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OVERVALUED EQUITY AND THE CASE FOR AN ASYMMETRIC INSIDER TRADING REGIME

*Thomas A. Lambert**

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[We do not want to maximize the price at which Berkshire shares trade. We wish instead for them to trade in a narrow range centered at intrinsic business value [We] are bothered as much by significant overvaluation as significant undervaluation.

Warren Buffett

Berkshire Hathaway Annual Report, 1988

INTRODUCTION

Warren Buffett is an anomaly. In expressing concern about the potential overvaluation of his company's stock, the Chairman and CEO of Berkshire Hathaway, Inc., has distinguished himself from the vast majority of corporate managers, most of whom believe (or at least act as if they believe) that their highest end is to maximize their company's stock price.¹ But Mr. Buffett is right to be bothered by overvaluation. Recent events in the financial world have revealed that overvaluation can be extremely damaging to a firm and its shareholders.² This revelation calls for a rethinking of insider trading policy.

For four decades now, corporate law scholars have debated whether the government should prohibit insider trading,³ commonly defined as stock trading on the basis of material, nonpublic information.⁴ Participants in this long-running debate have

1. See Michael C. Jensen, *Agency Costs of Overvalued Equity*, 34 FIN. MGMT. 5, 5-6 (2005) ("To my knowledge, with the exception of Warren Buffett (who hints at these forces in his 1988 letter to Berkshire shareholders) no leaders in the business and financial community have recognized the dangers of overvalued equity.").

2. See *id.*; see also *infra* notes 131-215 and accompanying text (discussing investor harms occasioned by equity overvaluation).

3. Earnest debate over the wisdom of an insider trading prohibition began some forty years ago with the publication of Henry Manne's book, *Insider Trading and the Stock Market*. HENRY G. MANNE, INSIDER TRADING AND THE STOCK MARKET (1966). The literature comprising the debate is far too voluminous to cite exhaustively. For an excellent overview of the debate, see Stephen M. Bainbridge, *Insider Trading*, in ENCYCLOPEDIA OF LAW AND ECONOMICS 772, 777-94 (Boudewijn Bouckaert & Gerrit De Geest eds., 1999), available at <http://encyclo.findlaw.com/5650book.pdf>. For arguments defending the legal prohibition on insider trading, see generally Roy A. Schotland, *Unsafe at Any Price: A Reply to Manne, Insider Trading and the Stock Market*, 53 VA. L. REV. 1425 (1967). For arguments in favor of deregulation of insider trading, see generally Dennis W. Carlton & Daniel R. Fischel, *The Regulation of Insider Trading*, 35 STAN. L. REV. 857 (1983).

4. See STEPHEN M. BAINBRIDGE, CORPORATION LAW AND ECONOMICS 519 (2002).

generally assumed that trading that decreases a stock's price ("price-decreasing insider trading") should be treated the same as trading that causes the price to rise ("price-increasing insider trading"): either both forms of trading should be regulated, or neither should. This Article considers whether there is a principled basis for affording different legal treatment to the two species of insider trading. It concludes that price-decreasing insider trading should be treated less harshly than price-increasing insider trading.

The reason for the proposed asymmetric treatment is that price-decreasing insider trading provides significantly more value to investors than price-increasing insider trading. Specifically, price-decreasing insider trading provides an effective means—perhaps the only cost-effective means—of combating the problem of overvalued equity,⁵ a problem whose magnitude commentators are just beginning to appreciate.⁶ Overvalued equity, which occurs when a stock's price becomes so high that it cannot be justified by expected future earnings,⁷ leads managers to take a number of value-destroying actions. Corporate insiders, of course, are in the best position to know when the stock of their company is overvalued, and deregulation of price-decreasing insider trading would create a means by which they could signal the market that the stock price is too high, thereby avoiding the costs associated with overvalued equity. While deregulation of price-increasing insider trading could

5. Congress and securities regulators have recently sought to reduce the costs of equity overvaluation by enacting laws and adopting rules designed to prevent firms from becoming overvalued as a result of misinformation. Most notably, the Sarbanes-Oxley Act of 2002, Pub. L. No. 107-24, 116 Stat. 745, which was adopted hastily in the panicked atmosphere created by the implosion of Enron Corporation and a massive accounting fraud at WorldCom Inc., imposes a number of restrictions designed to prevent overvaluation occasioned by accounting fraud. See Larry E. Ribstein, *Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002*, 28 J. CORP. L. 1, 11-18 (2002) (summarizing key provisions of Act); Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521, 1549-68 (2005) (detailing Act's political history and demonstrating lack of careful attention to costs and benefits of its reforms). Early indications are that the Act's restrictions do not create investor benefits commensurate with their substantial costs. See generally Larry E. Ribstein, *Sarbanes-Oxley After Three Years*, (U. Ill. Law & Econ. Working Papers Series, Working Paper No. LE05-016, 2005), available at <http://ssrn.com/abstract=746884> [hereinafter *Sarbanes-Oxley After Three Years*]; Romano, *supra* (reviewing empirical studies evaluating effectiveness of key Sarbanes-Oxley provisions).

6. See generally Jensen, *supra* note 1.

7. *Id.* at 5 ("Equity is overvalued when a firm's stock price is higher than its underlying value. . . . By definition, an overvalued equity means the company will not be able to deliver—except by pure luck—the performance to justify its value.").

similarly remedy the problem of *undervalued* equity, undervaluation causes fewer problems than overvaluation, and there are numerous other mechanisms for addressing that sort of mispricing. Moreover, the potential investor losses associated with price-increasing insider trading are higher than those associated with price-decreasing insider trading. Most corporations would therefore likely opt to permit (at least some) price-decreasing insider trading, while generally restricting price-increasing insider trading.

Of course, the signaling effect of price-decreasing insider trading, and thus its salutary price effect, would be stronger if the trades were publicly announced when executed. Accordingly, this Article concludes that most corporations would, if practically and legally able to do so, adopt an asymmetric insider trading regime that would generally permit price-decreasing insider trades as long as they were immediately announced to the public. Public disclosure would have the added benefit of policing potential mismanagement by insiders, who might otherwise be tempted to delay the transmission of “bad news” or even to create such news in an attempt to generate trading profits. Given that most investors and corporate managers would bargain for an insider trading policy generally permitting disclosed price-decreasing insider trading, while restricting price-increasing insider trading, regulators should posit such a policy as the default that will govern in the absence of express contracting. Current insider trading doctrine would permit them to do so.⁸

This Article consists of three parts. Part I briefly summarizes the long-running policy debate over insider trading. Part II describes the problem of overvalued equity, explains why price-decreasing insider trading will create greater investor benefits and impose lower investor costs than price-increasing insider trading, and describes the sort of asymmetric insider trading policy most corporations would adopt if expressly permitted to do so. Part III, then, argues that regulators could approve this sort of asymmetric insider trading regime under current law, even if the law is more hostile to insider trading than some advocates of insider trading deregulation assume.

8. While current insider trading doctrine would likely permit corporations to adopt policies liberalizing price-decreasing insider trading, corporations have not done so, most likely because regulators have not expressly promised them (and their insiders) immunity. The SEC has a long history of seeking to expand the insider trading prohibition. See BAINBRIDGE, *supra* note 4, at 583-86 (discussing regulators' zeal to expand insider trading prohibition beyond the limits of the enabling statute). While (as argued *infra* Part III) a corporation legally could authorize price-decreasing insider trading, if it did so, it would almost certainly face a lawsuit by zealous regulators.

I. SUMMARY OF THE INSIDER TRADING DEBATE

The federal insider trading prohibition coexists somewhat uneasily with the rest of the securities laws. Whereas the general aim of most of the securities laws is to ensure the accurate pricing of securities by requiring dissemination to the market of information regarding the true value of securities, the insider trading prohibition explicitly prohibits certain types of trading on the basis of material, nonpublic information, thereby preventing such trades from informing the market regarding the true value of the securities at issue.⁹ The result is a schizophrenic regulatory regime in which certain value-revealing disclosures are mandated, but certain value-revealing trades are forbidden. Such regulatory schizophrenia may make sense if there are harms associated with value-revealing insider trading, and, of course, proponents of the insider trading ban insist that there are. Thus, a debate has raged for the last forty years regarding whether there truly are harms associated with insider trading and, if so, whether they eclipse the harms created by the insider trading ban. Because an understanding of the case for an asymmetric insider trading regime requires a working understanding of the broader policy debate over the insider trading ban, I begin with a brief summary of the debate.¹⁰

Defenders of the ban on insider trading insist that it is fundamentally unfair for some traders to have an informational advantage over others, particularly when the advantaged traders are corporate insiders who are supposed to be acting as agents for those who lack the informational advantage.¹¹ Ban defenders also contend that insider trading causes efficiency losses by (1) discouraging investment in the apparently rigged stock market, thereby reducing the liquidity of capital markets;¹² (2) encouraging

9. See BAINBRIDGE, *supra* note 4, at 605 (“The basic function of a securities fraud regime is to ensure timely disclosure of accurate information to investors. Yet, it seems indisputable that the insider trading prohibition does not lead to increased disclosure.”).

10. Because excellent and detailed summaries of the debate exist elsewhere, my summary is somewhat cursory. For additional detail, see BAINBRIDGE, *supra* note 4, at 583-607; Bainbridge, *supra* note 3.

11. See, e.g., Schotland, *supra* note 3, at 1439 (“Even if we found that unfettered insider trading would bring an economic gain, we might still forego that gain in order to secure a stock market and intracorporate relationships that satisfy such noneconomic goals as fairness, just rewards and integrity.”). Other sources articulating versions of this fairness argument are cited *infra* note 40.

12. See Lawrence M. Ausubel, *Insider Trading in a Rational Expectations Economy*, 80 AM. ECON. REV. 1022, 1022-23 (1990) (asserting that insider trading deters potential investors from securities markets, as outsiders want to avoid dilution of their investment returns); Louis Loss, *The Fiduciary Concept*

insiders to delay disclosures¹³ and to make management decisions that increase share price volatility but do not maximize firm value;¹⁴ and (3) increasing the “bid-ask” spread of stock specialists, who systematically lose on trades with insiders (whom they cannot identify *ex ante*) and will thus tend to “insure” against such losses by charging a small premium on each trade.¹⁵ Finally, some defenders of the ban assert that it is justified as a means of protecting the corporation’s property rights in valuable information regarding firm prospects.¹⁶

Proponents of the deregulation of insider trading discount these arguments and assert that insider trading can be beneficial on the whole and ought to be limited, if at all, only by corporations

as Applied to Trading by Corporate “Insiders” in the United States, 33 MOD. L. REV. 34, 36 (1970) (arguing that insider trading constitutes a “grievous insult to the market in the sense that the very preservation of any capital market depends on liquidity, which rests in turn on the investor’s confidence that current quotations accurately reflect the objective value of his investment”); Jeffrey M. Laderman et al., *The Epidemic of Insider Trading*, BUS. WK., Apr. 29, 1985, at 78 (quoting then American Stock Exchange Chairman Arthur Levitt, Jr. as stating, “If the investor thinks he’s not getting a fair shake, he is not going to invest, and that is going to hurt capital investment in the long run”).

13. See Robert J. Haft, *The Effect of Insider Trading Rules on the Internal Efficiency of the Large Corporation*, 80 MICH. L. REV. 1051, 1054-55 (1982) (arguing that, if insider trading were permitted, “[s]ubordinates would stall the upward flow of critical information to maximize their opportunities for financial gain,” resulting in an “impair[ment] [of] corporate decision-making at all hierarchical levels”).

14. See, e.g., Saul Levmore, *Securities and Secrets: Insider Trading and the Law of Contracts*, 68 VA. L. REV. 117, 149 (1982) (noting that if insider trading is permitted “an insider can profit from a decrease in the firm’s stock price as well as in increase; the temptation of profit might actually encourage an insider to act against the corporation’s interest”); Schotland, *supra* note 3, at 1451; Morris Mendelson, *The Economics of Insider Trading Reconsidered*, 117 U. PA. L. REV. 470, 489-90 (1969) (reviewing HENRY G. MANNE, *INSIDER TRADING AND THE STOCK MARKET* (1966)).

15. See, e.g., John C. Coffee, Jr., *Is Selective Disclosure Now Lawful?*, N.Y. L.J., July 31, 1997, at 5 (“[T]he more that the law successfully prohibits the use of non-public information, the more that the market maker can (and will be forced by competitive pressure to) narrow the bid/asked spread.”); Jack L. Treynor, *Securities Law and Public Policy*, 50 FIN. ANALYSTS J. 10, 10 (May/June 1994) (“[Informed] trades can damage the dealer, perhaps fatally. That’s a valid reason for discouraging trading on so-called ‘inside’ information, quite apart from whether such trading entails misappropriation of corporate property or wire fraud.”); Thomas E. Copeland & Dan Galai, *Information Effects on the Bid-Ask Spread*, 38 J. FIN. 1457 (1983); Lawrence R. Glosten & Paul R. Milgrom, *Bid, Ask and Transaction Prices in a Specialist Market with Heterogeneously Informed Traders*, 14 J. FIN. ECON. 71 (1985).

16. See, e.g., BAINBRIDGE, *supra* note 4, at 598-607.

themselves via contract.¹⁷ With respect to the fairness argument, deregulation proponents retort that insider trading cannot be “unfair” to investors if they know in advance that it might occur and nonetheless choose to engage in the purportedly unfair trades.¹⁸ Moreover, deregulation proponents assert, the purported efficiency losses occasioned by insider trading are overblown. There is little evidence, they say, that insider trading reduces liquidity by discouraging individuals from investing in the stock market,¹⁹ and it might actually increase such liquidity by providing benefits to investors in equities.²⁰ With respect to the claim that insider trading creates incentives for delayed disclosures and value-reducing management, advocates of deregulation claim that such mismanagement is unlikely for several reasons. First, managers face reputational constraints that will discourage such misbehavior.²¹ In addition, managers, who generally work in teams, cannot engage in value-destroying mismanagement without persuading their colleagues to go along with the strategy, and any particular employee’s ability to engage in mismanagement will therefore be constrained by her colleagues’ attempts to maximize firm value or to gain personally by exposing proposed mismanagement.²² With respect to the argument that insider trading raises the cost of trading securities by increasing the bid-ask spread, proponents of deregulation point to empirical evidence

17. See, e.g., Carlton & Fischel, *supra* note 3, at 861.

18. Kenneth E. Scott, *Insider Trading: Rule 10b-5, Disclosure and Corporate Privacy*, 9 J. LEGAL STUD. 801, 807-09 (1980) (observing that if the existence of insider trading is known, outsiders will not be disadvantaged because the price they pay will reflect the risk of insider trading); Frank H. Easterbrook, *Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information*, 1981 SUP. CT. REV. 309, 323-30 (discussing and refuting fairness arguments).

19. See, e.g., Carlton & Fischel, *supra* note 3, at 880 n.76 (“[T]he notion that exchanges are harmed by insider trading is hard to square with the following facts: (1) the stock market was successful pre-1933 (before insider trading laws); (2) the stock market was successful pre-1960s (before judicial extension of insider trading laws); (3) the stock market is currently successful despite the existence of legal and perhaps illegal insider trading.”).

20. *Cf. id.* at 881 (“Compensating managers [by permitting insider trading] increases the size of the pie, and thus outsiders as well as insiders profit from the incentives managers are given to increase the value of the firm.”).

21. See *id.* at 874 (noting that a manager will be motivated, at least in part, by “his long run interest in his human capital”).

22. See *id.* at 873-74 (“Managers often work in teams and thus must first persuade one another that the firm should undertake a particular strategy. . . . [T]he ability of any one manager to pursue bad opportunities will be constrained because other managers and employees will attempt to maximize the firm’s value.”).

discounting this purported effect of insider trading.²³ Finally, deregulation proponents assert that, even if material nonpublic information is worthy of property protection, the property right need not be a non-transferable interest granted to the corporation; efficiency considerations may call for the right to be transferable and/or initially allocated to a different party (e.g., to insiders).²⁴

In addition to rebutting the arguments for regulation, proponents of deregulation have offered affirmative arguments for liberalizing insider trading. First, they maintain that insider trading should generally be permitted because it increases stock market efficiency (i.e., the degree to which stock prices reflect true value), which helps guarantee efficient resource allocation.²⁵

23. See generally Stanislav Dolgoplov, *Insider Trading and the Bid-Ask Spread: A Critical Evaluation of Adverse Selection in Market Making*, 33 CAP. U. L. REV. 83 (2004) (surveying empirical evidence regarding insider trading's effect on bid-ask spread and liquidity).

24. See Carlton & Fischel, *supra* note 3, at 878 (noting that the contention that inside information is property "does not address the key question of why the firm and not the managers always should be allocated the property right in information"); Easterbrook, *supra* note 18, at 331 (approving property rights approach but noting that "insider trading should be permitted to the extent the firm that created the information desires (or tolerates) such trading. The firm extracts value through exploiting the knowledge itself or reducing the salary of those who exploit it."); Jonathan R. Macey, *From Fairness to Contract: The New Direction of the Rules Against Insider Trading*, 13 HOFSTRA L. REV. 9, 32 (1984) (defending use of insider trading law to protect rights to information but arguing that "property owners"—i.e., the corporations to whom the right to inside information is allocated—should be "permitted to contract as to the use of the information they own").

25. Although there is some disagreement concerning the extent and timeliness of the price effect occasioned by insider trading, there is near consensus among economists that insider trading pushes the price of a stock in the right direction. Henry G. Manne, *Insider Trading: Hayek, Virtual Markets, and the Dog that Did Not Bark* 4 (ICER Working Paper No. 7-2005, 2005), available at <http://ssrn.com/abstract=679662>. For empirical data demonstrating that insider trading results in rapid incorporation of the impact of nonpublic information into market price, see Ji-Chai Lin & Michael S. Rozeff, *The Speed of Adjustment of Prices to Private Information: Empirical Tests*, 18 J. FIN. RES. 143 (1995); Lisa K. Meulbroek, *An Empirical Analysis of Illegal Insider Trading*, 47 J. FIN. 1661 (1992). For data from laboratory experiments suggesting that inside information is rapidly assimilated into market price, even when very few insiders participate in the market, see Martin Barner et al., *On the Microstructure of Price Determination and Information Aggregation with Sequential and Asymmetric Information Arrival in an Experimental Asset Market*, 1 ANNALS FIN. 73 (2005); Daniel Friedman et al., *The Informational Efficiency of Experimental Asset Markets*, 92 J. POL. ECON. 349 (1984). For theory supporting a rapid assimilation view, see Charles R. Plott & Shyam Sunder, *Efficiency of Experimental Security Markets with Insider Information: An Application of Rational-Expectations Models*, 90 J. POL. ECON. 663 (1982)

Corporate insiders, after all, generally know more about their company's prospects than anyone else. When they purchase or sell their own company's stock, thus betting their own money that the stock is mispriced, they convey valuable information to the marketplace. Assuming their trades somehow become public, other rational investors will likely follow their lead, which will cause stock prices to reflect more accurately the underlying value of the firm.²⁶ More efficient stock prices, then, will lead to a more efficient allocation of productive resources throughout the economy.²⁷

Deregulation advocates further maintain that corporations ought to be allowed to adopt liberal insider trading policies because permitting insider trading could be an efficient form of managerial compensation.²⁸ The argument here is that competition in the labor and capital markets will lead corporations to adopt efficient insider trading policies.²⁹ On the one hand, the market for managerial labor may reward corporations with liberal insider trading policies, for the right to make money through insider trading is valuable to potential managers. On the other hand, capital market pressures will prevent corporations from adopting insider trading policies that are, on balance, harmful to investors. Because granting managers the right to engage in insider trading lowers their salary requirements and creates an incentive for them to create "good news" for the corporation, the capital markets might reward firms with liberal insider trading policies.³⁰ To the extent insider trading causes investor harm in excess of these benefits, however, it will be

(demonstrating through simulation techniques that markets adjust very rapidly to inside information). For arguments that the price effect is less extensive and rapid, see Sugato Chakravarty & John J. McConnell, *Does Insider Trading Really Move Stock Prices?*, 34 J. FIN. & QUANTITATIVE ANALYSIS 191 (1999) (presenting data suggesting that informed trading by insiders has the same price affect as uninformed trading by outsiders); James D. Cox, *Insider Trading and Contracting: A Critical Response to the "Chicago School"*, 1986 DUKE L.J. 628, 646 (asserting that insider trading is a noisy device for communicating stock value). For the outlier view that insider trading does not push stock prices in the right direction, see Vernon L. Smith et al., *Bubbles, Crashes, and Endogenous Expectations in Experimental Spot Asset Markets*, 56 ECONOMETRICA 1119 (1988).

26. See *infra* notes 260-68 and accompanying text (discussing how insider trades lead to more efficient securities prices).

27. See *infra* notes 121-23 and accompanying text (discussing allocative inefficiencies occasioned by inaccurate securities prices).

