from contracting with each other because they fear that courts will stumble into errors when dealing with them and their bargain. In a legal system that permits optimal dishonesty, the opportunity for such errors and costs is multiplied. The courts not only must police fraud, but also must identify those cases in which the corporation has already incurred costs to obtain the information and in which the lied-to party would not normally undertake such information-generating activity on its own. To the extent that judicial inquiry here is costly and imperfectly carried out, the optimal-dishonesty rule will increase the inefficiencies of transacting.[68] These added inefficiencies, however, appear to be more than offset by the increased efficiency derived from preservation of the exploration incentives achieved by the optimal-dishonesty rule.

The forgoing analysis suggests that transactional dishonesty, in certain circumstances, will serve society well. Urging a corporation to be dishonest in its business transactions is, admittedly, a somewhat shocking concept. It is, however, not as foreign a concept as may first appear. In principle, it is not unlike the familiar concept of eminent domain.

When parties can negotiate with each other in advance, the law generally appreciates that bargaining is an efficient process for allocating resources among their alternate uses.[69] Even when the government needs a resource, it generally must go to the marketplace. If, however, the government has completed 3000 miles of an interstate highway that will extend over 3001 miles, the owner on whose land the remaining link must lie has enormous monopoly or "holdout" power deriving from the expense that would be entailed in building the entire highway (or a substantial portion thereof)

[68] It is easy to imagine, however, a number of preventive steps that optimally dishonest parties would learn to take under the proposed rule. These steps would improve the quality of evidence before the courts and decrease the inefficient byproduct of judicial error. For example, a buyer who has been dishonest in order to protect a recent discovery immediately can mail a sealed statement to an officer of the court. If litigation later develops, the "liar" will at least he able to show that his optimal-dishonesty defense was not conceived ex post when the surrounding circumstances became publicly known.

[69] See R. Posner, Economic Analysis of Law 39-41 (2d ed. 1977).

elsewhere.[70] In that case, the government is not forced to negotiate with the owner, but may take the property through an action of eminent domain and award the owner "just compensation."[71]

The "just compensation" that is awarded in return for the government's seizure specifically ignores the increase in the value of the seized property that results from the government's project.[72] Thus, if the project is the construction of a new highway through remote farmland, compensation will not reflect the fact that land in the area has risen in value because of its new accessibility to markets, but rather will reflect the value of area farmland before the new highway was proposed.

The optimal-dishonesty rule resembles eminent domain in several important respects. Both abrogate principles that are basic to our notions of fair dealing. Optimal dishonesty, as its discordant name implies, seems to contradict the moral principles that ought to be associated with the law. Eminent domain is similarly upsetting in its violation of property rights and individual freedom. Both concepts, however, are more palatable when viewed in their corrective roles. The owner of the 3001st tract of land who demands a high price for his property is really the despicable character. Similarly, the seller who, to preserve a fraud claim, asks specific questions about activities he would otherwise never engage in is really the contemptible party. Like eminent domain, optimal dishonesty operates to deny a windfall to a passive party when to do otherwise might lead to a net societal loss. A final assessment of the value of the rule should not be made, however, until other alternatives are considered and the cost of distinguishing fraud from optimal dishonesty is explored.

C. *Private Eminent Domain*

One possible alternative to optimal dishonesty would be a private version of eminent domain, which would empower the ex-

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[70] Even if the government has not yet begun to build the highway, the cost of negotiating in advance with thousands of sellers on enough alternate routes so as to diminish a seller's willingness to gamble and insist on a substantial premium is so great as to lead society to prefer forced takings. It is difficult, of course, for the government to be secretive. See note 74 infra.

[71] See United States v. Virginia Elec. & Power Co., 365 U.S. 624 (1960).

[72] See United States v. Cors, 337 U.S. 325 (1949) (owner of a tug requisitioned by the Navy could not recover the part of the tug's value attributable to the wartime situation).

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plorer to take private property and pay just compensation.[73] A significant benefit of this alternative is that it does not rely on the assumption that silence is golden. Thus, it may offer a means of protecting a corporation from a seller's positional monopoly without exacting the same fairness costs in the securities market as do regulatory patterns that protect corporate silence.[74]

Like optimal dishonesty, however, private eminent domain is not without inequities and inefficiencies. First, there are obvious court costs involved. Parties do not always settle their differences out of court and cannot be counted on always to agree on just compensation. Second, there is a more subtle cost of eminent domain—public or private—not associated with the optimal-dishonesty scheme. The seller-farmer may genuinely like his neighbors and his view. He may have a distaste for moving that is far stronger than "average." Yet, it is unlikely that his honest valuation will carry the day in a condemnation proceeding. The court will look to prediscovery market values and, we hope, include moving and relocation costs. But the marginal buyers who determine

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[73] The discussion in the text begs a variety of constitutional questions. Private eminent domain could be developed by legislative action authorizing certain companies, such as mining ventures, to bring condemnation actions. Historically, this power has been given to public service corporations, such as railroads, that commonly face obvious positional monopolists. Minnesota Canal & Power Co. v. Pratt, 101 Minn. 197, 112 N.W. 395 (1907). In more recent times, non-profit institutions have also enjoyed this power of private condemnation. See Bassett, Private Hospitals and the Public Right: Needed Standards of Consent for the Statutory Delegation of the Power of Eminent Domain, 11 U. San Francisco L. Rev. 53, 98-115 (1976) (discussing the legal issues associated with the use of eminent domain by non-public hospitals in California). Moreover, a number of states have endorsed private eminent domain, authorizing private companies to condemn property for reclamation, lumbering, mining, and redevelopment projects. See D. Hagman, Urban Planning and Land Development Control Law 314 (1975).