28. See, e.g., MANNE, *supra* note 3, at 116-19; Carlton & Fischel, *supra* note 3, at 869-71.

29. Carlton & Fischel, *supra* note 3, at 862-63.

30. *But see* Easterbrook, *supra* note 18, at 332 (arguing that the right to engage in insider trading is an inefficient compensation mechanism not likely to be selected by corporations).

disfavored by investors, who will price the firm's securities accordingly. Thus, deregulation advocates maintain that the interaction of the labor and capital markets will assure that firms will adopt insider trading policies that are, on the whole, value-maximizing.³¹

Professor Henry G. Manne, perhaps the founder of the deregulatory camp,³² has recently articulated what he characterizes as a third affirmative argument for deregulation of insider trading. He asserts that insider trading lowers the cost of managerial decisionmaking by providing managers with valuable information that they could not otherwise cost-effectively obtain.³³ Drawing on F.A. Hayek's famous observation that the chief problem facing managers charged with resource allocation decisions is the fact that time- and space-specific information is widely distributed,³⁴ Manne contends that corporate managers similarly face informational constraints. Just as Hayek saw the price mechanism as the primary solution to the problem of resource allocation generally,³⁵ Manne maintains that the price information generated by insider trading can similarly guide corporate managers in making decisions about how to allocate firm resources.³⁶

Not surprisingly, the affirmative case for liberalizing insider trading has not gone unchallenged. With regard to the argument that insider trading leads to more efficient securities prices, ban proponents retort that trading by insiders conveys information only

31. Carlton & Fischel, *supra* note 3, at 862-66.

32. See *supra* note 3; see also Henry G. Manne, *Economic Aspects of Required Disclosure Under Federal Securities Laws*, in WALL STREET IN TRANSITION 21 (1974); Henry G. Manne, *Insider Trading and the Law Professors*, 23 VAND. L. REV. 547 (1970).

33. See Manne, *supra* note 25, at 14-16. Professor Manne contends that the managerial benefits created by insider trading explain why investors and managers neither adopted contractual insider trading restrictions nor called for regulation of insider trading prior to the 1960s, when the SEC began regulating the practice in earnest. *Id.* at 19.

34. F.A. Hayek, *The Use of Knowledge in Society*, 35 AM. ECON. REV. 519, 519-20 (1945).

35. *Id.* at 526.

36. Manne, *supra* note 25, at 14-21. Manne's notion that insider trading creates "prices" that guide firm managers is innovative. Conventional economic theory has drawn a distinction between the market, in which resources are allocated in a decentralized fashion according to the price mechanism, and the firm, in which resources are allocated via managerial fiat without reference to prices (which generally do not exist within the firm). See R.H. Coase, *The Nature of the Firm*, 4 ECONOMICA (n.s.) 386, 389 (1937) ("[T]he distinguishing mark of the firm is the supersession of the price mechanism."). Manne suggests that insider trading may generate effective "prices" to guide resource allocation *within* firms.

to the extent it is revealed, and even then the message it conveys is “noisy” or ambiguous, given that insiders may trade for a variety of reasons, many of which are unrelated to their possession of inside information.³⁷ Ban defenders further maintain that insider trading is an inefficient, clumsy, and possibly perverse compensation mechanism.³⁸ With regard to Manne’s novel “managerial benefits” argument, ban defenders will likely respond with a version of their argument that insider trading is a noisy signaling device.³⁹ After all, the fact that the market value of the entire firm is rising or falling would not seem to convey much helpful information to a manager attempting to make a narrow management decision about one particular aspect of firm operations.

A striking aspect of the well-worn insider trading debate is its starkness: assuming that insider trading must be treated as a whole, ban defenders and opponents have argued over liberalization in all-or-nothing terms. They have not considered whether some species of insider trading should be treated differently than others. Part II of this Article argues that price-decreasing insider trading, which consists of trading by insiders on the basis of negative nonpublic information, provides greater net benefits to investors than price-increasing insider trading, which consists of trading by insiders on the basis of positive nonpublic information. Accordingly, the law should treat price-decreasing insider trading (insider sales, short sales, or purchases of put options) less harshly than price-increasing insider trading (insider purchases of stock or call

37. See Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 574 (1984) (discussing the limits of trade and price decoding).

38. See, e.g., BAINBRIDGE, *supra* note 4, at 591-92 (criticizing insider trading as compensation mechanism because (1) an insider’s compensation would be determined, in part, by his wealth; (2) the right to trade could not be limited to the insiders who created value-enhancing information; (3) “[a]llowing managers to profit from inside trading reduces the penalties associated with a project’s failure”; and (4) the value of the compensation is contingent and difficult to measure in advance and thus would be less desirable to managers); Easterbrook, *supra* note 18, at 332.

39. See *supra* note 37 and accompanying text. Indeed, it would be proper for ban proponents to reiterate their “noisy signal” argument here, for Manne’s managerial benefits argument is ultimately a version of the “traditional” argument that insider trading enhances allocative efficiency by increasing the efficiency of stock prices. Whereas the traditional argument focused on investors’ allocation of capital, Manne’s latest argument focuses on managers’ allocation of corporate resources. But, of course, managers making decisions about how to allocate corporate resources are ultimately acting as “investors,” and the role insider trading plays in guiding managers is similar to that which it plays in guiding individual investors.

options).

II. THE CASE FOR ASYMMETRIC TREATMENT OF PRICE-INCREASING AND PRICE-DECREASING INSIDER TRADING

The argument presented herein takes efficiency as the touchstone,⁴⁰ assuming that insider trading should be deregulated if, but only if, the benefits of permitting such trading (or, more accurately, of letting issuers decide for themselves whether or not to do so) exceed the costs of doing so. Accordingly, the case for asymmetric treatment of price-increasing and price-decreasing insider trading is structured around consideration of the relative costs and benefits of the two species of insider trading. Part II.A compares the benefits of the two types of insider trading by focusing on the relative costs of undervalued and overvalued equity. Observing that equity overvaluation is more costly to investors than equity undervaluation, Part II.A concludes that price-decreasing insider trading provides greater benefit to investors, and to society in general, than price-increasing insider trading. Part II.B, then, compares the costs of price-increasing and price-decreasing insider

40. This is controversial. See Benjamin Alarie, *Dividend Entitlements and Intermediate Default Rules*, 9 STAN. J.L. BUS. & FIN. 135, 137 (2004) (recognizing disagreement over ultimate criteria). Most scholars considering whether insider trading should be deregulated have taken efficiency as the determinative criterion. See, e.g., JONATHAN R. MACEY, *INSIDER TRADING: ECONOMICS, POLITICS, AND POLICY* (1991); Stephen Bainbridge, *The Insider Trading Prohibition: A Legal and Economic Enigma*, 38 U. FLA. L. REV. 35 (1986); Carlton & Fischel, *supra* note 3; Easterbrook, *supra* note 18; David D. Haddock, *Academic Hostility and SEC Acquiescence: Henry Manne's Insider Trading*, 50 CASE W. RES. L. REV. 313 (1999); David D. Haddock & Jonathan R. Macey, *A Coasian Model of Insider Trading*, 80 NW. U. L. REV. 1449 (1986); Larry E. Ribstein, *Federalism and Insider Trading*, 6 SUP. CT. ECON. REV. 123 (1998); Scott, *supra* note 18; Robert B. Thompson, *Insider Trading, Investor Harm, and Executive Compensation*, 50 CASE W. RES. L. REV. 291 (1999). However, many others have focused on various philosophical formulations of fairness. See, e.g., Gary Lawson, *The Ethics of Insider Trading*, 11 HARV. J.L. & PUB. POL'Y 727 (1988); Ian B. Lee, *Fairness and Insider Trading*, 2002 COLUM. BUS. L. REV. 119 (2002); Saul Levmore, *Securities and Secrets: Insider Trading and the Law of Contracts*, 68 VA. L. REV. 117 (1982); Steven R. Salbu, *The Misappropriation Theory of Insider Trading: A Legal, Economic, and Ethical Analysis*, 15 HARV. J.L. & PUB. POL'Y 223 (1992); Kim Lane Scheppelle, *"It's Just Not Right": The Ethics of Insider Trading*, 56 LAW & CONTEMP. PROBS. 123 (1993); Alan Strudler & Eric W. Orts, *Moral Principles in the Law of Insider Trading*, 78 TEX. L. REV. 375 (1999). Because a liberalized insider trading policy would not seem "unfair" if investors knew in advance that such trading might occur and nonetheless chose to purchase or sell the stock at issue, see *supra* note 18 and accompanying text, this Article focuses on efficiency considerations.

trading, concluding that the former imposes greater costs on investors than the latter. Part II.C argues that a policy permitting disclosed price-decreasing insider trading, while banning price-increasing insider trading, is likely the majoritarian default rule—i.e., the approach most corporate managers and investors would negotiate were they able to do so.

A. *Greater Benefits from Price-Decreasing Insider Trading*

Somewhat curiously, legal scholars have paid little attention to the difference between stock overvaluation and undervaluation.⁴¹ Professor Marcel Kahan, for example, ignored the distinction in setting forth a somewhat elaborate and otherwise exhaustive taxonomy of stock price inaccuracies.⁴² Acknowledging that stock prices can exhibit different types of inaccuracy and that securities policy should distinguish between these inaccuracies, Kahan classified inaccuracies in terms of cause (what caused the pricing inaccuracy?),⁴³ manifestation (how did the mispricing qualitatively manifest itself?),⁴⁴ and scope (what was the magnitude of the mispricing?).⁴⁵ Nowhere in his helpful and complex taxonomy did Kahan consider the relevance of direction—i.e., whether the price was inaccurately great or inaccurately small. Instead, he apparently assumed that overvaluation by a certain degree is equivalent, in terms of effect, to undervaluation by that same degree.⁴⁶ Similarly, Professor Lynn A. Stout's work down-playing the costs of stock price inaccuracy has assumed that overly high stock prices create essentially the same problems as stock prices

41. A share of common stock entitles its holder to a pro rata share of the corporation's "free cash flow," or cash flow that is not needed for current or future operations. Accordingly, the true value of a stock is the present value of the future payments the shareholder expects to receive, discounted for non-diversifiable risk (i.e., risk that cannot be eliminated by holding a diversified portfolio of stocks). See RICHARD A. BREALEY & STEWART C. MYERS, *PRINCIPLES OF CORPORATE FINANCE* 72 (5th ed. 1996); Merritt B. Fox et al., *Law, Share Price Accuracy, and Economic Performance: The New Evidence*, 102 MICH. L. REV. 331, 345 (2003) (defining a share of stock's "actual value" at any point in time as "the aggregate future stream of income—dividends and other distributions—paid out from then on to whoever holds the share over the lifetime of the firm (discounted to present value)"). A stock is overvalued if its market price is higher than this value and undervalued if this value exceeds the stock's market price.

42. See Marcel Kahan, *Securities Laws and the Social Costs of "Inaccurate" Stock Prices*, 41 DUKE L.J. 977, 987-88 (1992).

43. *Id.* at 988.

44. *Id.* at 994.

45. *Id.* at 999.

46. *Id.* at 1000.

that are too low.⁴⁷

This assumption is wrong. As explained below, stock overvaluation tends to cause greater investor harm than undervaluation. Accordingly, insider trading that reduces the price of overvalued equity will provide greater investor benefits than insider trading that increases the price of undervalued equity. The following discussion explains why equity overvaluation is more likely to occur and persist,⁴⁸ is more difficult to correct,⁴⁹ and is likely to cause greater investor harm⁵⁰ than equity undervaluation.

1. Overvaluation Is More Likely to Occur and Persist than Undervaluation

Stock prices may deviate from fundamental value for several reasons.⁵¹ First, prices may be inaccurate because of nonpublic information. Given that stock prices ultimately reflect expected future cash flows,⁵² and traders' expectations are based on publicly available information, the concealment or nondisclosure of material information regarding a company's future prospects may result in an inaccurate stock price.⁵³ So, for example, if a mining company has discovered a major ore strike but no one outside the company knows about the discovery, the stock price of the company, failing to incorporate the news that the company stands to make more money in the future because of the ore discovery, will be inaccurately low.⁵⁴ Stock price inaccuracies may also result from investor misassessment of public information (i.e., from investors improperly

47. Lynn A. Stout, *The Unimportance of Being Efficient: An Economic Analysis of Stock Market Pricing and Securities Regulation*, 87 MICH. L. REV. 613, 640-43 (1988) (focusing on efficient capital allocation as primary social benefit of accurate stock prices and drawing no distinction between overvaluation and undervaluation).

48. *Infra* notes 51-87, 94-120 and accompanying text.

49. *Infra* notes 90-93 and accompanying text.

50. *Infra* notes 121-217 and accompanying text.

51. Kahan, *supra* note 42, at 988 (cataloguing reasons stock prices may deviate from fundamental values).

52. *See supra* note 41 and accompanying text.

53. Kahan, *supra* note 42, at 988. Even adherents of the semi-strong version of the Efficient Capital Markets Hypothesis admit that concealment or nondisclosure of material information may result in stock prices that fail to reflect the true value of the underlying securities. *See, e.g.*, Jonathan R. Macey, *Efficient Capital Markets, Corporate Disclosure, and Enron*, 89 CORNELL L. REV. 394, 418 (2004) (noting that "material nonpublic information" is "not included in the 'semi-strong' form of efficiency").

54. *Cf. SEC v. Tex. Gulf Sulphur*, 401 F.2d 833, 833 (2d Cir. 1968) (holding that, in a similar fact scenario, an employee who withholds such information "must abstain from trading in or recommending securities concerned while such inside information remains undisclosed").

weighing public information in determining their willingness to pay for the stock at issue);⁵⁵ from speculative trading (i.e., from investors determining willingness-to-pay, not by their beliefs about the intrinsic value of the stock, but by their beliefs about what *others* will be willing to pay for the stock in the future);⁵⁶ or from liquidity crunches (i.e., the price-affecting surpluses and shortages that occur when investors engage in speculative trading).⁵⁷

For each of these sources of inaccuracy, information is the antidote. This point should be obvious for inaccuracies caused by nonpublic information, but it is true for the other sources of inaccuracy as well. Misassessment errors can be corrected if those with superior assessment skills—i.e., securities analysts and corporate managers, who know the business best—educate the investing public as to why the stock at issue is mispriced. Periods of speculative trading, which tend to be rather short-lived in any event, can be halted if managers or analysts inform enough traders that the speculation-driven stock price is diverting from true value and is likely to return to a more accurate level. And, of course, mispricing created by a liquidity crunch will be corrected by an

55. Kahan, *supra* note 42, at 989 (“[A] select group of especially skillful investors may arrive at an assessment of fundamental stock value that is consistently more precise than the share price determined by the stock market.”). Note that while this is a possibility, aggregate assessments of worth are normally more accurate than individual assessments of value. See JAMES SUROWIECKI, *THE WISDOM OF CROWDS* 3-39 (2004) (presenting an accessible and highly entertaining assertion of this position); Sanford Grossman, *On the Efficiency of Competitive Stock Markets Where Traders Have Diverse Information*, 31 J. FIN. 573, 573 (1976).

56. Kahan, *supra* note 42, at 990-92. John Maynard Keynes famously articulated this point in his amusing beauty contest analogy:

[P]rofessional investment may be likened to those newspaper competitions in which the competitors have to pick out the six prettiest faces from a hundred photographs, the prize being awarded to the competitor whose choice most nearly corresponds to the average preferences of the competitors as a whole; so that each competitor has to pick, not those faces which he himself finds prettiest, but those which he thinks likeliest to catch the fancy of the other competitors, all of whom are looking at the problem from the same point of view. It is not a case of choosing those which, to the best of one's judgment, are really the prettiest, nor even those which average opinion genuinely thinks the prettiest. We have reached the third degree where we devote our intelligences to anticipating what average opinion expects the average opinion to be. And there are some, I believe, who practice the fourth, fifth, and higher degrees.

JOHN MAYNARD KEYNES, *THE GENERAL THEORY OF EMPLOYMENT INTEREST AND MONEY* 156 (1936).

57. Kahan, *supra* note 42, at 992-93.

information campaign that halts the speculative trading causing the liquidity crunch.

Given that a lack of information is behind practically all instances of stock mispricing, it should not be at all surprising that the bulk of securities mispricing occurs in the direction of overvaluation rather than undervaluation.⁵⁸ Equity overvaluation is more likely to occur and persist than undervaluation because the entities most likely to provide the information that would correct mispricing—corporate managers and stock analysts—are much more likely to do so, and have better tools for doing so, when the mispricing is in the negative direction.

a. *Management Is Less Likely to Correct Overvaluation.* While scholars have articulated persuasive arguments in favor of the view that corporate managers, seeking to protect their reputations for trustworthiness, will have a tendency toward candor,⁵⁹ there are numerous reasons to believe that managers will tend to be systematically optimistic in their portrayals of their corporation's business, and will thus be less likely to correct overpricing than underpricing. As Professor Donald C. Langevoort has explained, corporate managers confront a number of biases and information flow difficulties that, taken together, lead them to highlight price-increasing information while suppressing price-decreasing information.⁶⁰ Moreover, even if managers were motivated to correct overvaluation, they might not be able to do so,

58. See Mark T. Finn et al., *Equity Mispricing: It's Mostly on the Short Side*, 55 FIN. ANALYSTS J. 117 (1999). Utilizing data on price earnings ratios and the level of firm repurchases and issuances of new stock, the authors identified two portfolios of mispriced stocks, one undervalued and one overvalued. *Id.* at 119-20. Whereas the undervalued stocks modestly outperformed the market, the overvalued stocks dramatically underperformed. *Id.* at 120-23. As the article's title indicates, the authors thus concluded that stock mispricing is "mostly on the short side."

59. Cf. Donald C. Langevoort, *Organized Illusions: A Behavioral Theory of Why Corporations Mislead Stock Market Investors (and Cause Other Social Harms)*, 146 U. PA. L. REV. 101, 106 (1997) (noting that, according to conventional economic analysis, "the interests of the company's highest executives are usually (albeit not always) fairly closely aligned with the ongoing interests of the firm, so that the question of why senior managers would engage in secondary-market deception remains an interesting one"); *id.* at 112 ("Senior management's group interests are contractually aligned with the long-term success of the firm as reflected in its share price, and the firm benefits from a reputation for honesty."). See generally Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669, 673-77 (1984) (describing management's interest in its own trustworthiness).

60. See Langevoort, *supra* note 59, at 114-56.

for overvaluation is more difficult to correct than undervaluation.⁶¹

i. *Last Period and Multiple Audience Problems.* Corporate managers may fail to be forthcoming with stock price-correcting bad news because they face “last period” and “multiple audience” problems. The last period problem exists when the undisclosed news is so bad that it might cause insolvency or some kind of managerial shake-up.⁶² If senior managers think the undisclosed bad news will result in company insolvency or in their being fired or demoted, they may decide that the costs to them of misleading disclosures (or omissions) are less than the costs to them of candor.⁶³ Thus, they may forego candor when they possess price-decreasing information, whereas they almost certainly would not do so if the undisclosed news were price-increasing.

The multiple audience problem results from the fact that corporate managers cannot make targeted disclosures of negative information only to shareholders. When managers make a corporate disclosure, they inform not only shareholders, but also other corporate constituencies, such as consumers, employees, and suppliers.⁶⁴ They may, therefore, conceal price-decreasing information in order to protect relationships with those constituencies, even though doing so may injure the firm’s relationship with investors, thereby raising the cost of capital, etc.⁶⁵

ii. *Cognitive and Motivational Biases That Produce Excessive Optimism.* The last period and multiple audience

61. See Jensen, *supra* note 1, at 14-17 (explaining why measures that typically correct undervaluation cannot correct overvaluation).

62. See Jennifer H. Arlen & William J. Carney, *Vicarious Liability for Fraud on Securities Markets: Theory and Evidence*, 1992 U. ILL. L. REV. 691, 724-27 (summarizing data showing that fraud on the market generally occurs when agents are afraid they are in their last period of employment); see also Reinier Kraakman et al., *When Are Shareholder Suits in Shareholder Interests?*, 82 GEO. L.J. 1733, 1760 n.80 (1994) (endorsing the view of Arlen and Carney).

63. Langevoort, *supra* note 59, at 114 (“If the senior management group believes that it faces the threat of company insolvency, with the high probability of group firing, then it will see the tradeoff for not lying as one of the threatened loss of salary, bonuses, and perquisites, plus any personal reputational damage resulting from such a termination.”); Arlen & Carney, *supra* note 62, at 693 (“Fraud on the Market usually occurs when agents fear themselves to be in their last period of employment.”).

64. Langevoort, *supra* note 59, at 116 (“When a company issues a press release, there are many different groups of audience, and no public form of communication is capable of simultaneously delivering one message to investors while sending a completely different message to another group.”).

65. *Id.* at 117 (noting that “fake optimism,” which seems puzzling if viewed only in terms of investor relations, “is not so puzzling if we see the false publicity as directed to other audiences,” such as retailers and customers).

problems explain why even wholly rational managers sometimes refrain from revealing price-decreasing information. Irrational optimism among managers would, of course, exacerbate the situation. Evidence from cognitive psychology suggests that managers may be subject to cognitive and motivational biases⁶⁶ that manifest themselves in an irrational tendency to discount negative corporate developments and to be falsely optimistic about their firms' chances of success.

a. *Confirmatory and Commitment Biases.* Cognitive psychologists have observed that individuals who must process a large volume of information frequently adopt heuristics, or mental shortcuts, to assist them with that task.⁶⁷ Often, those heuristics involve the creation of coherent "stories" into which the individuals attempt to "fit" the information they receive.⁶⁸ Confronted with sufficient inconsistent information, individuals will eventually revise their stories to fit the evidence, but such revision requires the use of scarce cognitive resources and is disfavored. Thus, in an attempt to process information as efficiently as possible, individuals will unconsciously tend to construe information and events in a manner that confirms their prior beliefs, attitudes, and impressions.⁶⁹ For corporate managers, this tendency may result in

66. Cognitive biases result from the fact that individuals are simply incapable of processing the tremendous amount of information available to them (i.e., their rationality is "bounded"). Those biases manifest themselves as mental shortcuts, or "heuristics," designed to permit individuals to process the vast quantities of information they encounter. *Id.* at 134 n.113 ("[Cognitive biases] exist simply to manage complexity and make action possible in a world of bounded rationality."). Motivational biases, by contrast, do not directly assist in cognition but instead help an individual achieve some (perhaps latently) desired end other than mere cognition. *Id.* ("[Motivational] biases exist because they serve some adaptive function not grounded in rationality, and thus are the more likely source of mythic beliefs.").

67. *Id.* at 135 ("A well-documented tendency of people who must operate in noisy informational environments is to adopt heuristic forms of thought.").

68. *See id.* ("Commonly, people build schemas to provide them with 'best available' interpretations.").

69. *See id.* ("When given enough motivation, people will revise their schemas to reflect new information. But processing limits lead to a bias against revision: The normal cognitive strategy is to construe information and events in such a way as to confirm prior attitudes, beliefs, and impressions."). This confirmatory bias, described in the text as a cognitive bias, may have motivational bases as well. At the individual level, revising a story causes anxiety, particularly if the revised story indicates that prior beliefs were mistaken and/or that plans for the future should be revisited. *See id.* at 136 ("Revising a schema is anxiety-provoking, especially if it opens up a host of troubling possibilities."). Accordingly, individuals may be unconsciously averse to evaluating evidence in a way that calls on them to revise their own stories.

a “commitment” bias⁷⁰ under which the managers strongly resist evidence that previously selected courses of action were ill-chosen.⁷¹ The upshot of the confirmatory and commitment biases, of course, is that managers will tend to view new information as confirming prior beliefs and the wisdom of past decisions—which means that they will tend to evaluate new information optimistically.

b. *Illusion of Control.* A second optimism bias stems from the fact that managers officially “control” corporate endeavors. There is substantial empirical support in the psychology literature for the proposition that individuals systematically overrate their own abilities and achievements.⁷² And, of course, if people overrate their own abilities, they will tend to overestimate the likelihood that

With respect to group decision making (the sort that generally occurs in business organizations), story revision is disfavored because of the threat it poses to group cohesiveness. The need to revise a story implies that the group, or, more likely, some portion thereof, was wrong in the past. Thus, group members will have to undergo the stability-threatening process of assigning blame, reallocating responsibilities, etc. Because they typically desire to avoid these stresses, group members will unconsciously tend to construe information in a story-confirming fashion. *Id.* at 138.

70. Langevoort treats the confirmatory and commitment biases as different biases. *See id.* at 135-38, 143. The distinction makes sense if the confirmatory bias is viewed as a cognitive bias (designed to permit the decisionmaker to process large volumes of information) and the commitment bias as a motivational bias (designed to avoid the stresses and other negative effects associated with changing course). *See supra* note 66 (defining cognitive and motivational biases). As noted, however, and as recognized by Langevoort, the confirmatory bias may be conceived of as a motivational bias as well. *See Langevoort, supra* note 59, at 136; *supra* note 69. So conceived, its resemblance to the commitment bias is striking. For present purposes, then, it is sufficient to lump the biases together, for both manifest themselves in a reluctance to change course and therefore result in a tendency to view new information in a decision-confirming (i.e., optimistic) fashion.

71. *See, e.g.,* Philip E. Tetlock et al., *Social and Cognitive Strategies for Coping with Accountability: Conformity, Complexity, and Bolstering*, 57 J. PERSONALITY & SOC. PSYCHOL. 632, 638 (1989) (noting that subjects who committed themselves to particular positions were more concerned with self-justification and engaged in less self-criticism). The confirmatory and commitment biases may result in managers “throwing good money after bad.” For example, some scholars have argued that the commitment bias is a primary cause of the chronic overcapacity that is common in industry. *See* Edward J. Zajac & Max H. Bazerman, *Blind Spots in Industry and Competitor Analysis: Implications of Interfirm (Mis)perceptions for Strategic Decisions*, 16 ACAD. MGMT. REV. 37, 45-47 (1991) (noting that firms may irrationally escalate commitment to expand capacity).

72. Langevoort, *supra* note 59, at 139 (“One of the most robust findings in the literature on individual decision making is that of the systematic tendency of many people to overrate their own abilities, contributions, and talents.”).

decisions they made were “right” and will lead to desirable results.⁷³ The implication in terms of managerial optimism should be clear: managers tend to believe they control their businesses’ affairs, and they therefore tend to overestimate their businesses’ prospects for success.⁷⁴ Moreover, this bias toward optimism is likely stronger in business organizations than elsewhere, for optimists tend to be favored in the hiring process⁷⁵ and in promotion decisions.⁷⁶

c. *General Self-Serving Beliefs.* Whereas self-aggrandizement is an indirect end of the confirmatory, commitment, and control biases,⁷⁷ some patterns of inference pursue self-promotion more directly. The self-serving inference, well-recognized by cognitive psychologists, manifests itself in a general tendency to “see what one wants to see.”⁷⁸ What one wants to see, of course, is something that is in her self-interest and is not threatening to her self-esteem or career prospects.⁷⁹ Thus, as Langevoort explains, “Management groups may subconsciously perceive information in a way, if at all possible, that permits them to maintain consistency

73. See MAX H. BAZERMAN, *JUDGMENT IN MANAGERIAL DECISION MAKING* 33 (4th ed. 1998) (discussing overconfidence among managers and summarizing experiment in which a sample of people who expressed near total certainty that their judgments were right (1000-to-1 odds) were in fact right only about 81% to 88% of the time).

74. See J.B. Heaton, *Managerial Optimism and Corporate Finance*, 2002 *FIN. MAN.* 33, 33, available at <http://ssrn.com/abstract=71411> (“[P]eople are more optimistic about outcomes that they believe they can control. Consistent with this first experimental finding, survey evidence indicates that managers underplay inherent uncertainty, believing that they have large amounts of control over the firm’s performance . . .”).

75. See Langevoort, *supra* note 59, at 140 (noting that “[o]ptimists are prized in the hiring process” and observing that numerous corporations utilize hiring tests designed by a leading research psychologist to assess high levels of optimism).

76. See *id.* (“[T]here is good reason to believe that the tournament-like competition for promotion up the executive ladder overweights optimism and its associated behavioral traits, inflating such behavior toward the top of the hierarchy.”).

77. Under the confirmatory and commitment biases, prior beliefs and decisions are elevated, suggesting that the decisionmaker was wise in the past. The illusion of control is manifested in beliefs that the decisionmaker controls things and does so well and is therefore praiseworthy.

78. See Peter H. Ditto & David F. Lopez, *Motivated Skepticism: Use of Differential Decision Criteria for Preferred and Nonpreferred Conclusions*, 63 *J. PERSONALITY & SOC. PSYCHOL.* 568, 568 (1992) (analyzing “the notion that people are less skeptical consumers of desirable than undesirable information”); see also THOMAS GILOVICH, *HOW WE KNOW WHAT ISN’T SO* 75-87, 76 (1991) (discussing the “tendency for people to believe . . . what they want to believe”).

79. Langevoort, *supra* note 59, at 144.

with their self-image of efficacy and control, thereby justifying (to themselves and others) preservation of their positions and status.”⁸⁰ This implies that management will tend to ignore negative (price-decreasing) information or irrationally spin it positively.

Taken together, the confirmatory, commitment, control, and general self-serving biases will tend to prevent even fully informed managers from accurately perceiving (and thus from accurately disclosing) price-decreasing information.⁸¹ Perhaps more importantly, managers cannot reveal information of which they are not aware, and they are less likely to learn of price-decreasing information than of price-increasing information.

iii. *Corporate Information Flow and Managerial Ignorance.*

Much of the information concerning the success of a firm’s endeavors—particularly non-quantifiable, “soft” information, such as the degree of consumer enthusiasm for new products, the progress of products through the research and development pipeline, etc.—is not immediately available to the firm’s senior managers. Instead, the agents with the most direct access to this information tend to be non-managerial employees and low- to mid-level managers.⁸² Senior managers, then, must rely on their underlings to provide them with information regarding crucial aspects of the firm’s prospects. The “upward” information flow from non-managerial employees and middle-managers to top management poses a difficult problem for large business organizations, which must devise means for ensuring orderly information flow.⁸³

80. *Id.*

81. One might wonder, of course, why market forces would not weed out those corporations (or those managers) that tend toward false optimism. *See id.* at 148 (“[S]hould we not expect those firms with unrealistic belief systems that do not learn from their errors to disappear, leaving only those that have successfully countered the problem of cognitive bias?”). Langevoort suggests that these managerial biases may persist, despite the competitive environments in which businesses operate, because “punishment” of irrational firms takes too long to provide effective discipline. *See id.* at 151 (noting that “because of variations in the intensity of competition, we cannot assume that firms with bias-filled cultures will necessarily die quickly” and that therefore “biases may persist for unusually long periods of time”). He also suggests the biases may be adaptive. *See id.* at 152-56 (“Put simply, there is reason to suspect that firms that inculcate certain types of [optimistic] belief systems may in many settings be competitively superior to those that are more doggedly ‘realistic.’”).

82. *See, e.g.,* Jane E. Dutton et al., *Reading the Wind: How Middle Managers Assess the Context for Selling Issues to Top Managers*, 18 STRATEGIC MGMT. J. 407, 407 (1997) (“It is often middle managers rather than the top managers who have their hands on the ‘pulse of the organization’ . . .”).

83. *See* Manne, *supra* note 25, at 14 (“Top-level managers are regularly beset with enormous problems of getting appropriate, truthful, and timely

The problem is that there is a danger at each stage of the information-relay system that material information will be suppressed or exaggerated in some fashion, as each information-provider will be tempted to tweak his message to conform to his self-interest.⁸⁴ Seeking promotion or other rewards, he has an incentive to inform his superiors of every bit of value-enhancing information of which he is aware.⁸⁵ By contrast, if he knows his endeavors are not going as well as expected, he may positively spin that information or keep it to himself in the hope that things will turn around soon.⁸⁶ By the time the price-affecting information reaches the senior managers in charge of corporate disclosure, it is likely to have been “massaged” so as to make underlings look good.⁸⁷ In other

information for making decisions”); see also KENNETH J. ARROW, *THE LIMITS OF ORGANIZATION* 33-43 (1974) (discussing difficulties of information flow within organizations); MERRITT B. FOX, *FINANCE AND INDUSTRIAL PERFORMANCE IN A DYNAMIC ECONOMY* 118 (1987) (“Ideas relating to the . . . financial decisions of top management . . . are likely to be processed as they make their way toward the top managers of a firm.”); Stephen M. Bainbridge, *Privately Ordered Participatory Management: An Organizational Failures Analysis*, 23 DEL. J. CORP. L. 979, 1013-14 (1998) (summarizing types of information-transmission problems corporate managers confront).

84. See Langevoort, *supra* note 59, at 120 (“[I]f material information must pass through a number of relay points in a hierarchy, the message can change (and lose accuracy) in the process.”).

85. See *id.* at 121 (noting that “[c]ompensation is often subjective and set by the immediate supervisor,” so that “the natural reporting temptation is to transmit information in a way that minimizes the potential for blaming oneself for bad news, and to convey as much good news as possible to the extent that the information can be attributed to the source—consistent, of course, with a general desire to have a reputation for credibility with one’s superiors”); see also Martha S. Feldman & James G. March, *Information in Organizations as Signal and Symbol*, 26 ADMIN. SCI. Q. 171, 176 (1981) (“Information is gathered and communicated in a context of conflict of interest and with consciousness of potential decision consequences. Often, information is produced in order to persuade someone to do something.”).

86. The danger that underlings will keep negative information to themselves is heightened in firms that have attempted to achieve orderly information flow by instructing underlings to distinguish between the unusual and the usual and to limit information flow to the former. See Roy Radner, *Hierarchy: The Economics of Managing*, 30 J. ECON. LITERATURE 1382, 1403-04 (describing the reporting rule of “management by exception”). An underling who may choose which information is unusual may exercise this discretion to suppress negative information.

87. See Dutton et al., *supra* note 82, at 409 (“[P]eople tend to control . . . information about themselves that will affect others’ perceptions of them.”); see also R. Joseph Mosen, Jr. & Anthony Downs, *A Theory of Large Managerial Firms*, 73 J. POL. ECON. 221, 236 (1965) (asserting that “[m]anagers are ‘economic men’ who desire to maximize their own lifetime incomes” and that large firms develop bureaucratic structures that “tend to . . . provide biased

words, it is likely to be positively biased. Unaware of negative information, the senior managers in charge of corporate disclosures can neither directly disclose the bad news nor factor it into their more general forecasts.

iv. *Difficulty of Correction.* Even if corporate managers were as likely to perceive overvaluation as undervaluation and were equally motivated to correct both forms of mispricing, they would be more likely to correct undervaluation than overvaluation because they have more effective means of doing so. Consider a manager confronted with evidence that her company is undervalued. She might issue a press release explaining why the market was undervaluing her firm, or she could initiate a stock repurchase, thereby signaling management's strong belief that the stock is undervalued.⁸⁸ Managers finding undervalued equity to be a chronic problem could adopt equity-based compensation schemes for executives (e.g., payment in stock or stock options).⁸⁹

A manager confronting overvalued equity, by contrast, is somewhat strapped. As a practical matter, managerial candor is not an option, for a manager who directly announced to the market that his corporation's stock was overpriced probably would not keep his job for very long.⁹⁰ Nor could the manager correct the mispricing by engaging in a sale transaction that would send the reverse signal of a stock repurchase. Whereas the signal sent by a stock buy-back is relatively unambiguous, a sale transaction designed to signal

information to top management which reflects its own desires and ideas too strongly") (emphasis omitted).

88. See Ok-Rial Song, *Hidden Social Costs of Open Market Share Repurchases*, 27 J. CORP. L. 425, 445 (2002) ("[S]ince a stock buyback announcement signals management's information about their company's undervaluation, the stock price rises in response to revelation of this information.").

89. Cf. John C. Coffee, Jr., *What Caused Enron? A Capsule Social and Economic History of the 1990s*, 89 CORNELL L. REV. 269, 275-76 (2004) (observing that equity-based compensation, which grew as a percentage of the compensation of CEOs of public corporations from five percent in 1990 to over sixty percent in 1999, "induce[s] management to obsess over their firm's day-to-day share price").

90. Jensen contends that boards of directors would not take kindly to managerial candor aimed at correcting overvaluation. He explains:

How could [a manager of an overvalued firm] argue to [his] board that a major effort must be made to *reduce* the price of the stock? In the last 10 years there has simply been no listening in boards for this problem. The likely result for any CEO in this situation is that the board would respond by saying: "If you cannot do it we will get someone who can."

Jensen, *supra* note 1, at 10.

overvaluation (e.g., an equity offering or a sale of treasury shares the corporation previously purchased) is much noisier. It could easily be interpreted as a means of raising capital for some sort of corporate undertaking. And, of course, equity-based compensation, which helps prevent undervaluation, exacerbates overvaluation by inducing managers to drive the share price higher even when they know the company is overvalued.⁹¹ Finally, the market for corporate control, which provides a final stop-gap against undervaluation,⁹² cannot remedy overvaluation. As Professor Michael C. Jensen has observed, “[i]t is difficult, to say the least, to buy up an overvalued company, eliminate its overvaluation, and make a profit.”⁹³ Thus, there is an asymmetry in the degree to which managers and market forces are able to correct the different species of mispricing: the primary options available for correcting negative mispricing are not practically available when the mispricing is in the positive direction.

b. *Analysts Are Less Likely to Correct Overvaluation.* Managers, of course, are not the only potential source of price-correcting information about a company whose stock is mispriced. Professional stock analysts make a career out of discovering instances of over or undervaluation and advising their clients to trade accordingly.⁹⁴ These highly skilled analysts are afforded tremendous access to corporate information and thus ought to be able to identify and inform the market of overvaluation.⁹⁵

Empirical evidence indicates, though, that analysts’ projections

91. See *id.* at 14 (“[E]quity-based incentives are like throwing gasoline on a fire—they make the problem [of overvaluation] worse, not better.”).

92. *Id.* (“The market for corporate control solved many of the problems of undervalued equity in the 1970s and 1980s through hostile takeovers, leveraged buyouts, and management buyouts.”).

93. *Id.*

94. All the major Wall Street brokerage firms and investment banks employ teams of equity analysts, called “sell-side” analysts because they work for brokerage firms rather than institutional clients such as mutual funds and hedge funds, who are charged with monitoring the performance of major companies and reporting on their potential investment value. See John R. Kroger, *Enron, Fraud, and Securities Reform: An Enron Prosecutor’s Perspective*, 76 U. COLO. L. REV. 57, 98 n.198 (2005) (describing role of sell-side analysts). The analysts make concrete and specific investment recommendations for the stocks they cover. The most common rating system involves five recommendations: “strong buy,” “buy,” “hold,” “sell,” and “strong sell.” *Id.* at 99 n.199.

95. See *id.* at 99 (“Wall Street equity analysts typically have numerous opportunities to question management about their corporations, through quarterly management conference calls, annual analyst meetings, and frequent interactions with the corporation’s investor relations staff.”).

are optimistically biased,⁹⁶ and recent stock market events suggest that analysts are not very effective at publicizing overvaluation. Consider, for example, analysts' treatment of Enron Corporation, whose bankruptcy on December 2, 2001, was, at the time, the largest ever.⁹⁷ In the fall of 2001, each of the fifteen largest Wall Street firms covering Enron's stock had buy recommendations in place.⁹⁸ As late as October 26, 2001—*after* Enron's CFO had been forced to resign,⁹⁹ the SEC had initiated an Enron investigation,¹⁰⁰ and the *Wall Street Journal* had run several stories about Enron's earnings management problems¹⁰¹—ten of the fifteen largest Wall

96. See, e.g., David N. Dreman & Michael A. Berry, *Analyst Forecasting Errors and Their Implications for Security Analysis*, 51 FIN. ANALYSTS J. 30 (1995); Scott E. Stickel, *Predicting Individual Analyst Earnings Forecasts*, 28 J. ACCOUNTING RES. 409 (1990). The optimism bias to which analysts are subject is vividly illustrated by events that occurred at Merrill Lynch between 1999 and 2002. See Affidavit of Eric R. Dinallo in Support of Application for an Order Pursuant to General Business Law Section 354 (April 2002) (affidavit of Assistant Attorney General of State of New York in Spitzer v. Merrill Lynch et al.), available at <http://www.oag.state.ny.us/press/2002/apr/MerrillL.pdf>. Without explanation, Merrill Lynch's Internet Research Group decided to stop issuing "reduce" and "sell" recommendations. *Id.* at 8-10. Moreover, Merrill analysts issued highly positive recommendations on stocks they were contemporaneously describing internally as "piece[s] of crap," "piece[s] of junk," and "piece[s] of shit." *Id.* at 13.

97. See BankruptcyData.com, The 15 Largest Bankruptcies 1980–Present, http://www.bankruptcydata.com/Research/15_Largest.htm (last visited Nov. 20, 2006). Enron's bankruptcy was eventually eclipsed by that of WorldCom, Inc. some eight months later. *Id.*

98. STAFF OF THE S. COMM. ON GOVERNMENTAL AFFAIRS, 107TH CONG., FINANCIAL OVERSIGHT OF ENRON: THE SEC AND PRIVATE-SECTOR WATCHDOGS 55 (Comm. Print 2002). Professor John Coffee maintains that the analysts should have known better:

[A]s of December 31, 2000, Enron already had a stock price that was seventy times earnings and six times its book value, and had earned an 89% return for the year (despite a 9% decrease over the same period for the S&P 500 index). Such a profile should have alerted any analyst who was even half awake to the possibility that Enron was seriously overvalued.

John C. Coffee, Jr., *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 B.U. L. REV. 301, 316 (2004).

99. Enron CFO Andy Fastow was forced to resign from his position on October 24, 2001. See BETHANY MCLEAN & PETER ELKIND, *THE SMARTEST GUYS IN THE ROOM* 377 (2003).

100. The SEC began an informal inquiry into Enron's earnings management on October 17, 2001. Enron publicly announced the informal probe on October 22, 2001, and its stock price immediately sank twenty percent. *Id.* at 371-72.