Alternatively, a state can avoid many of the constitutional questions concerning private condemnation by taking the land itself and then turning it over or selling it to another party. Barring "palpable bad faith," this resale procedure achieves the goal of private eminent domain and is legally permissible so long as the legislature determines that there is an ultimate public purpose at stake. See Redevelopment Auth. v. Owners or Parties in Interest, 1 Pa. Commw. Ct. 378, 274 A.2d 244 (1971). It ought to be noted, however, that in some cases, state constitutions may limit the condemnation procedure to land taken for a public *use*—and an ultimate public *purpose* may be an insufficient objective. J. Cribbet, Principles of the Law of Property 426-29 (2d ed. 1975).

[74] See notes 20-28 supra and accompanying text. Note that it is extremely difficult for the government to be secretive in its transactions inasmuch as it must vote funds for projects and involve many persons in its decisions. Thus, it is easy to understand the historical development of public eminent domain.

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market prices may not appreciate the value of playing checkers or sharing a picnic with one's neighbors. The optimal-dishonesty rule, on the other hand, merely removes the information about the ore discovery from the bargain, and does not interfere with the way in which personal preferences, such as neighborly camaraderie, affect the purchase price of the property.

A final decision about the relative merits and limitations of both optimal dishonesty and private eminent domain must await further empirical study. At this point, all that can be said is that use of one or the other (or both) is necessary, unless we are willing to allow windfalls to these passive parties and are willing to allow them to interfere with the exploration incentives crucial to our economic system. Armed with a better understanding of why corporate silence has been allowed and of alternatives to that silence, we now should be able to assess the efficiency cost of any given pattern of securities regulation and achieve an understanding of the potential tradeoffs among the law's various goals.

III. A Catalogue and Comparison of Injustices and Inefficiencies

A. *Disclose-or-Abstain*

Under the disclose-or-abstain pattern, the insider may choose between disclosing material information or abstaining from trading. When an insider, or management as a whole, learns of a new development and selects the everyday route of complete disclosure, the implications are relatively uncomplicated. No information is withheld from the marketplace and therefore, to the extent that an informed, competitive, market system can allocate resources, there are no efficiency concerns. In the simplest of cases, we can assume that management has decided that disclosure will not put the corporation at the mercy of a passive party or positional monopolist. For example, the development may be a discovery by the company's scientists that copper has desirable qualities in airplane engines. The company intends to profit from the increased value of its already-owned copper and not from going into any new business (aviation for example), nor from the purchase of additional copper. Disclosure therefore would not jeopardize a corporate opportunity. Neither is there any injustice present with respect to the relative fortunes of insiders and outsiders in the securities market. The in-

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formation has been revealed, and outsiders are as well informed as insiders.

On the other hand, the insider may choose nondisclosure and abstention. Whether or not this pattern of securities regulation is combined with any one of the schemes regulating contractual relations—eminent domain, optimal dishonesty, or common-law fraud—it may generate a number of inefficiencies and injustices.

The inefficiencies produced by the abstention option result from nondisclosure of available information. The misallocation that results from this lack of information in the securities market has already received a great deal of attention. Professor Manne, for example, has advocated the free-market pattern in securities law in order to be sure that *someone* will trade, communicate information, and properly direct the price of securities.[75] If the mining

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[75] See H. Manne, supra note 6; Manne, supra note 6. Professor Manne's arguments can be divided into "offensive" and "defensive" classes. The offensive arguments point to the benefits that insider trading can offer the corporation and society at large. The first major offensive argument is the notion that profits from insider trading are a potent incentive for desirable entrepreneurial behavior in large corporations. H. Manne, supra note 6, at 138-41. Salaries and bonuses are thought to be ineffective stimulants of managerial efforts because they are not well calibrated to actual performance and must be negotiated ex post or, worse, set in advance to depend on the overall corporate performance rather tban the individual's contribution. Id. at 134-36. On the other hand, to the extent that individual insiders trade only on their own discoveries, the argument goes, the increased stock prices that materialize will correspond to the value of the individual's contribution. Id. at 138-41. Curiously, Manne is not troubled by the fact that insiders may just sit back and trade on the ideas of fellow insiders, nor by the fact that an insider can profit from bad news—a fact that poses a substantial moral hazard.

The other major offensive argument considers the role of the stock market as an allocator of capital and the effect that insider trading has on the market price of the particular corporation's stock. The insider's transactions, so the argument goes, will nudge the market price in the "correct" direction. Thus, the market price will move earlier than it would have in the absence of insider trading, and will not wait for a formal disclosure of corporate news. Id. at 99, 105.