101. Beginning on October 17, 2001, the *Wall Street Journal* ran a series of articles suggesting that Enron's financial statements were misleading. See John Emshwiller & Rebecca Smith, *Enron Jolt: Investments, Assets Generate*

Street firms covering Enron maintained buy recommendations,¹⁰² as did fifteen of seventeen top Wall Street analysts surveyed by Thompson Financial/First Call.¹⁰³ And Enron was no outlier. Indeed, the ratio of buy to sell recommendations has recently been as high as 100-to-1,¹⁰⁴ and in the period immediately preceding a 60% drop in the NASDAQ, only 0.8% of analysts' recommendations were sell or strong sell.¹⁰⁵ Thus, the evidence suggests that analysts, quick to report undervaluation by issuing buy recommendations, are less responsive to mispricing in the positive direction.

How could analysts fail so miserably in identifying and informing the market of overvaluation? The most plausible answer is that stock analysts, like corporate managers, face a set of incentives that systematically biases them toward optimism.¹⁰⁶ Most stock analysts are employed by firms that make the lion's share of their money by providing brokerage and investment banking services.¹⁰⁷ The brokerage side of those firms benefits when stocks

Big Loss, WALL ST. J., Oct. 17, 2001, at C1; Rebecca Smith & John R. Emshwiller, *Enron CFO's Partnership Had Millions in Profit*, WALL ST. J., Oct. 19, 2001, at C1; Rebecca Smith & John R. Emshwiller, *Partnership Spurs Enron Equity Cut*, WALL ST. J., Oct. 18, 2001, at C1; Rebecca Smith & John R. Emshwiller, *SEC Seeks Information on Enron Dealings with Partnerships Recently Run by Fastow*, WALL ST. J., Oct. 23, 2001, at A3.

102. Kroger, *supra* note 94, at 102.

103. Susanne Craig & Jonathan Weil, *Heard on the Street: Most Analysts Remain Plugged In to Enron*, WALL ST. J., Oct. 26, 2001, at C1; *see also* Kroger, *supra* note 94, at 102 n.213.

104. Coffee, *supra* note 98, at 316-17.

105. Gene D'Avolio et al., *Technology, Information Production, and Market Efficiency* 14 (Harvard Inst. for Economic Research, Discussion Paper 1929, 2001), available at <http://ssrn.com/abstract=286597>.

106. In addition to these incentive-based biases toward optimism, analysts might confront selection biases or cognitive biases that push them to view a company's prospects optimistically. Selection bias may be a problem if analysts follow only stocks that they recommend and refrain from issuing forecasts on stocks they do not like. *See generally* Maureen McNichols & Patricia C. O'Brien, *Self-Selection and Analyst Coverage*, 35 J. ACCOUNTING RES. 167 (1997) (finding that stock analysts add coverage of stocks when their information is favorable and drop coverage when their information is unfavorable). Cognitive bias may be a problem if an analyst becomes too attached to a stock she covers, or too committed to a positive story she once told about a then-hot stock. *See* Harrison Hong, *Seeing Through the Seers of Wall Street: Analysts' Career Concerns and Biased Forecasts* (May 2004) (Princeton Working Paper), available at <http://www.princeton.edu/~hhong/seers.pdf> (noting possibility of selection and cognitive/behavioral biases but concluding that primary source of analyst bias is career concern).

107. While there are "non-affiliated" analysts who have no relation with investment banks, they play a relatively minor role in advising investors. Some have questioned whether the market would support analysts if not for the role

change hands, and optimistic “buy” recommendations, which may be acted upon by a larger group of investors, are more likely to generate trading activity than “sell” recommendations.¹⁰⁸ More importantly, the more lucrative investment banking side of a brokerage firm’s business¹⁰⁹ benefits from optimistic analyst reports.¹¹⁰

Issuers of securities want to make sure that the analysts

they played in selling securities. Consider, for example, the remarks of David M. Becker, then General Counsel of the SEC:

It’s also an open question in my mind whether the public wants to pay what it costs to get analysts whose bias is beyond question. Some independent research firms are thriving. Still, I would be interested in finding out whether truly independent analysis is a bit like legroom in an airplane. Everyone likes it; people complain about the lack of it; but when push comes to shove there aren’t that many people willing to pay for it.

David M. Becker, Gen. Counsel, SEC, Remarks Before the Committee on Federal Regulation of Securities of the American Bar Association: Analyzing Analysts 4 (Aug. 7, 2001) *available at* <http://www.sec.gov/news/speech/spch510.htm>; *see also* Kroger, *supra* note 94, at 103 (“There is, however, no real direct market for equity research.”); Jill E. Fisch & Hillary A. Sale, *The Securities Analyst as Agent: Rethinking the Regulation of Analysts*, 88 IOWA L. REV. 1035, 1045 (2003).

108. One might initially think that any stock recommendation other than a “hold” would benefit a firm’s brokerage business, for a negative recommendation (e.g., “strong sell”) would generate sales by customers who would utilize brokers. Positive recommendations are more likely, however, to generate significant brokerage income. Whereas a “buy” or “strong buy” recommendation can be acted upon by any investor, a “sell” or “strong sell” recommendation can be acted upon only by individuals who currently own the stock at issue or are willing to engage in a short sale or to purchase a put option. Because the latter group is significantly smaller than the former, a positive recommendation is likely to generate more trading activity, and thus more brokerage income, than a negative recommendation. *See* Coffee, *supra* note 98, at 317 n.43 (“[A] buy recommendation addresses the entire market and certainly all the firm’s customers, while a sell recommendation addresses only those customers who own the stock (probably well under one percent) and those with margin accounts who are willing to sell the stock short.”). Thus, analyst optimism will be favored by firms that have large brokerage operations.

109. Income from brokerage operations is a small and apparently shrinking portion of the business of most firms that employ analysts; the real money is in the investment banking side of the business. *See* Fisch & Sale, *supra* note 107, at 1046 (“Because of the elimination of fixed commissions and intense competition in commission levels, commission revenue currently reflects a relatively minor component of brokerage-firm revenue. For most major firms, investment banking revenue is far more significant.”).

110. *See* Kroger, *supra* note 94, at 103 (“[B]anks and brokers make money from research indirectly, in two ways: research leads to increased equity transactions for firm brokers, and it helps firm investment bankers sell their financial services to major corporations.”).

employed by their investment bank will drum up investor enthusiasm for the issue, so as to command the highest price possible.¹¹¹ They also want to ensure that the analysts continue to support the stock after the offering so that it increases in value.¹¹² Managers thus carefully consider the optimism and enthusiasm of an investment bank's analysts in determining whom to hire. Indeed, CEOs report that the reputation of the analyst covering the relevant industry is an important determinant of their choice of an underwriter for their companies' initial public and seasoned equity offerings.¹¹³ Analysts' employers therefore have an interest in assuring that their analysts issue rosy reports.¹¹⁴

Empirical evidence suggests that the employers have structured their promotion and compensation schemes accordingly. Attempting to discover whether analysts that issued optimistic predictions were rewarded with better jobs or assignments, Professors Harrison Hong

111. See Becker, *supra* note 107, at 3 ("To be most attractive to a prospective underwriting client, an analyst has to convince the client that he is enthusiastic about the issuer's prospects and that he can sow his enthusiasm among potential investors."); Fisch & Sale, *supra* note 107, at 1047 ("The issuer wants coverage from the analyst because a 'rousing endorsement from a highly ranked analyst' is believed to send the stock of a 'fledging' company into 'orbit.'") (quoting Jeffrey M. Laderman, *Wall Street's Spin Game*, BUS. WK., Oct. 5, 1998, at 148, 152).

112. See Fisch & Sale, *supra* note 107, at 1047 ("A firm also enhances the attractiveness of its investment banking services if it can provide continued analyst coverage that will help to maintain the price of the securities subsequent to the offering."). One might expect an issuer to be *disappointed* by post-offering price appreciation, which would seem to imply that the offering price was set too low and that the issuer was thus deprived of capital it might otherwise have raised. Ironically, however, corporations tend to view offerings as successful if the post-offering stock price increases. See Stout, *supra* note 47, at 662 ("[A]necdotal evidence suggests that management regards an initial public offering as 'successful' if the price of the issue in the aftermarket rises substantially above the offering price."). This reasoning may make sense if managers are issuing stock for reasons other than simply to raise capital as cheaply as possible; they might, for example, be more concerned with enhancing their or their firm's status and prestige, with creating a public market for insiders' shares, or with increasing their firm's ability to acquire other businesses for stock instead of cash. *Id.* at 663.

113. Hong, *supra* note 106, at 2-3.

114. Thus, Morgan Stanley's managing director of corporate finance famously stated in an internal memorandum:

Our objective is . . . to adopt a policy, fully understood by the entire Firm, including the Research Department, that we do not make negative or controversial comments about our clients as a matter of sound business practice. . . . Again, the philosophy and practical result needs to be "no negative comments about our clients."

The Rohrbach Memo: 'No Negative Comments,' WALL ST. J., July 14, 1992, at A6.

and Jeffrey D. Kubik analyzed the earnings forecasts and employment histories of 12,000 analysts working for 600 brokerage houses between 1983 and 2000.¹¹⁵ They found that analysts were “systematically rewarded for being optimistic as long as the optimism [was] within a range of accuracy that maintain[ed] the credibility of [the] analysts.”¹¹⁶ They also found that relatively optimistic analysts were much less likely to be fired or to leave a top brokerage house, and were much more likely to be hired by a better house.¹¹⁷ They were also given better assignments than their more pessimistic (realistic?) colleagues.¹¹⁸ For analysts covering stocks underwritten by their brokerage houses, the connection between forecast accuracy and career advancement was significantly more attenuated, and the dependence of career prospects on forecast optimism was significantly larger.¹¹⁹ It thus seems that analysts’ personal incentives have been aligned with the incentives of their employers—i.e., to issue enthusiastic and optimistic recommendations. Accordingly, analysts cannot be counted on to provide investors with the “bad news” necessary to correct instances of overvalued equity.¹²⁰

2. *Overvaluation Is More Harmful to Investors Than Is Undervaluation*

Of course, it would matter little that managers and analysts are

115. Harrison Hong & Jeffrey D. Kubik, *Analyzing the Analysts: Career Concerns and Biased Earnings Forecasts*, 58 J. FIN. 313, 315 (2003).

116. Hong, *supra* note 106, at 4 (summarizing the findings of Hong & Kubik, *supra* note 115).

117. *Id.*

118. *Id.*

119. *Id.* at 5.

120. It is no answer to say that the market will see through rosy analyst reports. As an initial matter, the empirical evidence (although sparse) suggests that the market does not see through these biased reports. Roni Michaely & Kent L. Womack, *Conflict of Interest and the Credibility of Underwriter Analyst Recommendations*, 12 REV. FIN. STUD. 653, 671-78 (1999) (providing empirical evidence suggesting that market has failed to discount excessive analyst optimism). Perhaps this is because the sophistication of the marginal investor is diminishing, *see* D’Aviolo et al., *supra* note 105, at 2-3, which decreases the likelihood that bias will be recognized. The market may eventually learn to discount analyst optimism (investor sophistication can hardly diminish indefinitely), but at this point, the marginal investor is apparently somewhat ignorant of the fact that analyst reports are biased. Ultimately, though, whether the market will or will not see through rosy analyst reports is irrelevant to the matter at hand. The point here is that analysts cannot be counted upon to provide price-decreasing information to correct stock overvaluation. Even if they do not *exacerbate* the problem (because the market discounts what they are saying), they certainly do not help alleviate it.

unlikely to correct overvaluation, and thus the argument for liberalizing price-decreasing insider trading would be weak, if overvaluation caused little harm to investors or to society in general. And one might initially wonder how overvaluation could cause *any* harm to investors, who generally want the market to value the stocks in their portfolios as highly as possible. It is therefore useful to examine the harms investors suffer as a result of stock mispricing. Such examination reveals that equity overvaluation causes greater investor harm than equity undervaluation.

a. *Greater Allocative Inefficiency.* Most commentators considering the costs of inaccurate stock prices have focused on the allocative inefficiency caused by mispricing.¹²¹ In a market economy, decisionmakers look to prices in determining how to allocate resources to their most highly valued uses.¹²² Inaccurate securities prices are generally considered to be undesirable because they result in an improper channeling of investment capital.¹²³

121. See, e.g., Stout, *supra* note 47, at 640-41 (“Commentators who stop to address the question [of why informationally efficient markets are desirable] generally conclude that informational efficiency—which addresses only the market’s speed in adjusting prices to new information—is desirable because it serves allocative efficiency—the proper allocation of scarce resources among competing alternate uses.”); Carlton & Fischel, *supra* note 3, at 866 (“The more accurately prices reflect information, the better prices guide capital investment in the economy.”); John C. Coffee, Jr., *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 VA. L. REV. 717, 734 (1984) (observing that securities prices are important “not so much because of their distributive consequences on investors but more because of their effect on allocative efficiency”); Merritt B. Fox, *Shelf Registration, Integrated Disclosure, and Underwriter Due Diligence: An Economic Analysis*, 70 VA. L. REV. 1005, 1015 (1984) (noting benefits of accurate prices in efficient market); David J. Schulte, *The Debatable Case for Securities Disclosure Regulation*, 13 J. CORP. L. 535, 539-42 (1988) (arguing that securities prices are important because of their effect on allocative efficiency). *But see* Stout, *supra* note 47, at 643-68 (arguing that benefits of efficient stock prices have been overstated).

122. See Hayek, *supra* note 34, at 526 (discussing how the price mechanism leads to an efficient allocation of resources throughout the economy).

123. Consider an economy with two firms—one with high expected future earnings and the other with the same assets but lower expected future earnings. More total wealth will be created if money from investors is allocated to the former firm, which will generate more value in the long run. If stock prices accurately reflect the discounted expected value of each company’s future earnings, the stock of the former company will be priced higher than that of the latter, and the former company will raise more money than the latter by selling the same percentage of its equity. Investment capital will therefore migrate in the right direction. If, however, stock prices are inaccurate—say, a ten percent share of the former company is priced the same as a ten percent share of the latter—then investment resources are unlikely to be channeled to their highest

While one might initially expect undervaluation and overvaluation to create allocative inefficiencies of similar magnitude, overvaluation likely causes greater allocative inefficiency than undervaluation. A firm whose stock is undervalued can raise the capital it needs to fund expenditures by tapping funding sources besides the equity markets.¹²⁴ For example, it can raise money through corporate borrowing. While some have argued that the corporation with a high and rising stock price can borrow more at a lower cost of capital than the corporation whose stock is declining,¹²⁵ the connection between stock price and borrowing ability seems tenuous.¹²⁶ First, managers of firms with undervalued stock prices can explain to lenders why their stock price is not reflective of future earnings. If they have a compelling story, they should be able to borrow the funds they need.¹²⁷ Moreover, the banking literature indicates that lenders measure loan risk—and thus determine the amount they are willing to lend and the interest rate they will charge—by comparing the corporation's outstanding debt to the value of its assets, not the market price of its stock.¹²⁸ In short, managers of a firm whose stock is undervalued can and likely will correct the problem with capital providers and will eventually get what they need, albeit perhaps at a higher cost. By contrast, management of an overvalued firm has no incentive to "correct" the mispricing when dealing with capital providers, and empirical research (discussed below) indicates that managers are more likely to cause their firm to issue equity when it

and best use.

124. See Stout, *supra* note 47, at 645 (noting that "[c]orporations can finance their projects through a number of means other than issuing stock," including "internally generated revenues" and "[a] host of forms of debt"). Stout adds:

The argument that efficient stock markets are essential to allocate properly investment capital assumes that, despite a plethora of alternate financing sources, corporations rely primarily on stock issues for raising funds. That assumption is at odds with actual corporate financing behavior. In fact, firms largely appear to avoid the stock market as a source of funding.

Id. at 645-46.

125. See, e.g., WILLIAM J. BAUMOL, *THE STOCK MARKET AND ECONOMIC EFFICIENCY* 81 (1965); HOMER KRIPKE, *THE SEC AND CORPORATE DISCLOSURE* 123 (1979).

126. See Stout, *supra* note 47, at 648-51 (arguing that stock prices play little influence in decisions to extend credit).

127. *Id.* at 649-50 ("The bank that readily lends on the basis of high share value unsupported by assets or revenues is unlikely to stay in the banking business long. Nor would rational lenders be deterred by depressed stock prices if the assets and revenues to support the loan exist.").

128. See *id.* at 650 & n.202 (citing numerous sources from banking literature).

is overvalued.¹²⁹ Thus, overvaluation may ultimately cause greater allocative inefficiency than undervaluation.

This social cost of overvalued equity, though, is not much of a “harm” to the shareholders of the mispriced firm. While society as a whole may be worse off because of the allocative inefficiency resulting from a firm’s overvaluation, that inefficiency results because the firm is able to raise more money at a given cost than it ought to be able to raise.¹³⁰ Any harm the firm’s shareholders experience by virtue of the allocative inefficiency injected into the economy as a whole is dwarfed by the immediate benefit they receive from the firm’s enhanced ability to raise capital.¹³¹ Thus, concern about inefficient allocation of investment capital occasioned by their firm’s overvaluation likely would not cause shareholders to value protection from overvaluation.

But shareholders might value such protection, and pay a premium for it, if overvaluation causes other costs that are concentrated more completely on shareholders. That appears to be the case. Recent economic events suggest that stock overvaluation causes at least three types of inefficiency that, unlike the inefficient allocation of investment capital, are borne primarily by the shareholders of an overvalued firm. First, overvaluation increases the agency costs involved in running a corporation. In addition, it saddles investors with expected reliance costs that tend to exceed the expected reliance costs occasioned by equity undervaluation. Finally, it increases the costs of monitoring managerial performance.

b. *Greater Agency Costs.* Agency costs are the costs that arise from individuals’ cooperative efforts.¹³² They appear whenever any principal hires an agent to act on his behalf, for the agent will

129. See *infra* note 179 and accompanying text.

130. Carlton and Fischel recognized the flip-side of this assertion—i.e., that accurate stock prices are beneficial to society as a whole, but not necessarily to individual firms or their investors. See Carlton & Fischel, *supra* note 3, at 866-67 (“From the perspective of an individual firm, however, efficient capital markets are a public good, unless private, as opposed to social, gains accrue to the firm when the prices of its own securities convey accurate information.”).

131. While this total benefit is smaller than the total cost associated with the firm’s overvaluation, the shareholders capture all the benefit but externalize much of the cost. Thus, their individual benefit from overvaluation likely exceeds, at least in the short-term, the harm they suffer as participants in the larger economy.

132. Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 J. FIN. ECON. 305, 309 (1976) (noting that “agency costs arise in any situation involving cooperative effort”).

always have an incentive to act opportunistically or to shirk (which is, of course, a form of opportunism), and the principal must therefore take steps to prevent or insure against such behavior.¹³³ Agency costs may thus be defined as the sum of the contracting, monitoring, and bonding costs incurred to reduce the conflicts of interest between principals and agents, plus the residual loss that occurs because it is generally impossible to perfectly identify the interests of agents and their principals.¹³⁴ In a corporation, agency costs arise because the directors, officers, and other managers charged with running the corporation's business have interests that conflict with the corporation's residual claimants, the shareholders.¹³⁵ While capital markets generally operate as a powerful tool for minimizing agency costs (because firms that have developed effective mechanisms for lowering such costs will be most attractive to investors),¹³⁶ recent economic developments suggest that, when equity becomes overvalued, securities markets tend to exacerbate agency costs.¹³⁷

A corporation's expected agency costs are a function of two factors: the likelihood that managers and investors will have divergent interests¹³⁸ and the magnitude of investor loss that will result if managers put their own interests ahead of investors'.¹³⁹ Because (1) overvaluation is more likely than undervaluation to cause managers' interests to diverge from those of investors and (2) the investor loss occasioned by managers' pursuing their own, rather

133. *Id.* at 308.

134. *Id.* at 308-09.

135. *See, e.g.*, David A. Skeel, Jr., *An Evolutionary Theory of Corporate Law and Corporate Bankruptcy*, 51 VAND. L. REV. 1325, 1332 (1998) ("If the managers (the agents of shareholders and the corporation) pursue their own interests—such as leisure or perks, or their own prestige—rather than the interests of shareholders (the principal), shareholders suffer the consequences.").

136. Jensen, *supra* note 1, at 6 (noting that markets have been viewed as "potent forces to help control agency costs"). Labor markets also help control agency costs, for managers who do not pursue their own interests at shareholder expense will be favored in the inter-firm competition for managerial talent.

137. *Id.* (describing "how securities markets can sometimes create and exacerbate conflicts of interest between managers and owners rather than resolve them").

138. The greater the likelihood of diverging interests, the greater the expected agency costs.

139. Acts of managerial opportunism differ in the degree to which they create loss for investors. For example, a manager who violates his duty of loyalty by causing the corporation to give \$50,000 to a pet charity creates less investor loss (i.e., destroys less corporate value) than a manager who causes the corporation to give \$50,000 to a firm that is developing a technology that will compete with that sold by the investor corporation.

than investors', interests is likely to be greater when stock mispricing is in the positive direction, overvaluation is likely to generate significantly higher agency costs than undervaluation. To see this point, compare undervalued and overvalued firms in terms of the likelihood of divergence between managers' and stockholders' interests and the degree of shareholder loss stemming from managerial opportunism.

i. *Agency Costs in the Undervalued Firm.* When a firm's equity is undervalued, the incentives of shareholders and managers are likely to be closely aligned: both groups will usually want to increase stock price so that it reflects fundamental value. Shareholders will desire this result because price appreciation adds to their long-term wealth¹⁴⁰ and enhances the corporation's overall health (and thus its value) by making it easier for the firm to raise large sums of money in the capital markets. Managers will typically want this result because (1) it is more prestigious to run a company with a relatively high stock price than one with a relatively low stock price,¹⁴¹ (2) their compensation frequently will be tied to stock price,¹⁴² and (3) the corporation will be more flexible because it can use its high-priced stock as currency or raise more money for expansion in the capital markets.¹⁴³ Given the overlap in shareholders' and managers' desires, it is unlikely that undervaluation will occasion any managerial behavior that diverges

140. Because the wealth accretion occurring when prices are brought up to the level of actual value is not likely to diminish absent a change in the fundamental value of the firm, the shareholder wealth effect here is long-term. Periods of equity overvaluation, by contrast, enhance shareholder wealth only in the short-term. Such transitory price enhancements are of little value to medium-term and long-term stockholders. Short-term stockholders may benefit from transitory increases in price, but only if they are able to time stock sales so that they sell at the temporarily high price. In practice, this is rather difficult, for investors must avoid selling too soon (prior to the peak) or too late (after the transitory price enhancement has ended). Thus, transitory stock price increases offer little value to stockholders. Enhancements that drive stock prices to the level of fundamental value, by contrast, are not likely to be transitory and are desirable to all shareholders, regardless of the length of time they intend to hold their stock.

141. See Jensen, *supra* note 1, at 8 (noting the prestige associated with managing a company with a high stock price).

142. See Coffee, *supra* note 89, at 275-76 (noting growth in equity-based compensation); D'Avolio et al., *supra* note 105, at 10 (same).

143. Cf. Andrei Shleifer & Robert W. Vishny, *Stock Market Driven Acquisitions*, 70 J. FIN. ECON. 295, 309 (2003) ("The benefit of having a high valuation for making acquisitions also points to an incentive to raise a firm's stock price even through earnings manipulation, a phenomenon whose prevalence is becoming increasingly apparent.").

from shareholder interests.

In the unlikely event managers were dissuaded from taking steps to drive the stock price up to fundamental value,¹⁴⁴ the investor loss resulting from such opportunism would be relatively minor. Some loss could result if the company had to forego investments because its depressed stock price hampered its ability to raise money in the equity markets, but the company could always pursue another form of financing and could likely negotiate a favorable interest rate by explaining to lenders why the stock price was artificially depressed.¹⁴⁵ Investors would also experience loss in that their portfolios would be undervalued during the period in which managers opportunistically failed to correct the depressed stock price. Such periods, however, would likely be short. Because undervaluation could usually be corrected by the action of a single manager, managers would normally have to work in concert to keep the stock price depressed. This coordinated behavior would be unlikely to occur naturally, for most managers want to avoid undervaluation,¹⁴⁶ and persistent undervaluation would therefore require some sort of collusion among managers. Any such cartel would be inherently unstable, given the benefits that would likely accrue to a cheater.¹⁴⁷ Thus, any periods of investor wealth depression occasioned by managers' (improbable) failure to correct undervaluation are likely to be transitory.

ii. *Agency Costs in the Overvalued Firm.* The situation is markedly different when a firm's stock is overvalued. Unlike undervaluation, overvaluation is likely to create a substantial divergence in the interests of shareholders and managers, and the investor loss that will result if managers of overvalued firms pursue

144. Shirking might prevent managers from taking affirmative steps to correct undervalued stock prices. Or managers might want to keep stock prices depressed below value if they had short-sold and needed to repurchase. Of course, management short-selling is highly unlikely when a stock is undervalued. (For many managers, it is illegal, *see* Securities Exchange Act § 16(c), 15 U.S.C. § 78p(c) (2000), and those managers for whom it is an option would not short a stock if they knew its price was depressed below value.) Moreover, even managers that had sold short would not want to keep the price depressed indefinitely; they would desire the low price to remain for just long enough for them to repurchase the stock at the depressed price.

145. *See* Stout, *supra* note 47, at 648-50; *see also supra* notes 126-28 and accompanying text.

146. *See supra* notes 141-43 and accompanying text.

147. Investors would love the cheater whose action corrected undervalued equity; the press would heap praise upon her; the labor market would reward her with a host of employment opportunities. If she were a stockholder or had equity-based compensation, her wealth would increase.

their own interests, rather than those of stockholders, is likely to be substantial.

a. *Greater Divergence in Interests.* When a firm's stock price is overvalued, the interests of shareholders and managers are likely to diverge. Managers are unlikely to prefer that the stock price fall to fundamental value, for (as noted) they reap a host of benefits from a high stock price.¹⁴⁸ While most managers will realize that overvaluation cannot last forever and that price correction is likely to occur eventually,¹⁴⁹ they may nonetheless refrain from taking steps to reduce price to fundamental value. Their tendencies toward optimism¹⁵⁰ will likely lead them to believe either that they can eventually cause the firm to generate cash flows that will justify the currently inflated price or that they will be able to exit the corporation (by resigning their positions and selling their stock) prior to the inevitable price correction.¹⁵¹ Thus, corporate managers have little incentive to correct equity overvaluation.

On first glance, one might suppose that shareholders would similarly desire for equity overvaluation to persist; after all, the higher the stock price, the greater a shareholder's wealth. Because overvaluation tends to be eventually corrected, however, medium- to long-term shareholders generally cannot capture the transitory wealth increase stemming from overvaluation and thus will not care to extend periods of overvaluation.¹⁵² While short-term shareholders may be able to profit from transitory periods of overvaluation, they

148. See *supra* notes 141-43 and accompanying text. As Professor Jensen has observed, "If you are the CEO or CFO [of an overvalued company], you are on TV, and covered by the press, investors love you, your options are increasing in value, and the capital markets are wide open to your firm." Jensen, *supra* note 1, at 8.

149. See Langevoort, *supra* note 59, at 106 ("[I]n most bad-news scenarios, concealment simply delays the appreciation of the truth rather than avoids it indefinitely . . .").

150. See *supra* notes 66-72 and accompanying text.

151. For example, accounts of the financial collapse at Enron suggest that the firm's managers, well aware of the corporation's overvaluation, believed that they could either turn the company around or exit before collapse. According to one prominent account:

Enron's accounting games were never meant to last forever. . . . The goal was to maintain the impression that Enron was humming until [CEO Jeff] Skilling's next big idea kicked in and started raking in *real* profits. . . . In Skilling's mind, though, there was no way he was going to fail. He had always succeeded before, and his successes had transformed the company. Why would it be any different with EES and broadband?

MCLEAN & ELKIND, *supra* note 99, at 171.

152. See *supra* note 140.

can do so only if they sell their stock prior to the inevitable price correction. Such a “bail before correction” strategy is much riskier for shareholders than for managers, for shareholders know little about corporate events that may reveal overvaluation and are thus more likely to delay too long before selling their stock. Moreover, shareholders possess neither actual nor apparent control over the events likely to reveal overvaluation and will thus tend to be less optimistic than managers about their ability to sell their stock before the inevitable price-correction.¹⁵³ Accordingly, even short-term stockholders will value periods of overvaluation less than managers will.

In addition, any “upside” experienced by shareholders during periods of overvaluation is likely to be counteracted by a significant downside. For reasons detailed below, managers are likely, during periods of equity overvaluation, to engage in behavior that destroys real corporate value. Given this probability, stockholders are even more likely to prefer that managers correct equity overvaluation.

b. *Greater Investor Losses From Managerial Opportunism.* Whereas the investor losses stemming from a managerial failure to correct undervalued equity are likely to be small,¹⁵⁴ the losses occasioned by overvaluation may be significant. In essence, managers of overvalued firms are “buying time”—hoping to trick the market into maintaining the high stock price until they can exit the firm (both as shareholders and as managers) or can produce the corporate performance required to justify the stock price.¹⁵⁵ Such continued trickery requires beating analysts’ expectations, for the capital markets routinely punish firms that fail to meet such expectations.¹⁵⁶ Indeed, one recent study found that the average stock price of firms beating consensus analyst forecasts for the quarter rose 5.5% more during the quarter than a size-matched portfolio; by contrast, the average stock price of firms missing consensus expectations fell by 5.04% more during the quarter than a size-matched portfolio.¹⁵⁷ It is therefore crucial that

153. On the optimistic biases created by actual or apparent control over events, see *supra* notes 73-77 and accompanying text.

154. See *supra* notes 144-47 and accompanying text.

155. See Jensen, *supra* note 1, at 8-10 (noting that the objective of managers of overvalued firms is to “postpone the day of reckoning until [they] are gone or [they] figure out how to resolve the issue”); see also *supra* note 151.

156. See Jensen, *supra* note 1, at 7 (“CEOs and CFOs know that the capital markets will punish the entire firm if they miss analysts’ forecasts by as much as a penny. . . . [T]he capital markets reward a firm with a premium for meeting or beating the analysts’ expectations during the quarter.”).

157. Douglas J. Skinner & Richard G. Sloan, *Earnings Surprises, Growth*

managers of an overvalued firm continue to meet or beat analysts' expectations. The problem, of course, is that they cannot perpetually do so by exploiting legitimate value-creating opportunities.¹⁵⁸ Once those options have been exhausted, they will eventually turn to gimmicks that are designed to produce numbers that appease the market but actually reduce long-term firm value.¹⁵⁹

Jensen has identified three such gimmicks that are routinely pursued by managers of overvalued firms:

To appear to be satisfying growth expectations you use your overvalued equity to make long run value destroying acquisitions; you use your access to cheap debt and equity capital to engage in excessive internal spending and risky negative net present value investments that the market thinks will generate value; and eventually you turn to further accounting manipulation and even fraudulent practices to continue the appearance of growth and value creation.¹⁶⁰

Consider how these three gimmicks work in concert to destroy corporate value.

(i). *Value-Destroying Acquisitions.* Because corporate acquisitions create the appearance of growth (and thus may fool the market for at least a while), corporate managers that have exhausted other growth options may find such acquisitions attractive, even if they are ultimately value-reducing. The findings of a recent study by Professors Sara B. Moeller, Frederick P. Schlingemann, and René M. Stulz are consistent with the claim that equity overvaluation leads managers to pursue value-destroying acquisitions.¹⁶¹ The authors compared how merger announcements affected the stock prices of acquiring firms during the 1998-2001 period, a period of significant equity overvaluation, with the

Expectations, and Stock Returns or Don't Let an Earnings Torpedo Sink Your Portfolio, 7 REV. ACCT. STUD. 289, 297 tbl.1 (2002).

158. See Jensen, *supra* note 1, at 7 ("Generally, the only way for managers to meet those expectations year in and year out is to cook their numbers to mask the inherent uncertainty in their businesses. And that cannot be done without sacrificing value.")

159. See *id.* at 8-10 ("You realize the markets will hammer you unless your company's performance justifies the stock price. So after all value-creating alternatives have been taken you start to take actions that destroy long run value that you hope will at least appear to generate the market's expected performance in the short run.")

160. *Id.* at 10 (footnotes omitted).

161. Sara B. Moeller, Frederick P. Schlingemann & René M. Stulz, *Wealth Destruction on a Massive Scale? A Study of Acquiring-Firm Returns in the Recent Merger Wave*, 60 J. FIN. 757, 760 (2005).

acquiring-firm price effects occasioned by merger announcements in the 1980s.¹⁶² They found that, for the 1998-2001 period, the value of acquiring firms declined by a total of \$240 billion in the three-day periods surrounding announcements of acquisitions.¹⁶³ During all of the 1980s, by contrast, the loss in value of acquiring firms during the three-day period surrounding merger announcements was only \$4.2 billion.¹⁶⁴ Moreover, whereas the acquirers' losses in the 1980s were offset by gains to acquirees, for a net synergy gain of \$11.6 billion, such an offset did not occur in the 1998-2001 period; rather, the losses to acquirers exceeded acquirees' gains for a net synergy loss of \$134 billion.¹⁶⁵

Equity overvaluation seems to have influenced this value destruction. The authors found that most of the value losses were attributable to eighty-seven "large loss" transactions, in which the loss to each acquiring firm exceeded \$1 billion.¹⁶⁶ The bidders in those transactions appear to have been overvalued: they had statistically significantly higher Tobin's q and market-to-book ratios (both proxies for overvaluation)¹⁶⁷ than both the bidders in other deals during the same time period and all bidders in the period from 1980-1997.¹⁶⁸ Moreover, a substantially greater proportion of bidders in large loss deals financed their acquisitions using equity: 71.6% of the bidders in large loss deals did so, as opposed to 35.2% of other bidders during the same time period and 30.3% of all bidders in the 1980-1997 period.¹⁶⁹ In short, what the authors term "wealth destruction on a massive scale" appears to have occurred because overvalued bidders used their high-priced stock to finance deals that, from an investor's perspective, should not have been pursued.¹⁷⁰ Such findings are consistent with Jensen's assertion

162. *Id.* at 757.

163. *Id.* at 758-59.

164. *Id.* at 758, 762 tbl.I.

165. *Id.* at 762 tbl.I.

166. *Id.* at 759. The total loss to the bidders' shareholders in these transactions was \$397 billion, which represented an average abnormal return of -10.6%. *Id.* The average loss to acquiring-firm shareholders was \$2.31 per dollar spent on the acquisition. *Id.* at 765.

167. Tobin's q is, in essence, the market value of a firm's assets divided by the replacement value of those assets. BREALEY & MYERS, *supra* note 41, at 775. Obviously, the higher this figure, the more overvalued the firm is. Market to book ratio is the market value of a firm's assets divided by the book value of those assets. *Id.* at 774-75. Again, the higher this figure, the more highly valued is the firm as a going concern.

168. Moeller et al., *supra* note 161, at 773 tbl.III.

169. *Id.* at 772 tbl.III (Panel A).

170. See also Shleifer & Vishny, *supra* note 143, at 297-99 (providing a model consistent with the observation that overvalued firms engage in

that equity overvaluation leads to unwise acquisitions that are designed to dupe the market but will ultimately be revealed, to the detriment of shareholders.¹⁷¹

(ii). *Negative NPV Greenfield Investments and Avoidance of Positive NPV Investments.* Equity overvaluation also tends to lead managers to reduce firm value by pursuing certain greenfield investments that have a negative net present value (“NPV”) and avoiding other investments that have a positive NPV.¹⁷² As explained below, this occurs because overvaluation effectively provides managers with additional capital to invest in enterprise expansion,¹⁷³ and, since managers receive private benefits from expansion, they will tend to do so beyond the point that is optimal for shareholders (i.e., the point at which the firm’s value is maximized).¹⁷⁴ Moreover, a relatively high stock price tends to make marginal investment opportunities appear more valuable than they actually are, furthering the possibility that they will be pursued by

enhanced merger activities that produce negative long-run returns).

171. Jensen explains:

The evidence is consistent with the argument . . . [that] management makes acquisitions to con the market into believing that management is going to create the value that the market expects, and is able to continue to fool it for some period of time by providing the illusion of growth. When the market finds out that the high value and growth was an illusion the firm’s value falls precipitously because all the overvaluation will disappear as well as the value of the core business that has been compromised by the attempts to avoid discovery.

Jensen, *supra* note 1, at 11-13. While Jensen concedes that “the data are also consistent with the hypothesis that the earlier acquisitions [i.e., those occurring prior to the large loss deal] truly created value,” and acknowledges that “[a]dditional work must be done to sort this issue out,” he points to the case of Nortel Corporation as suggesting that acquisitions by overvalued firms prior to a large loss deal are similarly wealth-destructive in the long run, and that the large loss deal simply tips the market off to the acquirer’s overvaluation. *Id.* at 13.

172. “Greenfield investments” refers to investments in new projects, as opposed to acquisitions of existing enterprises. Keith E. Maskus, *The Role of Intellectual Property Rights in Encouraging Foreign Direct Investment and Technology Transfer*, 9 DUKE J. COMP. & INT’L L. 109, 113 (1998). A manager seeking to maximize the value of her firm (and thus shareholder wealth) should pursue all those projects where the discounted present value of expected project returns exceeds the discounted present value of the expenses associated with pursuit of the project. Such a project would have a “positive NPV.” By contrast, managers seeking to maximize shareholder wealth should avoid any “negative NPV” project—i.e., a project where the discounted present value of expected returns is less than the discounted present value of the project’s expenses. See BREALEY & MYERS, *supra* note 41, at 85-106.

173. See *infra* notes 179-83 and accompanying text.

174. See *infra* notes 184-88 and accompanying text.

management.¹⁷⁵ Once managers begin a “growth strategy” of acquisitions and internal investments, they find that such a strategy is difficult to alter; they therefore tend to sacrifice firm value by pursuing the growth strategy for too long.¹⁷⁶ Finally, because managers of overvalued firms live in constant fear of discovery by the securities markets,¹⁷⁷ they will forego positive NPV projects that may temporarily reduce earnings per share.¹⁷⁸ Consider how these forces work together to reduce firm value.

(a). *More Money to Invest.* When equity is overvalued, firm managers effectively have more capital to invest. Most obviously, they may pay for expenses using their firm’s inflated stock as currency. In addition, they can raise more actual cash by issuing new equity at prices reflecting their firm’s overvaluation. Empirical data on the issuance of equity indicate that managers do, in fact, take advantage of periods of overvaluation by issuing equity.¹⁷⁹ Moreover, managers admit to such behavior in anonymous surveys. Professors John R. Graham and Campbell R. Harvey, for example, found that two-thirds of CFOs agree that “[t]he amount by which our stock is undervalued or overvalued by the market” is an “important or very important” consideration in deciding to issue equity.¹⁸⁰ Nearly as many (62.6%)

175. See *infra* notes 189-97 and accompanying text.

176. See *infra* notes 198-201 and accompanying text.

177. See Jensen, *supra* note 1, at 7-8, 10 & n.10.

178. *Id.* at 10.

179. See Malcolm Baker & Jeffrey Wurgler, *Market Timing and Capital Structure*, 57 J. FIN. 1, 1 (2002) (“[A]nalyzes of actual financing decisions show that firms tend to issue equity instead of debt when market value is high, relative to book value and past market values, and tend to repurchase equity when market value is low.”). Baker and Wurgler note that numerous studies have observed a coincidence of seasoned equity issues and high stock prices. *Id.* at 1 n.1 (citing Robert A. Taggart, Jr., *A Model of Corporate Financing Decisions*, 32 J. FIN. 1467, 1484 (1977); Paul Asquith & David W. Mullins, Jr., *Equity Issues and Offering Dilution*, 15 J. FIN. ECON. 61, 85-86 (1986); Armen Hovakimian et al., *The Debt-Equity Choice*, 36 J. FIN. & QUANTITATIVE ANALYSIS 1, 22 (2001); Robert A. Korajczyk et al., *The Effects of Information Releases on the Pricing and Timing of Equity Issues*, 4 REV. FIN. STUD. 685, 707 (1991); Kooyul Jung et al., *Timing, Investment Opportunities, Managerial Discretion, and the Security Issue Decision*, 42 J. FIN. ECON. 159, 182-83 (1996); Paul Marsh, *The Choice Between Equity and Debt: An Empirical Study*, 37 J. FIN. 121, 142 (1982)). Similarly, they note, studies observe a coincidence of high valuations and initial public offerings. *Id.* (citing Tim Loughran et al., *Initial Public Offerings: International Insights*, 2 PACIFIC-BASIN FIN. J. 165 (1994); Marco Pagano et al., *Why Do Companies Go Public? An Empirical Analysis*, 53 J. FIN. 27, 60 (1998)).

180. John R. Graham & Campbell R. Harvey, *The Theory and Practice of Corporate Finance: Evidence from the Field*, 60 J. FIN. ECON. 187, 216 tbl.8 (2001).

agreed that “[i]f our stock price has recently risen, the price at which we can sell is ‘high.’”¹⁸¹ CFOs further reported that equity market prices were the second most important of thirteen factors normally considered in determining whether to issue common stock,¹⁸² and was the second most important of eight factors normally considered in determining whether to issue convertible debt.¹⁸³ Equity overvaluation is therefore likely to increase the resources with which managers may pursue firm expansion.