Manne's defensive arguments identify those actually injured by insider trading and evaluate their injury. Because, the argument goes, long-term investors do not alter their holdings of shares just before, during, or after the insider's trade, they do not appear to be injured. Moreover, a long-term investor who sells during a period of insider trading is actually better off than he would have been had the insider abstained and kept silent; the insider's purchases drive up the stock's price so that an investor who decides to sell on a given day receives more for his stock because of insider trading than he would from insider abstention. Id. at 114-16. Again, Manne is not concerned about the opposite result that occurs when an insider trades on bad news; the insider's sales drive down the price of stock, injuring the selling investor. Similarly, the possibility of requiring insiders to trade for the corporation's account, rather than their own, is not pursued. Such trades would benefit all shareholders and push market prices "correctly." For evidence that inside information can yield a supra-

company's stock price does not reflect the ore discovery, those activities that react to stock price signals will be inefficiently managed. This sort of inefficiency is illustrated by the individual who would begin acting school tomorrow but for the fact that his inheritance of one hundred shares of the mining company's stock is insufficient to support his tastes for material goods. Instead, he begins college (on borrowed money) and resigns himself to a better-paying, but less enjoyable, future in the workplace. In three months, the insider is prepared to disclose the information, and the student's shares double in value. He now quits college and waits for the next year, when acting school will once again accept beginners. Meanwhile, he has wasted his time, his teachers' time, and the opportunity for another student to occupy the space in college.

Apart from the waste caused by misinformation in the securities

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normal investment return, see Finnerty, Insiders and Market Efficiency, 31 J. Fin. 1141 (1976); Jaffe, Special Information and Insider Trading, 47 J. Bus. 410 (1974); Lorie & Niederhoffer, Predictive and Statistical Properties of Insider Trading, 11 J.L. & Econ. 35 (1968).

A second focal point of the defensive arguments in favor of the free-market pattern is the cost of any alternative legal pattern. The disclose-or-abstain pattern, for example, requires some policing of and litigating over the content and timing of disclosures and of insider trades. Professor Kennetb Scott has noted that, although the current legal pattern might be evolving in the direction of universal disclosure, such a rule would generate substantial enforcement and administrative difficulties. See Scott, supra note 13, at 812. Although a harsh set of penalties might encourage the doubtful to disclose rather than to trade and be silent, information-producing incentives may thereby be destroyed. This argument draws on the premise that silence is golden; it is based on the notion that if information must be shared, it often will not be generated.

A final focal point of the defensive arguments has been a somewhat narrow and unsatisfying version of modern capital market tbeory. Outsiders are not injured by profitable insider trading, the argument runs, because they know about the possibility of insider trading in advance and therefore require a greater return on their funds than they would if the market were secure from this possibility. See id. at 808. Professor Scott draws on a gambling analogy and argues that "if I know you are using percentage dice, I won't play without an appropriate adjustment of the odds; the game is, after all, voluntary." Id. Unfortunately, the game may not be truly voluntary because many investors have no domestic investment alternative; to include some corporate risk in their portfolios, they must buy shares of corporations that are governed by the one reigning legal pattern. Moreover, tbe argument ignores the social cost tbat results from the disinclination to invest, however voluntary such distancing from insider trading may be. Would Scott's argnment also apply to embezzlement? If legal rules permitted such theft by insiders, some noninsiders, aware of the possibility of embezzlement, might insist on higher returns. Other investors, however, would stay away, just as some storekeepers would close down rather tban raise prices in response to a legal regime that did not prosecute shoplifters.

market, inefficiency is also caused by a lack of information in what can be called the "real" or "local" market. Appealing once again to a mundane example, imagine a marginal gasoline station that is located near the ore discovery site. Its owner has flirted with bankruptcy once too often and now decides to close down and move some of the old equipment and his family to a more promising location some thousand miles away. When the insider belatedly discloses, the gas-station owner will hear the good news and realize that the mining business will support a larger local population, which, in turn, will support a profitable gas station. Accordingly, the gas-station owner may return to his original location, but he will have wasted substantial relocation expenses. Had the local market been informed of the ore discovery, this waste could have been avoided. In sum, the absence of information affects both the securities market and the local market.

We see, then, that the disclose-or-abstain pattern causes misallocations because of the poor information that pervades both the securities market and the local market. In addition, as described in Part I, this scheme generates injustices to individual outsiders and especially to the group of outsiders to whom the corporation owes the primary fiduciary duty.[76] Finally, although the insider is allowed to abstain to protect the corporation from the power of positional monopolies, the pattern will not always achieve that result. Abstention in the securities market may be undercut by forced disclosure in the local market. Some seller-farmers, of course, will be unsuspicious, badly advised, or magnificently concerned about the long-term goals of society and will not ask specific or even general questions about the buyer's employer, motives, or knowledge. Others, however, will seek to exploit the learning of traditional contract law and, at virtually no cost to themselves, will ask the general or specific questions described above.[77] These questions will force a sharing of the discovery value of the information, a disincentive to future explorers, and a net societal loss. This inefficient process may be eliminated by coupling disclose-or-abstain with a legal system that permits either optimal dishonesty or private eminent domain. As demonstrated above, however, each of

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[76] See text accompanying note 23 supra.

[77] See text accompanying notes 64-67 supra.

these possibilities produces its own inefficiencies.[78]

It is yet unknown whether the costs of private eminent domain—judicial time and expense, and insensitivity to the idiosyncratic factors that affect value—will be less than those associated with distinguishing optimal dishonesty from fraud. The pervasive character of private eminent domain, however, suggests that it may be the more costly of the two schemes. If abstention can be expected generally to stave off forcing questions by seller-farmers, optimal dishonesty could be used to remedy those situations where it did not. On the other hand, if private eminent domain is at all available, it must always be used: it would hardly be sensible to have the parties try their hands at bargaining and then to permit one to call for condemnation. Thus, in return for occasionally preserving an explorer's incentive, private eminent domain would inflict its inefficiencies and inequities on society in a number of instances where it is uncalled for. On the other hand, optimal dishonesty, with its attendant inefficiencies, would be used only in those cases in which the passive party seeks to benefit from exploration he neither has supported nor would have conducted himself.

Although in the absence of relentless exploitive questions, optimal dishonesty seems the better of the two schemes, it would not remedy all of the ills of disclose-or-abstain. First, it would not address the misinformation and resulting misallocations in the two distinct markets—securities and local—that are affected by the disclose-or-abstain pattern.[79] Second, it would not equalize the positions of insiders and outsiders.[80]

B. Free-Market

The inefficiencies and injustices that attend the free-market pattern are easily compared to those generated by disclose-or-abstain. It was shown above that the free-market pattern is a poor performer in terms of its ability to meet the fairness goal of equalizing the positions of insiders and outsiders:[81] it allows insiders to profit at the expense of the ignorant parties with whom they trade and from whom they have withheld information.

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[78] See text accompanying notes 68-74 supra.

[79] See note 75 supra and accompanying text.

[80] See notes 20-24 supra and accompanying text.

[81] See notes 25-28 supra and accompanying text.

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On the other hand, the free-market pattern is superior to disclose-or-abstain in disseminating information to the securities market: trading by well-informed insiders will push security prices in the correct direction.[82] That many traders might be able to effect these price changes more quickly than a few[83] does not alter the result that this is a substantial advantage of the free-market pattern over the disclose-or-abstain rule.

It has also been argued that the free-market pattern increases efficiency by offering additional compensation to insiders as incentives for hard work and profitmaking.[84] This argument, however, fails to acknowledge that an insider can profit from a decrease in the firm's stock price as well as an increase; the temptation of profit might actually encourage an insider to act against the corporation's interest. Thus, there is nothing to ensure that this hard work will be in the desired direction.[85] More realistically, the temptation of profit might encourage subtle acts against the corporation's interest. Not only might the insider delay disclosure longer than necessary, but also he might structure corporate transactions in a way that increases the number of occasions of secret-keeping. Overinvestment might develop in certain industries (or in exploration itself) and underinvestment in others, as insiders guide their firms into enterprises that generate "events" that might be capitalized upon by traders in the stock market who have early access to the relevant information.

In essence, a free-market pattern gives the insider a fringe benefit that is as untidy and senseless as an unlimited personal travel allowance. Its value is not related to the insider's responsibilities or to the firm's performance. It takes the place of other rewards that would be more likely to yield behavior that benefits the company

[82] See note 75 supra.

[83] Professor Manne might dispute this statement. He would analyze the relative speeds of price adjustment by considering the quality and mix of various signals in the marketplace. H. Manne, supra note 6, at 77-91. Trading by a few insiders who know what they are doing, he argues, may effect price adjustments as quickly as trading by many. This useful but tangential way of looking at the marketplace is not pursued in this discussion.

[84] Id. at 131-45.

[85] Professor Manne notes that if insiders perform poorly in order to create bad news, they will soon be unemployed. Id. at 155. Although this is probably true, it does not adequately address the fact that the incentive provided by insider access to information is not a sure incentive to good work. Moreover, it may be some time before a bad-news generator is discovered, and insiders may profit in the meantime.

as a whole.[86] It leaves the shareholders uncertain, at least ex ante, about the true cost of managerial services and therefore makes it difficult for them to choose the most cost-effective method of running their firm. In sum, it is unlikely that the free-market pattern can be defended as the best available stimulant for productive managerial effort.

In addition, the withholding of information under the free-market pattern gives rise to the same inefficiencies in the local market as does abstention.[87] No matter how well the stock prices adjust with insider trading, local markets will continue to operate without material information until disclosure is complete. Using the two examples described above,[88] insider trading will signal the aspiring actor that he can afford to attend acting school, but the gas-station owner will remain uninformed of the potential profitability of his current locale and will complete his wasteful move to a distant location.[89] Here, the free-market pattern suffers somewhat in comparison with disclose-or-abstain because insiders have an incentive to withhold information longer than is necessary for the corporation's protection in local markets in order to profit from insider

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[86] If managers require more profit-oriented compensation, a better approach would be to tie the reward directly to the firm's profit. If it is considered necessary for the reward to be tied to the stock price itself, some sort of phantom stock plan might he used. It is not necessary for the insider to be able to trade on a daily basis.