(b). *Incentives to Over-Invest.* This easy access to investment resources causes a version of what Jensen has termed the “agency costs of free cash flow,”¹⁸⁴ for managers with the resources to do so are likely to pursue firm expansion beyond the point that is optimal for stockholders. Whereas the rational stockholder desires the firm to expand to the point at which its marginal cost of expansion equals the marginal value added to the firm because of such expansion,¹⁸⁵ managers will tend to seek expansion to the point at which their private marginal benefits occasioned by the expansion equal their marginal cost of seeking that level of expansion (including, of course, the cost of any “punishment” they expect to receive because they have pursued expansion excessively). The problem arises because managers’ personal marginal costs and benefits from expansion are not strictly proportionate to the total costs and benefits created by the expansion. Specifically, managers receive a disproportionately large

181. *Id.*

182. CFOs ranked market price a more important factor in determining whether to issue common stock than “[p]roviding shares to employee bonus/stock option plans”; “[m]aintaining a target debt-to-equity ratio”; “[d]iluting the holdings of certain stockholders”; “[s]tock is our ‘least risky’ source of funds”; “[w]hether our recent profits have been sufficient to fund our activities”; “[u]sing a similar amount of equity as is used by other firms in our industry”; “[i]ssuing stock gives investors a better impression of our firm’s prospects than issuing debt”; “[i]nability to obtain funds using debt, convertibles, or other sources”; “[c]ommon stock is our cheapest source of funds”; and “[t]he capital gains tax rates faced by our investors (relative to tax rates on dividends).” *Id.* The only commonly considered factor deemed more important than a high market price was concern about earnings per share dilution. *Id.*

183. *Id.* at 221 tbl.10.

184. Michael C. Jensen, *Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers*, 76 AM. ECON. REV. (PAPERS & PROC.) 323, 324 (1986).

185. See Henry G. Grabowski & Dennis C. Mueller, *Managerial and Stockholder Welfare Models of Firm Expenditures*, 54 REV. ECON. & STAT. 9, 12 (1972). Because marginal costs of expansion tend to rise as expansion continues, and marginal benefits tend to fall, expansion beyond the point at which marginal costs equal marginal benefits reduces firm value. See Jensen, *supra* note 184, at 323-24.

share of the benefits of firm expansion.¹⁸⁶ All else being equal, managers of bigger firms are better off than managers of smaller firms—for example, their job prestige grows, they have more resources under their control, and their compensation often increases (as managerial compensation is frequently related to sales volume).¹⁸⁷ In addition, managers often have an interest in firm expansion as a means of providing new employment positions, for firms often reward middle managers with promotion rather than year-to-year bonuses.¹⁸⁸ Thus, rational, self-interested managers will pursue a level of investment that is excessive in that it fails to maximize firm value.

(c). *Skewed Perceptions of Likely Project Success.* In addition to the “supply side” effect whereby managers engage in a greater number of negative NPV projects because they have access to the funds with which to do so, overvaluation may have a “demand side” effect: it may make proposed projects look more profitable and may therefore cause managers to believe that negative NPV projects are actually positive NPV projects. Professors Christopher Polk and Paola Sapienza have recently provided empirical evidence consistent with this observation.¹⁸⁹

The research by Polk and Sapienza builds on a prior study by Professor Jeremy C. Stein, who showed that stock price valuations affect firm investment through what one might term an “equity-issuance” channel.¹⁹⁰ Stein demonstrated that equity-dependent firms (i.e., those lacking ample access to cash and/or debt) would base investment decisions on their stock price, foregoing positive NPV investments when the price was low and the amount of capital that could be raised in a stock issuance was relatively small.¹⁹¹ The upshot of Stein’s findings was that higher stock prices would “enable good (i.e., positive net present value) projects that otherwise would not occur.”¹⁹² Polk and Sapienza asked a follow-up question: could stock price misvaluation affect firm investment decisions through a “catering channel” as well as an “equity-issuance” channel, so that higher stock prices increase the level of investment by firms that are

186. See Jensen & Meckling, *supra* note 132, at 312-13.

187. See Jensen, *supra* note 184, at 323 (citing Kevin J. Murphy, *Corporate Performance and Managerial Remuneration: An Empirical Analysis*, 7 J. ACCT. & ECON. 11 (April 1985)).

188. *Id.* at 323.

189. See Christopher Polk & Paola Sapienza, *The Real Effects of Investor Sentiment* 32 (Nat’l Bureau of Econ. Research, Working Paper No. 10563, 2004), available at <http://www.nber.org/papers/w10563.pdf>.

190. See Jeremy C. Stein, *Rational Capital Budgeting in an Irrational World*, 69 J. BUS. 429, 443-44 (1996).

191. *Id.* at 445.

192. Polk & Sapienza, *supra* note 189, at 2.

not equity-dependent?¹⁹³ They theorized that managers expand firm investment when stock prices are high because they evaluate proposed projects according to current stock price levels. Managers may, for example, posit multiples by which proposed projects will increase stock prices, thereby causing proposed projects to appear more desirable the higher current stock price is.¹⁹⁴ If that is the case, then one would expect to find both that investment levels increased as stock prices rose and that increased investment was associated with lower returns (indicating that the increased investment was not merely the result of equity-dependent firms' enhanced ability to pursue positive NPV projects).

Polk and Sapienza found both correlations. Adjusting for investment opportunities, they found that firms with overpriced stock tended to engage in more investment.¹⁹⁵ In addition, they found that firms that engaged in higher levels of investment experienced relatively lower stock returns.¹⁹⁶ These findings suggest that higher equity prices do not simply enable firms to pursue a greater number of positive NPV investments; instead, they cause investment to expand to include negative NPV projects. That finding is consistent with the authors' theory that managers evaluate project proposals according to current stock price levels.¹⁹⁷

193. *Id.*

194. *Id.* Polk and Sapienza explain:

If new investment projects are evaluated at the current stock market price, for example as in the practice of using "multiples" to evaluate new projects, and if there is enough asymmetry of information regarding project quality, a rational manager may find it optimal to invest in projects with negative NPV *even when the project is not financed with equity issues*. Firms with ample cash or debt capacity may have an incentive to waste resources when their stock price is overpriced and to forgo positive investment opportunities when their stock price is undervalued. Thus mispricing may affect investment without working through an equity channel

Id.

195. *Id.* at 5. Polk and Sapienza utilized three well-established proxies for overvaluation: high discretionary accruals, high net equity issuances, and price momentum. *Id.* at 4-5 (discussing why these metrics are fair proxies for overvaluation). Adjusting for investment opportunities, the authors found "a positive relation between all of these three mispricing proxies and firm investment." *Id.* at 5.

196. *Id.* at 6 ("We find that firms with high (low) investment have low (high) stock returns, after controlling for investment opportunities and other characteristics linked to return predictability.").

197. *Id.* at 2-3. Of course, it is also consistent with managers acting in a consciously opportunistic fashion and pursuing projects they believe to have a negative NPV simply because such projects promise them personal benefits. See Jensen & Meckling, *supra* note 132, at 312-13.

If, indeed, they do so, then overvaluation will lead to further investor loss by causing managers to overestimate the value of proposed projects.

(d). *The “Stickiness” of a Growth Strategy.* Acquisitions and internal investments represent “growth” strategies for firms. Recent research suggests that once corporate managers set a firm on this sort of growth course, that course can be difficult to reverse, and value-destruction may result.¹⁹⁸ Professors Philippe Aghion and Jeremy C. Stein observe that constraints on firms’ resources, particularly on managers’ time, force firms to decide between increasing sales growth (i.e., pursuing a growth strategy) and improving profit margins (by, for example, lowering per unit costs).¹⁹⁹ Investors, then, evaluate the firm’s performance and prospects according to whether its managers have chosen a growth or margins strategy, altering their performance measures depending on the strategy management has selected.²⁰⁰ In particular, if the market believes a firm is pursuing a growth strategy, its valuation will tend to put more weight on realized growth. That will, in turn, encourage managers to stick with the growth strategy so as to avoid disappointing the market. Only when the growth strategy becomes severely inefficient will managers shift to a cost-cutting strategy.²⁰¹ Thus, decisions to pursue growth strategies are “sticky.” Managers who adopt such strategies in an attempt to bolster stock price or keep an inflated stock price from declining will tend to pursue such strategies too long—i.e., to the point at which they are sacrificing firm value.

(e). *Avoidance of Positive NPV Projects.* In addition to causing active value destruction through unwise acquisitions and greenfield investments, overvaluation may cause passive value

198. Philippe Aghion & Jeremy C. Stein, *Growth vs. Margins: Destabilizing Consequences of Giving the Stock Market What It Wants* 2-3 (Nat’l Bureau of Econ. Research, Working Paper No. 10999, 2004), available at <http://www.nber.org/papers/w10999.pdf>.

199. *Id.* at 1 (“[D]oing more on one dimension [i.e., either growth or margins] necessarily implies doing less on the other.”). Other scholars have similarly recognized that managers face this sort of “multi-tasking” problem. See, e.g., Bengt Holmstrom & Paul Milgrom, *Multitask Principal-Agent Analyses: Incentive Contracts, Asset Ownership, and Job Design*, 7 J.L. ECON. & ORG. 24, 25-26 (1991) (noting the difficulty of managing employees with multi-dimensional tasks).

200. Aghion & Stein, *supra* note 198, at 1 (citing Harrison G. Hong & Jeremy C. Stein, *Simple Forecasts and Paradigm Shifts*, Harv. Inst. Econ. Research Working Paper No. 2007, 2003, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=412801 (demonstrating how this sort of emphasis shift occurred in analysts’ reports on Amazon.com)).

201. *Id.* at 2-3.

destruction by encouraging managers to forego positive NPV projects. Because the dominant strategy of managers of overvalued firms is, in the words of Jensen, to “postpone the day of reckoning until [they] are gone or [they] figure out how to resolve the issue,”²⁰² they will look for opportunities to conceal their firm’s overvaluation from the market. One way to do so is to delay investment expenditures in order to meet quarterly earnings expectations and avoid the value reassessment that accompanies missing such an expectation.²⁰³ Accordingly, many managers will delay positive NPV investments—even where such a delay entails a sacrifice in firm value—in an attempt to dupe the market.

Recent research suggests that this sort of value-sacrificing behavior is widespread. In their 2004 survey of 401 corporate CFOs, Professors John R. Graham, Campbell R. Harvey, and Shivaram Rajgopal posed the following question: “Near the end of the quarter, it looks like your company might come in below the desired earnings target. Within what is permitted by GAAP, which of the following choices might your company make?”²⁰⁴ Eighty percent of respondents stated that their companies would be willing to delay discretionary expenditures on research and development, advertising, and maintenance, and over fifty-five percent stated that their company would “delay starting a new project even if this entails a small sacrifice in value.”²⁰⁵ Overvaluation thus tends to cause passive value destruction as managers attempt to buy time by delaying positive NPV investments.

(iii). *Eventual Fraud.* Once managers of overvalued firms have exhausted their opportunities to boost or maintain apparent firm value through acquisitions and greenfield investments, they face a temptation to pursue more direct means of duping the market. They may begin with “earnings management,” the well-accepted practice of smoothing earnings by strategically timing the recognition of revenues and expenses in order to meet

202. Jensen, *supra* note 1, at 10; see also *supra* notes 155-59 and accompanying text (discussing objectives of managers of overvalued firms).

203. See *supra* notes 156-57 and accompanying text (discussing stock price effects of earnings surprises).

204. John R. Graham, Campbell R. Harvey & Shivaram Rajgopal, *The Economic Implications of Corporate Financial Reporting* tbl.6 (Nat’l Bureau of Econ. Research, Working Paper 10550, 2005), available at <http://ssrn.com/abstract=491627>.

205. *Id.* Around forty percent of respondents stated that they would “book revenues now rather than next quarter (if justified in either quarter).” *Id.* This result is consistent with the view that earnings management is being used to dupe the market to prevent discovery of overvaluation. See *infra* notes 206-08 and accompanying text.

market projections.²⁰⁶ Indeed, around forty percent of the CFOs surveyed by Graham, Harvey, and Rajgopal reported that they would “book revenues now rather than next quarter” if their company were in danger of missing an earnings target.²⁰⁷ Some scholars have argued that earnings management is itself fraudulent.²⁰⁸ Even if it is not, though, it tends to evolve rapidly into outright fraud, for managers who recognize revenues early and push recognition of expenses into the future will face more difficult accounting challenges in subsequent quarters and will eventually have no choice but to lie or have their company be discovered as overvalued.²⁰⁹

It should be obvious that accounting manipulation will create significant agency costs for a firm. In the likely event that a firm’s accounting manipulations are revealed, the firm’s reputation for honesty and candor will be damaged. Such a reputation is, of course, essential to a successful firm: when a company’s managers are less than forthright, customers will be less willing to do business with the firm; compliance costs will rise as regulators monitor the firm more closely; potential business partners will be less willing to embark on joint ventures; lenders will be less likely to extend credit on favorable terms; and investors will invest their money elsewhere (or demand a higher return on investment). Accounting manipulations thus make it hard for a company to flourish and, in extreme cases, may kill the company altogether.²¹⁰ Thus, the agency

206. See Jensen, *supra* note 1, at 7-8 (describing earnings management and noting that it “has been considered an integral part of every top manager’s job for at least the last two decades”).

207. Graham et al., *supra* note 204, at tbl.6.

208. For example, Jensen argues:

[W]hen managers smooth earnings to meet market projections, they are not creating value for the firm; they are both lying and making poor decisions that destroy value. . . . [W]hen numbers are manipulated to tell the markets what they want to hear (or what managers want them to hear) rather than the true status of the firm—it is lying, and when real operating decisions that would maximize value are compromised to meet market expectations real long-term value is being destroyed.

Jensen, *supra* note 1, at 8 (footnote omitted).

209. *Id.* (“Revenues borrowed from the future and today’s expenses pushed to tomorrow require even more manipulation in the future to forestall the day of reckoning.”).

210. Enron represents perhaps the most striking recent example of this process. See MCLEAN & ELKIND, *supra* note 99, at 386-87, 394, 398, 401-03 (describing the lack of faith and trust that banks, analysts, trading partners, and the public felt toward Enron immediately preceding its collapse); MIMI SWARTZ & SHERRON WATKINS, *POWER FAILURE: THE INSIDE STORY OF THE COLLAPSE OF ENRON* (2003). Valued at its peak at around \$70 billion, Enron

costs created by accounting manipulation, which overvalued equity encourages as a means of buying time, are potentially huge.

c. *Greater Reliance Costs.* In addition to imposing greater agency costs than undervaluation, equity overvaluation is likely to cause investors to suffer greater “reliance” losses. To see this point, consider two hypothetical cases of misrepresentation. In one case, a credible source informs the victim (Victim A) that her savings are worth twenty-five percent less than they are actually worth. In the second, the victim (Victim B) is told that her savings are worth twenty-five percent more than they actually are. In both cases, the truth is revealed one year after the misrepresentation is made. Who is likely to suffer greater damages—Victim A or Victim B?

To answer this question, consider the two victims’ likely courses of action. Victim A, misinformed that her savings are undervalued, will likely save more (i.e., divert income from current consumption to savings), and/or move her invested funds, which she believes are not adequately appreciating, into what she deems to be the next best investments.²¹¹ Her damage occasioned by the misrepresentation

was actually worth around \$30 billion—still a significant amount by anyone’s standards. Jensen, *supra* note 1, at 10-11. Through accounting manipulations aimed at disguising this degree of overvaluation, however, Enron’s managers impaired the company’s reputation and, in the process, destroyed its value. *Id.* at 11. As Jensen explains:

[S]enior managers’ efforts to defend the \$40 billion of excess valuation (which was a mistake that was going to go away anyway) effectively destroyed the \$30 billion core value. . . . [Enron’s managers] destroyed [the company] by trying to fool the markets through accounting manipulations, hiding debt through off-balance sheet partnerships, and over hyped new ventures such as their broadband futures effort. In doing this, Enron’s managers gambled with their critical asset—Enron’s reputation for integrity.

Id.

211. Above minimal income levels, individuals tend not to spend their entire incomes on immediate consumption; instead, they set a portion aside in the form of savings to pay for future consumption. Stout, *supra* note 47, at 682. In allocating their income, they attempt to achieve an optimal balance between present and future consumption. Their decisions regarding how much to save and where to invest are influenced by their current investment portfolio. Jeffrey N. Gordon & Lewis A. Kornhauser, *Efficient Markets, Costly Information, and Securities Research*, 60 N.Y.U. L. REV. 761, 767 (1985) (“[C]apital markets facilitate individual planning of consumption over time in light of anticipated resources. . . . [They also] guide investment and saving decisions through prices.”). If an investor believes his portfolio is worth less than it is, he’ll tend to divert too much money toward savings and away from current consumption. He may also divert money from the undervalued security into other investments. If the investor believes his portfolio is worth more than it is, he will tend to divert money away from savings and toward current

will thus consist of (1) her net utility loss from foregoing current consumption to save instead, plus (2) the difference between her "second best" investment returns and the returns she would have received had she not moved her invested funds. Victim B, led to believe that she's richer than she really is, will likely save less and consume more. If her impressive returns lead her to save more, she will likely invest in the same investments currently in her purportedly (but not actually) high-performing portfolio. Indeed, this pattern of increased consumption and re-investment in apparently appreciating enterprises occurred all too often during the technology bubble of the late 1990s.

While it is impossible to say, without more facts, whether Victim A or Victim B is hurt to a greater degree, the stronger intuition seems to be that Victim B (the one misinformed that her savings were worth more than they are) would probably suffer greater harm in the long run. Individuals normally allocate their resources according to expected marginal utility. Their first resources are devoted to basic necessities (e.g., food and shelter), then they typically save for the future, and whatever is left over is spent on luxuries (e.g., consumption of non-necessities, charitable contributions, etc.).²¹² As they move from necessities to luxuries, their expenditures tend to produce less incremental utility. A person who is misinformed that she's wealthier than she really is will tend to shift from investment spending to luxury spending too quickly, thereby allocating her resources in a manner that fails to maximize her expected utility. It thus appears that the reliance losses occasioned by equity overvaluation (a misrepresentation that one is richer than one really is) are greater than those occasioned by equity undervaluation. Investors may therefore place a premium on corporate policies that reduce the risk of overvaluation.

d. *Greater Impairment of Stock Price as a Managerial Monitoring Tool.* Corporate managers who fail to increase firm value frequently are, and should be, replaced. The decision to replace incumbent managers is generally initiated by the board of directors or by large shareholders (e.g., institutional investors). Because information regarding the performance of managers is costly to obtain (particularly in large enterprises in which the

consumption. See *id.* at 768-69 (arguing that individuals save too little when their securities are undervalued, and save too much when their securities are overvalued). But see Stout, *supra* note 47, at 682-84 (arguing that efficient securities prices are not that important to investors in deciding how to allocate their money).

212. Cf. Stout, *supra* note 47, at 682 (discussing how individuals tend to allocate financial resources as their income grows).

relevant information is possessed by numerous employees scattered throughout the firm),²¹³ directors and large shareholders rationally seek out proxies for managerial performance. Stock price reflects the discounted present value of the firm's future cash flows²¹⁴ and is therefore a good, though admittedly imperfect, proxy.²¹⁵

Stock mispricing obviously thwarts the effectiveness of this monitoring tool.²¹⁶ If stock is undervalued, directors and institutional shareholders will be too quick to replace incumbent management, and if stock is overvalued, directors and large shareholders may fail to seek replacement when they ought to do so. Both forms of mispricing therefore increase the difficulty of monitoring managers.

But the degree to which mispricing thwarts effective managerial monitoring is likely to be greater when stocks are mispriced upward than when the mispricing is in a downward direction. If the directors of a corporation decide to replace an incumbent manager upon observing a stock price that appears to be too low, the manager can plead her case to the board, explaining why the stock price is temporarily depressed and will eventually rebound. If, for example, management is concealing price-increasing information for strategic purposes (as in *SEC v. Texas Gulf Sulphur*²¹⁷), the manager will generally explain that fact to the board or institutional investors. Thus, those parties are likely to learn of mispricing in a downward direction before they make a poor staffing decision. On the other hand, if the stock is overvalued

213. See Bainbridge, *supra* note 83, at 1013-14 (arguing that longer information paths "equate to less accurate information and poorer decisions."); Manne, *supra* note 25, at 14-15 (suggesting that there is usually a delay in time for information to reach a top manager).

214. BREALEY & MYERS, *supra* note 41, at 59-62.

215. A falling stock price does not, of course, necessarily signal poor management. Nor does a rising stock price signal good management. Even a rising stock price may signal poor management if the price is rising more slowly than the stock price of similarly situated benchmark firms, and a falling stock price may signal good management if the rate of decrease is slower than that of benchmark firms.

216. See Carlton & Fischel, *supra* note 3, at 867 ("[A]ccurately priced securities will enable firms to observe more accurately when corporate managers are successful. Thus, markets for managerial services and for corporate control will function more effectively.").

217. 401 F.2d 833 (2d Cir. 1968) (discussed *infra* at notes 219-22, 307-10 and accompanying text). In *Texas Gulf Sulphur*, a mining company that had discovered a valuable ore deposit attempted to keep its stock price depressed (i.e., at a level not reflecting the ore discovery) so that it could buy up surrounding land and mineral rights without tipping off current owners of those lands and rights. *Id.* at 844.

because of undisclosed information, there will likely be no opportunity for the directors or institutional investors to learn of this fact (management is unlikely to volunteer the information), and they may thus fail to replace managers who really ought to be replaced. In other words, identification of mispricing within the boardroom is much less likely to occur if the price is too high than if it is too low, and overvaluation is therefore more likely than undervaluation to reduce the efficacy of stock price as a low-cost tool for monitoring managers.