In a phantom stock plan, the executive-beneficiaries would be given units that are related in value to the corporation's actual stock. These units would be acquired over time and modified to reflect dividends and other important events. The result would be a plan that looks much like a stock-option arrangement, but one that does not, for example, require young executives to be able to afford to exercise their options. See Herzel & Perlman, Stock Appreciation Rights, 33 Bus. Law. 749 (1978).

Critics of the phantom stock plan assert that managers who are encouraged to increase their firm's stock price will put short-run profits ahead of the long-term welfare of the corporation (and of society as a whole). For our purposes, it is sufficient to note that because the stock market also consistently values the short-run, the rewards that are available to insiders in a free-market pattern are unlikely to be as closely linked to the long-term health of the corporation as are the rewards that accrue under stock-incentive or profit-sharing plans. The tax and other characteristics of phantom stock plans are explored in Phantom stock plans: an increasingly popular form of executive compensation, 22 J. Tax'n 342 (1965); Note, Phantom Stock Plans, 76 Harv. L. Rev. 619 (1963).

[87] See text following note 75 supra.

[88] See id.

[89] Although this inefficiency is ignored by advocates of the free-market pattern, it does not seem any less serious than the inefficiences they do address—misinformation in the securities market resulting from abstention and the positional monopolies that are formed by overdisclosure.

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trading. The longer the withholding period, of course, the greater the inefficiency from misinformation in the local market, and the more continuing the injustices. Disclose-or-abstain offers no such sanction-free temptation.[90]

Finally, the inefficiencies that result from positional monopolies and insufficient exploration incentives seem roughly equivalent to those discussed with respect to the disclose-or-abstain pattern.[91] If our prototypical seller-farmer learns to ask those pointed questions that are virtually cost-free to the asker, but potentially ruinous to the corporate buyer and the system as a whole, we must either suffer the effects of reduced incentives for exploring and information gathering or adopt either the optimal-dishonesty rule or private eminent domain. As discussed above, eminent domain seems too costly an antidote for what will probably be an occasional problem.[92] On the other hand, if insiders may trade as they wish, it is conceivable that the changing stock price will be a stronger signal to seller-farmers to ask ruinous questions or to demand a premium for their properties than would abstention. Thus, it may be that under the free-market pattern only private eminent domain would protect the corporation from the seller's positional monopoly, because the seller will have learned to suspect the corporation's optimally dishonest responses. It is possible that the decision to disclose and employ private eminent domain or to withhold and engage in insider trading could be left to insiders who should be able to judge the significance of the stock market clues that would result from their trading. The incentive for an insider to withhold information is so great, however, that it is unlikely that disclosure would occur in all the cases in which the risk of a positional monopoly indicates that private eminent domain would be the wisest course. Thus, one of the costs of the free-market pattern must be the risk of positional monopolies, despite nondisclosure and despite the availability of private eminent domain.[93] This cost (to the

[90] Even in a disclose-or-abstain scheme, the information-laden insider may withhold for an unnecessarily long period in his quest to help the corporation and prevent positional monopolies, but he pays a cost—abstention from trading—for doing so. Thus, it is at least true that the excessive lag will be as long or longer under the free-market pattern than under the disclose-or-abstain rule.

[91] See text accompanying notes 75-80 supra.

[92] See text accompanying notes 78-83 supra.

[93] The cost of positional monopolies thus caused by the information revealed by a rise in

firm as well as to society as a whole), coupled with misallocations in the local market and incentives for insider mismanagement, suggests that the free-market pattern is not as efficient an alternative to "fairer" patterns of regulation as its proponents would have us believe.

C. *Always-Disclose/Disclose-or-Suspend*

1. *Always-Disclose*

An always-disclose pattern of securities law produces a refreshingly small number of inefficiencies. If any insider with material non-public information must immediately disclose and share his knowledge with the world at large, no inefficiencies will arise from lack of information or from misinformation; the securities market and the local market will emit correct signals.[94] On the other hand, the price that is paid for correct information—and, hence, for the choice of always-disclose over free-market or disclose-or-abstain—is that passive parties, such as our familiar seller-farmer, will also have access to the disclosed information and will interfere with exploration incentives.[95] Optimal dishonesty is of little help in parrying this interference; the correct information will already have been disclosed by the corporation or corporate insider. Few seller-farmers will be fooled by self-serving statements on the part of the buyer—especially when seller-farmers learn that the rule allows dishonesty in these situations. If the always-disclose pattern is to protect the incentive structure for explorers, it must do so with private eminent domain.

The costs of private eminent domain are difficult to quantify, particularly because it is difficult to determine how often passive parties will know to ask specific questions. Properly applied, eminent domain does not wait for situations in which the seller-farmer asks embarrassing questions; it short-circuits the bargaining pro-

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stock price will, of course, be offset to some extent by the inefficiency costs saved as a result of improved information in the local market.

[94] A potential drawback to the always-disclose rule is that the corporation may spew out so much information that it becomes expensive to sort out the useful from the useless, and the net result may be a poorer set of signals. This problem is beyond the scope of this essay. A quick response to the problem is that it would seem that the market is better informed with too much information than it would be with too little or incorrect information. This tradeoff is left for another effort.

[95] See notes 75-93 supra and accompanying text.

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cess completely.[96] Thus, in the situations in which the seller-farmer would not have asked questions, the costs of eminent domain are unnecessary. Moreover, although eminent domain is proposed as a scheme that protects the corporation without exacting fairness costs from outsiders in the securities market, condemnation carries its own injustices against the seller-farmer in the local market who may go uncompensated for his litigation costs or his unique tastes.[97]

Given the lack of empirical evidence on the costs of private eminent domain, it is difficult to make a final judgment about the merits of an always-disclose pattern that relies on this anticontractual device to protect the corporation in its dealings with the seller-farmer. Even without private eminent domain, however, the always-disclose pattern might still be preferable to the other available patterns. Assuming that exploration and information gathering suffer as a result of windfalls to passive parties, it still may be that the always-disclose pattern is more efficient than, for example, either the free-market or the disclose-or-abstain scheme. These last patterns, even when accompanied by an optimal-dishonesty rule, leave misimpressions in the local market. Moreover, it must also be true that the free-market pattern "corrects" prices in the securities market more slowly than an always-disclose rule, which would ensure many more fully informed traders. To the extent that this is true, the free-market pattern generates an additional set of misallocations that is not generated by always-disclose.[98] Disclose-or-abstain is even more inefficient in this way

[96] See text accompanying notes 78-83 supra.

[97] See text following note 74 supra.

[98] In comparison with the free-market pattern, the always-disclose pattern imposes an additional cost that must he considered. A rule that requires corporate disclosure imposes incredible enforcement costs, both because insiders will be unsure of what must be disclosed and whether they qualify as insiders, and because the detection of violations—to the extent that it is possible at all—will be expensive. But this argument hardly shatters the potential of an always-disclose pattern. In the first place, deterrence will be adequate if the penalty is severe enough to compensate for the low probability of detection. For example, the law could impose a fine to be paid to the "private attorney general" who detects the violation that, when multiplied by the probability of detection, would effectively deter illicit trading. Because there is no problem of overdeterrence here—under always-disclose, insider trading is never socially useful—the fine could even be increased beyond the compensatory amount. The fine, however, ought not to be too great because it occasionally may fall on the innocent trader whom the court mistakenly has found liable. The higher the penalty and the more the perceived probability of judicial error, the more some individuals will be inefficiently

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than the free-market pattern; under disclose-or-abstain, stock prices are more completely immunized from the corrective pull of undisclosed information. Thus, in addition to misallocations in the local market, disclose-or-abstain generates those misallocations that result from poor information in the securities market. It is by no means certain that the societal loss from insufficient exploration incentives that may attend always-disclose is greater than the loss from the two sources of misallocations that attend the disclose-or-abstain pattern.

2. *Disclose-or-Suspend*

Always-disclose is attractive from a fairness perspective, but more evidence is required before its efficiency costs can be assessed—either with or without private eminent domain. A fourth regulatory scheme is, as we have seen, one that allows a corporation to suspend trading in its securities whenever the costs of disclosure would be sufficiently high and the scope of private eminent domain too broad.[99] This regulatory pattern, however, does not escape the shadows of familiar inefficiencies and injustices.

Inasmuch as there will be no disclosure of material information under the suspension option,[100] there will be misallocations in both the local market and the securities market. Yet, neither of these markets will host as severe misallocations under suspension as under the other nondisclosure patterns (free-market and disclose-or-abstain). Particularly in the securities market, suspension itself serves as telling information, and it might be said that capital will often pause rather than flow in the wrong direction. In terms of our earlier illustration,[101] the would-be actor may be somewhat curious about the suspension of trading in the shares he has inher-

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deterred from all association with the securities market.

These potential enforcement costs, however, might be diminished if always-disclose were coupled with private eminent domain. The more a corporation is permitted to force sales of property or goods that it promises to use more efficiently, the more unnecessary is corporate secrecy and thus, the more insiders will voluntarily disclose. Disclosure therefore could become a regular element of corporate behavior, and corporations might police their own employees in order to avoid corporate penalties for nondisclosure.

[99] See text accompanying notes 35-39 supra.

[100] Because suspension is a rather drastic and costly option, it probably will be exercised infrequently. Nevertheless, it is useful to catalogue the inefficiencies and injustices that attend such a choice.

[101] See text following note 75 supra.

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ited. He might, for example, postpone both college and acting school and take a temporary job until the situation becomes clear. In the end, he will lose valuable time, but will not have wasted tuition (and opportunity cost). Meanwhile, someone else can attend college in his place.