B. Lower Costs From Price-Decreasing Insider Trading

Part II.A demonstrated that price-decreasing insider trading provides greater benefits to investors than does insider trading that increases stock prices. Part II.B examines the cost side of the balance, concluding that the investor costs occasioned by price-decreasing insider trading are likely to be lower than those caused by price-increasing insider trading.

1. Less Likely to Thwart Corporate Opportunities

Of the two species of insider trading, price-decreasing insider trading is less likely to cause what is perhaps the most important type of corporate harm occasioned by insider trading: the thwarting of value-enhancing corporate transactions that could otherwise be accomplished.²¹⁸ To see this point, consider why price-increasing insider trading might prevent such transactions from occurring and why price-decreasing insider trading generally could not do so.

Price-increasing insider trading may injure a corporation seeking to take advantage of nonpublic information regarding an asset's hidden value. Suppose, for example, that managers are aware that some asset the corporation seeks to acquire is undervalued and, if purchased by the corporation, would enhance corporate value.²¹⁹ The law generally permits an asset buyer who has discovered information regarding an asset's hidden value to refrain from disclosing that information,²²⁰ and the corporation will

218. See BAINBRIDGE, *supra* note 4, at 600-02 (discussing how insider trading could thwart value-creating corporate transactions).

219. The classic case involving this sort of fact pattern is *Texas Gulf Sulphur*, in which geologists from a mining company had discovered a valuable ore deposit. 401 F.2d at 843. Managers knew that the value of the company would be substantially enhanced if it could acquire land and mineral rights from neighbors at a favorable price. *Id.* at 844.

220. See RESTATEMENT (SECOND) OF CONTRACTS § 161 cmt. d (1981) ("A buyer of property . . . is not ordinarily expected to disclose circumstances that make the property more valuable than the seller supposes."). Professor Anthony T. Kronman explains why this is so:

thus want to keep such information a secret in order to prevent the asset's price from rising.²²¹ If managers, who are aware of the corporation's forthcoming asset purchase, attempt to profit personally by purchasing their corporation's own stock, their trading may cause an increase in the corporation's stock price.²²² That price activity may then cause the current owner of the asset not to sell or to demand a higher price. Price-increasing insider trading, then, would squander an otherwise available corporate opportunity.²²³ While such insider trading would appear to be a violation of the insiders' fiduciary duties, regardless of the law on insider trading,²²⁴ the insider trading prohibition does act as a prophylactic bar to this sort of corporate harm.

With respect to price-decreasing insider trading, by contrast, it

By and large, the cases requiring disclosure involve information which is likely to have been casually acquired The cases permitting nondisclosure, on the other hand, involve information which, on the whole, is likely to have been deliberately produced. Taken as a group, the disclosure cases give at least the appearance of promoting allocative efficiency by limiting the assignment of property rights to those types of information which are likely to be the fruit of a deliberate investment (either in the development of expertise or in actual searching).

Anthony T. Kronman, *Mistake, Disclosure, Information, and the Law of Contracts*, 7 J. LEGAL STUD. 1, 18 (1978). Because the information regarding the hidden value of an asset the corporation would like to acquire is likely to have been "deliberately produced," the corporation will generally have the right to refrain from disclosing such information prior to purchase.

221. In *Texas Gulf Sulphur*, for example, the company president specifically ordered insiders to keep the discovery at issue a secret so as not to tip off neighboring landowners. 401 F.2d at 843.

222. Once again, in *Texas Gulf Sulphur* the stock price rose substantially following unauthorized insider trading (from 20% when chemical assay results proved the discovery to around 37 when the discovery was publicly announced). *Id.* at 847.

223. Price-increasing insider trading could also thwart value-creating acquisitions of other businesses. As Bainbridge explains:

If managers charged with overseeing an acquisition buy shares in the target, and their trading has a significant upward effect on the price of the target's stock, the takeover will be more expensive. If significant price and volume changes are caused by their trading, that also might tip off others to the secret, interfering with the bidder's plans, as by alerting the target to the need for defensive measures.

BAINBRIDGE, *supra* note 4, at 600.

224. See Todd A. Bauman, Comment, *Insider Trading at Common Law*, 51 U. CHI. L. REV. 838, 863 n.114 (1984) ("[I]f a manager actually harms his corporation through a particular insider-trading transaction, he should be liable to his firm for a breach of his duty of care, even if it is determined that insider trading in general does not violate a manager's duty of loyalty.").

is difficult to see how such trading could thwart a value-creating corporate transaction that could otherwise be legally accomplished. The relevant situation would be one in which the corporation had an interest in keeping its stock's price inflated above its true value in order to accomplish some transaction. For example, the corporation might desire to use its overvalued stock as consideration for a purchase, to issue new equity at an inflated price, or to secure credit on favorable terms. But it probably could not do so. If insiders were aware of information indicating that the stock was overvalued but refrained from disclosing that information, any stock price-dependent transaction entered into during the period of inflation would likely be voidable by the corporation's counter-party.²²⁵ Thus, corporate transactions that would be thwarted by price-decreasing insider trading probably could not be legally accomplished in any event.

There is, in short, an asymmetry in the law regarding pre-contract disclosures, and that asymmetry causes price-increasing insider trading to be more value-destructive than price-decreasing insider trading. Because a corporation generally need not disclose information about hidden value before transacting on the basis of that information, it may legitimately keep such information a secret.²²⁶ Price-increasing insider trading may prevent it from doing so, and may thereby thwart value-creating transactions. Information suggesting that the corporation is overvalued, however, must generally be disclosed.²²⁷ Accordingly, price-decreasing insider trading would not reveal any corporate secrets that would not otherwise have to be revealed. It is therefore less likely to squander legitimate corporate opportunities.

225. See, e.g., RESTATEMENT (SECOND) OF CONTRACTS § 164 (1981) (permitting rescission of contract by party who is victim of fraudulent or material misrepresentation); *id.* § 161(b) (stating circumstances under which failure to disclose negative information may give rise to right to void a contract).

226. See *id.* § 161(b) cmt. d (observing that while “[a] buyer of property . . . is not ordinarily expected to disclose circumstances that make the property more valuable than the seller supposes,” the seller is “ordinarily expected to disclose a known latent defect of quality or title that is of such a character as would probably prevent the buyer from buying at the contract price”); Kronman, *supra* note 220, at 18 (arguing that deliberately produced information regarding hidden value need not be disclosed prior to contracting).

227. See RESTATEMENT (SECOND) OF CONTRACTS § 164(b) (1981) (stating that nondisclosure of a fact is fraudulent and renders a contract voidable where the non-disclosing party “knows that disclosure of the fact would correct a mistake of the other party as to a basic assumption on which that party is making the contract and if nondisclosure of the fact amounts to a failure to act in good faith and in accordance with reasonable standards of fair dealing”).

2. *Less Likely to Infringe Corporate Property Rights*

Some scholars, who are skeptical of most claims that insider trading harms investors and society in general, defend the insider trading prohibition (some version of it, at least) on grounds that it protects corporations' property rights to information regarding their business and prospects.²²⁸ Professor Stephen M. Bainbridge, for example, discounts most of the standard arguments that insider trading is harmful,²²⁹ but nonetheless concludes that the insider trading prohibition is justifiable "as a means of protecting property rights in information."²³⁰ Bainbridge and other "propertarians" explain that assigning the corporation a property right in information regarding firm prospects, and protecting that right by banning trading by insiders on the basis of that information, protects the firm's economic incentive to produce socially valuable information.²³¹ Bainbridge admits that property protection is not as crucial here as it is with traditionally recognized forms of intellectual property such as patents, for firm managers may be motivated to produce socially valuable information regarding the corporation's prospects even if that information does not receive property protection.²³² Nonetheless, he argues, "[t]here is no

228. See, e.g., BAINBRIDGE, *supra* note 4, at 598-607; Easterbrook, *supra* note 18, at 313; Macey, *supra* note 24, at 32.

229. See BAINBRIDGE, *supra* note 4, at 592-98 (discounting pro-regulation arguments other than those related to protection of firm's property rights).

230. *Id.* at 791.

231. See *id.* at 599 ("The rationale for prohibiting insider trading is the same as that for prohibiting patent infringement or theft of trade secrets: protecting the economic incentive to produce socially valuable information."); Easterbrook, *supra* note 18, at 313 (explaining how property protection may be necessary to preserve incentives to create information); Macey, *supra* note 24, at 30 ("Legal rules should be developed that insure the optimal production of information. Analysis of how optimal production might be achieved is best seen by viewing inside information as a form of property interest."); see also *United States v. Chestman*, 947 F.2d 551 (2d Cir. 1991) (Winter, J., dissenting), in which Judge Winter rationalized the federal insider trading ban as follows:

Information is perhaps the most precious commodity in commercial markets. It is expensive to produce, and, because it involves facts and ideas that can be easily photocopied or carried in one's head, there is a ubiquitous risk that those who pay to produce information will see others reap the profit from it. Where the profit from an activity is likely to be diverted, investment in that activity will decline. If the law fails to protect property rights in commercial information, therefore, less will be invested in generating such information.

Id. at 576-77 (Winter, J., dissenting).

232. BAINBRIDGE, *supra* note 4, at 604 ("From the corporation's perspective . . . legalizing insider trading would have a relatively small effect on the firm's incentive to develop new information."); see Kimberly D. Krawiec, *Fairness*,

avoiding the necessity of assigning a property interest in the information to either the corporation or the insider,²³³ and, because assignment of the right to the corporation is likely to have some positive incentive effect at the margin,²³⁴ the right ought to be assigned to the corporation.²³⁵ The argument for assigning the right to insiders, Bainbridge argues, is “considerably weaker.”²³⁶ He says that “[t]he only plausible reason for doing so is the argument that legalized insider trading would be an appropriate compensation scheme.”²³⁷ In sum, the proprietarians reason that because the incentive benefits of assigning the right to the corporation would likely exceed any benefits from providing insiders with compensation in the form of legal insider trading, the right to inside information ought to be given to the corporation.

This analysis assumes, though, that positive inside information (i.e., “good news” suggesting that the corporation is undervalued) and negative inside information (i.e., “bad news” suggesting that the corporation is overvalued) should be treated the same.²³⁸ In actuality, there are good reasons to afford different treatment to the two types of information. To see this point, consider (1) why the law creates rights to information, and (2) how it ought to go about assigning those rights.

The creation of a right to information should be based upon the extent to which creation of the right would enhance incentives to produce the information at issue; the more likely it is that property protection would enhance those incentives, the more appropriate it

Efficiency, and Insider Trading: Deconstructing the Coin of the Realm in the Information Age, 95 NW. U. L. REV. 443, 488-90 (2001) (arguing that firm managers would create the socially valuable information purportedly protected by the insider trading ban even if the corporation did not “own” the “right” to that information).

233. BAINBRIDGE, *supra* note 4, at 604.

234. *Id.* (“As with other property rights, the law . . . should simply assume (although the assumption will sometimes be wrong) that assigning the property right to agent-produced information to the firm maximizes the social incentives for the production of valuable new information.”).

235. *Id.* (“In some cases, however, insider trading will harm the corporation’s interests and thus adversely affect its incentives in this regard [i.e., to develop new, socially beneficial information]. This argues for assigning the property right to the corporation, rather than the insider.”).

236. *Id.*

237. *Id.*; see *supra* notes 28-31 and accompanying text (discussing argument that insider trading may provide efficient compensation mechanism).

238. It also appears to assume that the right should not be transferable from the corporation to insiders, a point that many proprietarians fiercely contest. See *supra* note 24 and accompanying text.

is for the law to recognize such a right.²³⁹ This observation suggests that property status is more appropriately afforded to positive inside information than to negative inside information. “Good news” is, to a large degree, deliberately *created* by the corporation’s agents as they perpetually work to cut costs, increase revenues, and expand markets. “Bad news,” on the other hand, tends simply to happen. Because there generally is less deliberate effort involved in creating negative inside information, there is less need for property protection at all. While it may be desirable to create incentives to *discover* negative inside information (as when an enterprising manager investigates consumer demand for his firm’s new or proposed product and discovers that it is softer than expected, or when a mid-level accountant scrutinizes records to discover that her peers are fudging the numbers to make the firm appear more profitable than it really is), there is no need to provide incentives to *create* the underlying facts. With respect to positive inside information, on the other hand, the law should encourage *both* the discovery *and* the creation of the underlying facts.²⁴⁰ Thus, the case for affording property status to inside information is stronger for positive inside information than for negative inside information, though it still might be desirable to recognize property rights to negative inside information so as to encourage its discovery.

The more important consideration, though, is the question of assignment. Assuming there are good reasons for affording property status to both positive and negative inside information, should the rights to both sorts of information be assigned to the same party? Probably not. Investors would be best off if the right to information regarding corporate affairs were assigned to the corporate constituent most likely to use it to maximize firm value. If giving the right to the information to the corporation and denying insiders a right to use it would maximize firm value, then the corporation ought to get the right; if instead firm value would be maximized by giving the right to corporate agents, then investors would prefer that the right be distributed accordingly.²⁴¹ There are good reasons

239. See BAINBRIDGE, *supra* note 4, at 599; Easterbrook, *supra* note 18, at 313-14.

240. Note, though, that the case for property rights in positive inside information still is not as strong as the case for traditional forms of intellectual property, for managers are generally motivated to create good news even without property protection. See Krawiec, *supra* note 232, at 489 (“Issuers create valuable information about themselves to operate a successful business enterprise, not to generate trading profits.”).

241. One can imagine a hypothetical bargain among investors and managers over how the rights to positive and negative inside information should be allocated. The party that could create the most value from the information

to believe that the corporation is most likely to maximize the value of positive inside information, but that corporate agents acting in their individual capacities are more likely to maximize the value of negative inside information.

First, consider positive inside information. As noted, it is often the case that a value-enhancing corporate opportunity will be available only if the firm is able to enter into contracts that would be thwarted (or would be possible only on less favorable terms) by insider trades.²⁴² If the good news regarding the corporate opportunity were exploitable by insiders, the opportunity and the corporate value created thereby would not be available to the firm. Accordingly, value would be maximized by giving the firm the right to positive inside information.

With regard to negative inside information, by contrast, employees are more likely to be the value-maximizers. If the corporation "owns" bad news, corporate managers will likely suppress the news to the extent they are permitted to do so under the securities laws,²⁴³ leading to a period of overvaluation and the costs that accompany such mispricing.²⁴⁴ This period of overvaluation, unlike the period of undervaluation that will occur if managers suppress good news in order to pursue a corporate opportunity that might otherwise be thwarted,²⁴⁵ will not result in the creation of any lasting value for the corporation. Thus, if the

would, assuming it could capture that value for itself because the information's benefits accrued to it naturally or could be "sold" to those it benefited, be willing to "pay" the most for the information. (The corporation would "pay" by providing a higher wage to employees in exchange for their forbearance from using the information; the employees would "pay" by reducing their wage demands.) In any event, the party valuing the information the most would likely end up with it. *See generally* R.H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1 (1960). The law, then, ought to initially assign the right to the party most likely to create the most value from the information—the ultimate "buyer" in the hypothetical bargain.

242. Insider trades would signal the firm's contracting partner to refrain from executing the deal or to demand more favorable terms. *See supra* notes 219-24 and accompanying text.

243. Bad news need not be disclosed absent some affirmative disclosure requirement, such as one of the requirements imposed by the laws mandating periodic disclosures. *See, e.g.*, *Gallagher v. Abbott Labs.*, 269 F.3d 806, 808 (7th Cir. 2001) ("We do not have a system of continuous disclosure. Instead firms are entitled to keep silent (about good news as well as bad news) unless positive law creates a duty to disclose."). This means corporate managers will often be free to sit on bad news and allow overvaluation to persist (and increase in magnitude).

244. *See supra* notes 148-205 and accompanying text (discussing agency costs resulting from overvaluation).

245. *See supra* notes 218-21 and accompanying text.

negative information is owned by the corporation, it is not likely to be used in a way that enhances investor wealth in a non-transitory fashion. If, instead, corporate employees own the bad news they discover, they are likely to trade on it, pushing the corporation's stock price toward actual value.²⁴⁶ This salutary effect on price will alleviate the investor harms associated with equity overvaluation (e.g., agency costs) *and* will benefit society as a whole (not just investors) by enhancing allocative efficiency.

In sum, the optimal allocation of property rights in inside information regarding firm prospects—i.e., the allocation corporate agents and investors would agree to in a hypothetical bargain²⁴⁷—would likely assign the right to positive inside information to the corporation, while allocating the right to negative inside information to corporate insiders. Thus, price-decreasing insider trading, unlike price-increasing insider trading, would not infringe upon the corporation's right to information concerning firm prospects.

3. *Less Likely to Dissuade Investors*

A corporation's liberalization of insider trading might dissuade potential stockholders from investing in that corporation. Investors may be dissuaded by concerns about firm value (i.e., they may perceive that a liberalized insider trading policy will result in management decisions that lower the firm's fundamental value),²⁴⁸ or they may steer clear of the firm out of concern that they could end up trading stock with an insider possessing an informational advantage. It is likely, though, that investors would be less dissuaded by an asymmetric policy that liberalized price-decreasing insider trading but generally banned the price-increasing variety than by all-or-nothing policies that either permitted or banned all insider trading.

To see this point, consider the decision calculus facing an investor deciding among investments in three firms that are identical except for their insider trading policies. Suppose that Firm A bans all insider trading, Firm B permits all insider trading, and Firm C permits price-decreasing insider trading (at least, if it is disclosed)²⁴⁹ while generally banning price-increasing insider

246. See *infra* notes 260-87 and accompanying text (explaining why agents are likely to engage in price-decreasing insider trading if permitted to do so).

247. See *supra* note 241.

248. See *supra* note 14 and accompanying text; *infra* notes 289-90 and accompanying text (discussing potential mismanagement occasioned by a liberalized insider trading policy).

249. For reasons discussed below, a firm adopting a policy liberalizing price-decreasing insider trading would likely require that such trading be disclosed at the time of execution. See *infra* notes 260-80 and accompanying text.

trading. With respect to Firm A (no insider trading allowed), the investor would take comfort in the fact that she would not be purchasing stock from an insider with superior information, but she would worry that the stock might be currently overvalued or that it might become substantially overvalued, leading to increased agency costs and a potential crash.²⁵⁰ With respect to Firm B (all insider trading allowed), the investor would not be concerned about significant overvaluation (insider trading would prevent such mispricing),²⁵¹ but she might worry that the liberalized insider trading policy could result in insiders' squandering corporate opportunities, thereby reducing long-term firm value.²⁵² With respect to Firm C (only price-decreasing insider trading allowed), the investor would take comfort in the fact that the stock is unlikely to be overvalued,²⁵³ and she would not worry about insiders squandering otherwise available corporate opportunities.²⁵⁴ While she would run the risk that she might be buying from an insider possessing an informational advantage, she would not be particularly concerned, for the extent of overvaluation likely would not be great.²⁵⁵ Moreover, for reasons discussed below, any concerns about corporate mismanagement would be allayed by a corporate policy requiring that price-decreasing insider trading be immediately disclosed.²⁵⁶ Thus, of the three possible insider trading policies, a policy authorizing price-decreasing insider trading, but not the price-increasing variety, seems least likely to dissuade potential investors.

250. See *supra* notes 132-212 and accompanying text (discussing overvaluation's effect on agency costs and reliance costs).

251. As explained below, disclosed price-decreasing insider trading would prevent stock price overvaluation by "derivatively informing" the market that those closest to the business believed it to be overvalued. See *infra* notes 260-80 and accompanying text.

252. See *supra* notes 218-23 and accompanying text (explaining how price-increasing insider trading may squander corporate opportunities).

253. See *infra* notes 260-80 and accompanying text (explaining why disclosed price-decreasing insider trading will prevent overvaluation).

254. See *supra* notes 223-25 and accompanying text (explaining why price-decreasing insider trading, unlike the price-increasing variety, would not thwart otherwise available corporate opportunities).

255. See *infra* notes 284-87 and accompanying text (explaining how liberalized price-decreasing insider trading essentially creates a "bounty" for the first insider to "report" overvaluation, thereby preventing companies from becoming significantly overvalued).

256. See *infra* notes 289-96 and accompanying text (explaining how disclosure requirement could alleviate concerns about mismanagement occasioned by liberalized price-decreasing insider trading).

C. Synthesis: An Asymmetric Insider Trading Policy as Majoritarian Default

So far, we have seen that: (1) undervaluation is more likely to be self-correcting (even without insider trading) than overvaluation;²⁵⁷ (2) in the long run, undervaluation is unlikely to impose significant costs on investors, while overvaluation is likely to do so;²⁵⁸ and (3) whereas insider trading that pushes a stock's price upward toward actual value may cause harm to the corporation and its investors, insider trading that pushes an inflated price downward toward value is unlikely to do so.²⁵⁹ Taken together, these observations suggest that an asymmetric insider trading policy that permits some form of price-decreasing insider trading, while generally banning price-increasing insider trading, is the policy investors and managers would likely bargain for were they able (practically and legally) to do so. In other words, an asymmetric insider trading policy that liberalizes only price-decreasing insider trading likely represents the majoritarian default policy.