Suspension may provide information in the local market as well. Parties in the local market sometimes will be able to see the link between a suspension of securities trading and some local development and will avoid inefficient decisions.[102] In many of these cases, people will behave more efficiently because they will know to wait before committing resources. Again using an earlier example,[103] the gas-station owner who learns of a suspension in securities trading by the corporation that has recently been exploring in the area might postpone his relocation until the information behind the suspension is disclosed. By hesitating, he sacrifices the opportunity for an immediate improvement in his situation, but he avoids the costs of a wasteful move.[104]

Suspension, however, generates a unique inefficiency by freezing the flow of capital. Other, unrelated projects may go unpursued because capital cannot leave its current position. Even though a working capital market obviously is more useful than a suspended one, the "flow of capital" concept may be of exaggerated importance. The inefficiencies created by suspension in securities trading will occur only rarely and will exert a very minimal effect on the economy as a whole. Distinguishing a suspension of trading in the securities market from a suspension of trading in a resource necessary to the business of the underlying corporation may illustrate this point. A suspension in copper trading, for example, would have a dramatic effect on a mining company; the firm would

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[102] For example, Corporation *X* may be the largest enterprise in the area and may limit its activities to oil exploration. If it suspends trading in its securities, it will give away a good deal of information; it is unlikely that an impartial decisionmaker would suspend trading when the corporate knowledge is that a drilling location proved unproductive. This factor is, of course, the source of the otber major efficiency cost of the suspension option; sellers thus informed can exert a positional monopoly over tbe exploring corporation.

[103] See text following note 75 supra.

[104] Of course, always-disclose would be more efficient in this situation because the gas-station owner could immediately undertake tbe expansion necessary to accommodate a larger clientele if the news were favorable, or pull up stakes without further delay if it were not. During the period of suspension and nondisclosure, however, the gas-station owner must wait before committing bis resources.

switch to other products because of its desire to make an immediate profit and because of the preference for positive signals (high prices) over empty signals (suspension and, therefore, no prices). When the mining company's stock is suspended, however, there is no immediate flow of capital away from mining and thus no dramatic effect on the company's business. After all, the mining company received its capital when it issued the stock; subsequent changes in investors' ability to buy or sell the stock on the secondary market affect the relative wealth of individual shareholders, but not the amount of capital that is at the company's disposal.

To be sure, suspension does generate some misallocations. Some companies in the capital market will be issuing new securities and seeking new capital at the time our hypothetical mining company is suspending trading in its securities. Thus, savings may flow too easily to these new ventures because they cannot flow into the mining company, or it may flow too slowly into these new ventures because potential investors have their wealth tied up in the suspended securities. Similarly, if the mining company's business prospects suddenly improve—because of the discovery of a new copper deposit, for example—capital may flow too slowly into the mining company because potential investors cannot purchase the company's new securities during the period of suspension. Nevertheless, despite its ominous sound, suspension in trading for a short period of time is not a particularly powerful source of misallocation. It is, instead, an interference with one small corner of a large market. It is not analogous to the suspension of trading in copper, but rather to the suspension of trading in thirty-day futures in copper. The effects of these suspensions are quite localized and easily circumvented unless there are many such suspensions in effect at one time.

Finally, suspension may generate inefficiency by providing some warning to well-informed passive parties. As with the warning that may be provided by a change in stock price, optimal dishonesty is probably an insufficient antidote,[105] but eminent domain may be too costly for the few instances in which its cure is needed.[106] Thus, an evaluation of the disclose-or-suspend pattern must include the increased risk that despite nondisclosure the corporation

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[105] See text following note 92 supra.

[106] See text accompanying notes 78-83 supra.

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will be subject to the seller's positional monopoly.

Although suspension, like disclosure, maintains a balance between insiders and outsiders—because neither group can trade at the other's expense—to the extent that illiquidity is not overcome by borrowing against the frozen asset, poorer shareholders may suffer more under this pattern of regulation than their wealthier counterparts.[107] This possible unfairness, coupled with the inefficiencies caused by suspension, suggests that, of the two patterns, always-disclose is more nearly fair and not much less efficient than is disclose-or-suspend. In fact, only the imperfections of eminent domain prevent the always-disclose scheme from satisfying our goals of efficiency and fairness.[108]

D. *Blind-Trust or Forbidden Ownership*

Any advantages that the free-market or disclose-or-abstain patterns allow insiders could be eliminated easily by altogether barring insiders from trading. Such a pattern might either disallow insider ownership in any form or give insiders some shareholder interest by creating a blind trust and employing a trustee to trade on the insider's behalf.[109] In the most extreme version of the blind-trust scheme, the trustee would purchase and sell shares in a random fashion, but in a way that should, on average, increase the insider's stake in the corporation's performance. Although this pattern does not meet the fairness goal—because insiders are disadvantaged if their investments are less liquid than outsiders' and if they prefer to use their own ingenuity in "beating the market"—it

[107] See text accompanying notes 36-38 supra.

[108] This conclusion assumes that if eminent domain were perfect, and private eminent domain the prevailing contractual rule, enforcement costs ensuring disclosure would be quite low. As indicated earlier, a different conclusion might be drawn after enforcement costs are studied and informational advantages evaluated. See note 98 supra.

[109] See notes 40-43 supra and accompanying text. To be sure, there are substantial policing problems with this pattern tbat cannot be ignored. The pattern would be meaningless without some effort to ensure that insiders would not trade through their families or tippees. But *every* pattern has attendant policing costs. An always-disclose rule requires checks to ensure that disclosure did indeed take place as soon as the information was available and before opportunities for insider activity could be exploited. A disclose-or-suspend rule requires additional checks to pass on the occasions of suspension. Even a free-market pattern requires policing, because insiders may try to delay disclosure longer than is necessary for the corporation's purposes in order to give themselves more time for profit making. In fact, each of the schemes that requires disclosure should probably be policed to ensure that the disclosed information is not offered with undue pessimism. See note 19 supra.

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certainly is not a pattern that advantages the insiders at an outsider's expense.

Because this pattern is fair regardless of whether insiders disclose material information, the silence-is-golden principle can be retained. In the absence of an always-disclose rule, the need for private eminent domain, and the high costs it entails, is not compelling; an optimal-dishonesty rule would parry the suspicions of those passive parties who learn to ask difficult questions.

The blind-trust pattern therefore would eliminate insider advantages and protect the corporation's interest in silence. Nevertheless, because this pattern tolerates nondisclosure, misallocations will result from poor information in both the securities and local markets. In sum, this last pattern has much more to do with eliminating insider advantages than with altering the tradeoff among inefficiencies or with satisfying the precise goal of equalizing the trading positions of insiders and outsiders.

Conclusion

It is clear from the forgoing analysis that every pattern of securities regulation is plagued by a variety of inefficiencies and injustices. It may be less clear, but it is no less important to realize, that the choice among these patterns is not one that requires an election between economic efficiency and some concept of fairness; rather it is one that requires weighing *both* the inefficiencies *and* injustices of each pattern against those of another.

Although this article does not presume to guess how the specific inefficiencies and injustices match up against one another, a few comments are appropriate. First, of the six primary sources of inefficiency that were discussed—poor information in the securities market,[110] poor information in the local market,[111] insufficient incentives to explore and inform,[112] imperfections in eminent domain,[113] costs of distinguishing fraud from optimal dishonesty,[114] and frozen capital markets[115]—none is particularly easy to measure

[110] See notes 75-76 supra and accompanying text.

[111] See id.

[112] See notes 49, 60, 62-64 supra and accompanying text.

[113] See text accompanying notes 74-75 supra.

[114] See text accompanying notes 67-71 supra.

[115] See text accompanying notes 36-37, 104-05 supra.

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in an empirical fashion.[116]

Second, the choice among patterns in securities law ultimately involves a decision about the law of contracts. It may be clear that when buying land one need not divulge the results of years of geological expeditions, but once an additional market—such as the securities market—is involved, the situation is quite complicated. Full information may promote fairness and efficiency in one market while destroying important incentives in a different market. Thus, it is important to realize that fairness and efficiency at one level often can be achieved only at the expense of similar societal goals at another.

My own feeling is that information is a terribly important fluid in our economic system and that the misallocations that accompany both the free-market and the disclose-or-abstain patterns have been underestimated. Thus, the ideal regulatory pattern would be one that mandated more disclosure without sacrificing incentives for exploration and without exacting large enforcement costs. As such, it may be worthwhile to concentrate future research and creative efforts on private eminent domain or some similar scheme that would allow the adoption of an always-disclose or disclose-or-suspend pattern. Furthermore, the study of private eminent domain schemes should be accompanied by a study of the detection systems and enforcement costs that would be associated with more mandated disclosure. There is a great deal of room for innovation in these areas.

Once the task of choosing among patterns of securities regulation is linked to the variety of rules in contract and property law, new and exciting alternatives and questions appear. It is hoped that the future path of the law will not be constricted by a sense that the familiar patterns are the only ones available. On the other

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[116] Eminent domain may prove somewhat more susceptible to an efficiency analysis because the parties involved may be able to reveal the extent of their undercompensation by experiments that let them buy out of the condemnation procedure, or by "self-evaluations" of their properties. See Calabresi & Melamed, Property Rules, Liability Rules, and Inalienability: One View of the Cathedral, 85 Harv. L. Rev. 1089, 1109 n.38 (1972). For a discussion of these "self-assessment" proposals and extensions to other valuation problems, see Levmore, Self-Assessed Valuation Systems for Tort and Other Law (forthcoming in 68 Va. L. Rev.). The court and administrative costs that are involved are, of course, more readily measured. But eminent domain stands alone in this regard; the other inefficiencies affect large numbers of people and enterprises at many stages—and involve more complex economic phenomena.

hand, any attempts at change should be undertaken with an understanding of the characteristics that attend each regulatory pattern proposed to govern disclosure by corporate insiders and by contracting parties in general, and with an understanding of the crucial interplay among these patterns.

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