But that's the easy part. As with so many policy proposals, the devil is in the details. Specifically, how would corporations structure a policy liberalizing price-decreasing insider trading so as to maximize such trading's salutary effect on stock price? Would corporate insiders engage in price-decreasing insider trading if they were legally permitted to do so? And would a policy liberalizing such trading encourage mismanagement and/or hinder the flow of negative information within the corporation? The following discussion outlines the sort of liberalized policy corporations would likely adopt (Part II.C.1) and addresses potential problems such a policy might create (Part II.C.2).

1. The Design of the Default Policy: Disclosed Price-Decreasing Insider Trading Permitted

The fundamental objective of a policy liberalizing price-decreasing insider trading would be to harness insider trading's power to drive stock prices toward their fundamental value.²⁶⁰

257. See *supra* Part II.A.1 (explaining why managers and analysts are more likely to correct undervaluation than overvaluation).

258. See *supra* Part II.A.2 (explaining why overvaluation is more likely to cause significant investor harm than undervaluation).

259. See *supra* Part II.B (discussing how price-increasing insider trading is more likely than the price-decreasing variety to squander corporate opportunities, infringe upon corporate property rights to information, and dissuade potential investors).

260. As discussed above, there is near consensus among economists that insider trading pushes a stock's market price toward its fundamental value.

Accordingly, structuring an effective policy requires consideration of the mechanisms by which insider trading leads to more accurate securities prices. Insider trading has its price-correcting effect because it conveys a valuable piece of information: that those closest to the company and most informed about its operations believe it to be either undervalued (in the case of insider purchases) or overvalued (in the case of insider sales).²⁶¹ Armed with that information, investors who are not privy to the actual facts motivating the insider transactions will nonetheless follow the lead of the insiders by buying or selling the stock or adjusting their reservation prices (the amount they would be willing to pay to obtain the stock or would require to give it up).²⁶² As a result of this process, the market price of the stock will change to reflect the information conveyed by insider trades and, because insiders are the individuals best-informed about the company's true prospects, will become more accurate.²⁶³

As Professors Ronald J. Gilson and Reinier H. Kraakman famously explained, there are actually two mechanisms by which insider trading may "derivatively inform" traders of stock mispricing (and thereby promote price-correction).²⁶⁴ First, investors may

See supra note 25 and accompanying text.

261. *See* Gilson & Kraakman, *supra* note 37, at 629-30 (explaining why insider trading will tend to push stock prices in the right direction).

262. *See* Jesse M. Fried, *Reducing the Profitability of Corporate Insider Trading Through Pretrading Disclosure*, 71 S. CAL. L. REV. 303, 324 (1998) (explaining how investors follow the lead of insiders in determining how to value a stock and where to invest their money).

263. It is important to recognize that insider trading's salutary price effect results from the information such trading conveys, not from the fact that the trading alters the supply of or demand for the security at issue. The supply effect of insider trading could not be responsible for the price changes it causes because the relevant supply at issue is not the particular security being traded, but is instead the risk-reward combination offered by that security *and a host of others*, and is thus so vast that any increased or reduced demand by insiders would be too small to affect price. *See* Gilson & Kraakman, *supra* note 37, at 630 (noting that because "the relevant supply for purposes of determining the impact of insider trading is not the 'float' in the particular security, but rather the total of all other investment opportunities with a similar relationship between risk and return," the supply change occasioned by insider trading "is simply too small to have any but a transitory, and probably insignificant, impact on the price of the security"); *see also* R.A. BREALEY, AN INTRODUCTION TO RISK AND RETURN FROM COMMON STOCKS 35-44 (2d ed. 1983) (making a similar point); Frank H. Easterbrook, *Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information*, 1981 SUP. CT. REV. 309, 335-36 (making a similar point).

264. The trading and reservation price-adjustment that occurs following insider trades is "derivatively informed," for it is based on information inferred

engage in “trade decoding” whereby they deduce binary information regarding a firm’s prospects (i.e., that they are either improving or worsening) from insiders’ trades.²⁶⁵ The problem with trade decoding, Gilson and Kraakman argued, is that “uninformed traders must be able to identify informed traders individually and observe their trading activities directly,”²⁶⁶ and they are somewhat limited in their ability to do so because not all trades by insiders must be disclosed to the market, and those that must be disclosed need not be disclosed immediately.²⁶⁷ Non-insiders may also engage in “price decoding,” whereby they observe a price change occasioned by insider trading of a sufficient volume, compare the price change to the public information concerning the firm’s prospects, and infer what possible new information would successfully explain observed price changes.²⁶⁸

Trade decoding and price decoding differ in terms of their preconditions (i.e., what is required in order for each to occur?) and their effects (i.e., what information does each convey?). With respect to preconditions, trade decoding requires some identification of insider trades,²⁶⁹ while price decoding does not require such identification,²⁷⁰ but instead requires trading of a quantity sufficient to cause some sort of change in price or observable trading volume.²⁷¹ With respect to the level of information provided, trade decoding reveals only whether a firm’s prospects are improving or declining, whereas price decoding provides information regarding *why* the firm’s prospects are changing.²⁷²

In light of these differences, trade decoding is more likely to be

from facts related to the trading of others. See Gilson & Kraakman, *supra* note 37, at 572-79 (describing derivatively informed trading).

265. *Id.* at 573 (“Trade decoding occurs whenever uninformed traders glean trading information by directly observing the transactions of informed traders.”).

266. *Id.* at 574.

267. See 15 U.S.C.A. § 78p(a) (West 1997 & Supp. 2006) (requiring only that officers, directors, and ten percent shareholders—no other insiders—disclose their trades in their own company’s securities within two business days).

268. Gilson & Kraakman, *supra* note 37, at 575 (describing price decoding).

269. *Id.* at 574 (“[U]nformed traders must be able to identify informed traders individually and observe their trading activities directly.”).

270. *Id.* at 574-75 (noting that price decoding “does not require uninformed traders to discover the identity of their informed cohorts”).

271. *Id.* at 575 (summarizing “the logic of price decoding” as follows: “When trading on inside information is of sufficient volume to cause a change in price, this otherwise inexplicable change may itself signal the presence of new information to the uninformed.”).

272. *Id.* at 575-76 (explaining that price decoding may permit investors to determine the actual content of the information generating insider trades).

the means by which insider trading would reduce the price of overvalued equity.²⁷³ Correction of overvaluation requires only that investors know that insiders believe—and are willing to bet money on the fact—that their firm is overvalued. Because investors need not know the reason for the insiders' belief, the enhanced information provided by price decoding is of little value if the goal is simply to align price with fundamental value.²⁷⁴ Moreover, the precondition for trade decoding is more likely to be met than the precondition for price decoding. It is unlikely that insiders believing a firm to be overvalued will sell enough stock to move the market price by altering supply.²⁷⁵ It is more likely that insider sales (or purchases of put options) will be revealed to the market. First, insiders' brokers may tend to share information regarding insider transactions with others.²⁷⁶ Second, many insiders (officers, directors, and shareholders owning at least ten percent of voting securities) will have to disclose their sales within two business days pursuant to Exchange Act Section 16(a),²⁷⁷ a provision that has been rather markedly amended since Gilson and Kraakman opined that trade decoding would be unlikely to occur in a timely fashion.²⁷⁸

273. *Id.* at 631-32 (arguing that trade decoding is the primary means by which insider trading leads to market efficiency).

274. This is simply an application of F.A. Hayek's famous point that for efficiency purposes it is not necessary for decisionmakers to know *why* willingness to pay for a commodity has changed, but merely that it has. See Hayek, *supra* note 34, at 525 ("It is always a question of the relative importance of the particular things with which he is concerned, and the causes which alter their relative importance are of no interest to him beyond the effect on those concrete things of his own environment.").

275. See *supra* note 263 (noting the unlikelihood that non-transitory stock price changes could be occasioned by supply effects resulting from insider transactions).

276. This is an instance of what Gilson and Kraakman term "pure" informational leakage. See Gilson & Kraakman, *supra* note 37, at 572-73.

277. 15 U.S.C.A. § 78p(a)(2) (West 1997 & Supp. 2006).

278. The Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002), amended Section 16(a) to require that insider transactions be reported within two business days, that they be reported electronically (so the SEC could quickly make them public), and that they be posted on the relevant corporation's Internet website at the time of reporting. See 15 U.S.C.A. § 78p(a)(2) (West 1997 & Supp. 2006) (reflecting Sarbanes-Oxley amendments). Prior to this amendment, Section 16(a) permitted paper filing, did not require disclosure at the corporate level, and required reporting to the SEC only by the tenth day of the month following the transaction at issue (so up to forty days could pass before insider trades were publicly reported). See 15 U.S.C. § 78p(a) (2000), amended by Pub. L. No. 107-204, § 403(a), 116 Stat. 745 (2002) (current version at 15 U.S.C.A. § 78p(a)(2) (West 1997 & Supp. 2006)). Thus, Gilson and Kraakman argued (in 1984) that "while certain insiders are currently required by Section 16(a) of the Securities Exchange Act to disclose their trading,

Of course, the easier it is for market participants to identify instances of insider selling (and thus to engage in trade decoding), the more likely price correction is to occur, and to do so rapidly.²⁷⁹ Thus, a corporation seeking to prevent the overvaluation of its stock by liberalizing price-decreasing insider trading would probably adopt procedures that would ensure that such trades could quickly be identified by traders. It might, for example, require its agents to report their sales (or purchases of put options) immediately, or it might require agents to funnel all such transactions through particular brokers who would immediately report the transactions as a matter of course. The firm would also ensure that the reported information was publicized as quickly as possible, perhaps by maintaining a constantly updated Internet site cataloguing insider stock sales and put option purchases. Analysts following the company, then, could monitor the site for interesting trades (i.e., large sales or put purchases by employees in a position to know some sort of price-decreasing information) and could direct their clients to trade in accordance with the information they gleaned.²⁸⁰ In short, most firms would elect a policy that permitted *immediately disclosed* price-decreasing insider trading.

2. Potential Problems

The primary objective of a corporate policy liberalizing price-decreasing insider trading could be achieved only if corporate insiders would actually engage in such trading. Moreover, the liberalized insider trading policy would be counterproductive if the value enhancement occasioned by preventing and reducing overvaluation were outweighed by value destruction resulting from an increase in corporate mismanagement. Critics may therefore contend that (1) corporate insiders would not engage in price-decreasing insider trading even if permitted to do so, or (2) the value

disclosure is required only some ten to forty days after the trade, hardly an aid to efficient operation of the derivatively informed trading mechanism." Gilson & Kraakman, *supra* note 37, at 632 (footnotes omitted).

279. Carlton & Fischel, *supra* note 3, at 868 ("The greater the ability of market participants to identify insider trading, the more information such trading will convey."); Gilson & Kraakman, *supra* note 37, at 631-32 ("[T]he greater the number of uninformed traders who are able to learn the identity of insider traders, the size of their trades, and other derivative information, the more effectively the derivatively informed trading mechanism will operate and the greater will be the market's relative efficiency with respect to the inside information.").

280. A number of private services compile information on insider trading reports and distribute it to market participants. See Fried, *supra* note 262, at 324.

loss resulting from authorizing price-decreasing insider trading would outweigh any value enhancement occasioned by reducing the incidence and magnitude of equity overvaluation. Neither criticism undermines the case for liberalizing price-decreasing insider trading.

a. *Would Insiders Actually Engage in Disclosed Trading?*

There are several reasons to doubt that price-decreasing insider trading, even if authorized, would be widespread. In many (perhaps most) corporate cultures, betting against the company would be considered treasonous, and insiders considering whether to engage in price-decreasing insider trading might be concerned about negative job repercussions.²⁸¹ Perhaps more importantly, insiders may forego price-decreasing insider trading because they personally stand to benefit from overvalued equity. Many insiders attain reputational benefits from being associated with a firm with a high stock price,²⁸² and, of course, the value of their holdings of company stock is enhanced, at least temporarily, if the stock is overvalued. Thus, even if they know the mispricing will eventually be corrected, one might expect them to hold on to appreciating stock for as long as possible so as to maximize their trading gains. In addition, insiders may worry that a price correction will result in a corporate shake-up that threatens their jobs or compensation.²⁸³ Therefore, one might question whether insiders who knew of overvaluation would reveal it by engaging in authorized trading.

Insiders likely would, for the temptation of financial rewards would probably overwhelm the forces stifling price-decreasing insider trading. A company that had adopted a policy liberalizing such trading would have made an apparent attempt to alter the corporate norms against betting against the company, so insiders considering whether to engage in price-decreasing insider trading would have received an implicit green light from their principals. Undoubtedly, some corporations would adopt an official policy allowing price-decreasing insider trading, while simultaneously maintaining a corporate norm that such trading is improper, but such a clandestine norm would be difficult to maintain. In the end, the constant allure of potential insider trading profits (which grow as the extent of overvaluation increases), coupled with the corporation's official imprimatur on price-decreasing insider trading, would likely lead to defections by rogue insiders who would have strong grounds for attacking any apparently retaliatory employment

281. Cf. SUROWIECKI, *supra* note 55, at 224-28 (discussing powerful social norms against short-selling).

282. See *supra* notes 141-43 and accompanying text.

283. This is a version of the "last period" problem discussed *supra* at notes 62-63 and accompanying text.

decision. Corporate norms against price-decreasing insider trading, then, likely pose little barrier to the success of a liberalized insider trading policy.

Nor is it likely that insiders would collusively refrain from engaging in price-decreasing insider trading in order to maintain and enhance a high stock price. As antitrust scholars have long noted, cartels are inherently unstable.²⁸⁴ Because the first colluder to defect gains a disproportionate share of any surplus created by the collusion, each participant has a private incentive to be the first defector.²⁸⁵ With price-fixing, the first cartel member to lower his price from the agreed-upon level stands to steal business from all other participants, so cheating (or the possibility thereof) usually undermines a cartel.²⁸⁶ Here, the first insider to engage in disclosed price-decreasing insider trading would make the most money on her sale, for after the initial instance of such trading, the price at which subsequent sales could be consummated would likely be reduced. Each insider colluding to keep the stock price inflated would therefore face a private incentive to be the first defector.²⁸⁷ And, of course, the magnitude of this incentive would grow as the discrepancy between price and value expanded. Any conspiracy to refrain from price-decreasing insider trading is therefore likely to fail.

Ultimately, a policy liberalizing price-decreasing insider trading provides a means of rewarding whistleblowers with a “bounty” for conveying information (via their trading) that the stock price is overvalued. In many—perhaps most—cases, the price inflation will be due to some concealment by insiders. Thus, in authorizing publicly disclosed price-decreasing insider trading, a corporation would be putting in place a bounty system designed to promote

284. Christopher R. Leslie, *Trust, Distrust, and Antitrust*, 82 TEX. L. REV. 515, 518 (2004); see also Alexis Jacquemin & Margaret E. Slade, *Cartels, Collusion, and Horizontal Merger*, in 1 HANDBOOK OF INDUSTRIAL ORGANIZATIONS 416, 420-21 (Richard Schmalensee & Robert D. Willig eds., 1989) (explaining how incentives to cheat render cartels inherently unstable).

285. See Leslie, *supra* note 284, at 518-19 (2004) (observing that “cartels are inherently unstable” because members have an incentive to cheat by defecting or reporting the cartel).

286. PHILLIP E. AREEDA, HERBERT HOVENKAMP, & JOHN L. SOLOW, ANTITRUST LAW, para. 405b2, at 25 (1995) (“[P]rice fixing often carries the seeds of its own destruction. For the effect of fixing a price well above costs is to induce each collaborator to try to win additional sales.”).

287. Cf. Carlton & Fischel, *supra* note 3, at 874 (“Collusion to decrease the value of the firm among managers in pursuit of trading profits is unlikely to succeed because, as in all cartels, each rational member will cheat insofar as the gains to a lone cheater from exposing others will exceed his gains from collusion.”).

candor by rewarding insiders who blow the whistle on nondisclosure of material information. The financial rewards available from this sort of bounty scheme (which is a well-established means of combating fraud²⁸⁸ and would be valued by investors) would likely drive knowledgeable insiders to engage in price-decreasing insider trading, despite any informal corporate norms or collusive tendencies that might discourage such trading.

b. *What About Corporate Mismanagement and/or Impairment of Intra-Firm Information Flow?* Even if one were confident that insiders would engage in authorized price-decreasing insider trading, thereby reducing the incidence and magnitude of overvalued equity, one might still oppose trading liberalization if it threatens to cause value-reducing actions by insiders. At least two types of conduct are potentially troubling. First, authorizing price-decreasing insider trading may create a perverse incentive for insiders to create conditions that reduce stock price and then to trade before the stock price falls.²⁸⁹ Second, liberalizing such trading may impair the intra-firm flow of important information, for insiders at each level within the corporate hierarchy may delay the transmission of negative information until they have traded on the bad news.²⁹⁰ If the investor losses occasioned by deliberate mismanagement and/or delayed disclosure outweigh the value of gains resulting from reducing equity overvaluation, a policy liberalizing price-decreasing insider trading will not be optimal.

In actuality, there is probably little reason to worry about deliberate mismanagement or delayed disclosure. As Carlton and Fischel have observed, mismanagement occasioned by the possibility of gains from price-decreasing insider trading is unlikely because corporate managers, who generally work in teams, cannot engage in value-destroying mismanagement without persuading their colleagues to go along with the strategy, and any particular employee's ability to engage in mismanagement will therefore be constrained by his colleagues' attempts to maximize firm value or to

288. For example, the *qui tam* provisions of the False Claims Act permit a private plaintiff to bring a civil action under the Act on behalf of the government, and if the action is successful, the private plaintiff receives a statutory bounty from the government's recovery. 31 U.S.C. § 3730(d) (2000). See generally AM. BAR ASS'N, QUI TAM LITIGATION UNDER THE FALSE CLAIMS ACT (Howard W. Cox & Peter B. Hutt II eds., 2d ed. 1999).

289. One of the chief arguments against deregulating insider trading in general is that such deregulation would create perverse incentives for managers to create "bad news" upon which they could earn trading profits. See *supra* note 14 and accompanying text. See generally Levmore, *supra* note 14; Mendelson, *supra* note 14; Schotland, *supra* note 3.

290. See Haft, *supra* note 13.

gain personally by exposing proposed mismanagement.²⁹¹ Moreover, if trades must be immediately disclosed, as would be likely,²⁹² any traders responsible for causing a stock price to fall would be exposed. Both senior managers and plaintiffs' lawyers are likely to pay keen attention to trading disclosures. If an insider's trade were followed by a stock price decrease, and the insider's position within the firm suggested that he had some control over the business decision(s) that reduced the firm's value, he would likely be subject to adverse employment action or, if he were senior enough, to a derivative suit.²⁹³ Similarly, if an insider were to delay disclosure of negative information in order to trade on it first, his superiors could easily note the timing of his trade and, if the delay harmed (or could have harmed) the enterprise,²⁹⁴ would likely punish the offender. In short, publicity will police instances of deliberate mismanagement and delay in conveying information.

Of course, the ultimate rejoinder to claims that the liberalized price-decreasing insider trading policy proposed herein will reduce corporate value is that the proposed policy is merely a default rule. If a corporation finds that the costs associated with liberalizing price-decreasing insider trading exceed the benefits to investors, it will likely jettison the policy, for competitive capital markets encourage firms to minimize their costs of capital by adopting insider trading policies that maximize firm value.²⁹⁵ This Article argues that most firms would likely adopt a policy permitting price-decreasing insider trading while generally banning price-increasing insider trading. If that rule is adopted as the default policy, firms

291. See Carlton & Fischel, *supra* note 3, at 874 (“[T]he ability of any one manager to pursue bad opportunities will be constrained because other managers and employees will attempt to maximize the firm’s value.”).

292. See *supra* notes 260-80 and accompanying text (arguing that firms adopting a policy liberalizing price-decreasing insider trading would likely require contemporaneous disclosure of such trades).

293. Plaintiffs’ lawyers are the driving force behind most derivative litigation. See BAINBRIDGE, *supra* note 4, at 367 (“[T]he real party in interest—the party on the plaintiffs’ side with the greatest personal interest in the outcome of the [derivative] litigation—is the plaintiffs’ attorney rather than the nominal shareholder-plaintiff.”). Under a regime permitting publicized price-decreasing insider trading, those attorneys would likely follow insider trading disclosures and initiate actions against insiders who appear to have contributed to value-reducing corporate decisions.

294. Given the speed with which securities trades can be executed, delaying conveyance of information in order to first trade on it likely would have little adverse effect on the intra-firm flow of information.

295. See Carlton & Fischel, *supra* note 3, at 862-63 (“If it is bad, firms that allow insider trading will be at a competitive disadvantage compared with firms that curtail insider trading.”).

discovering that liberalization creates greater losses than benefits can—and will—adopt more restrictive policies.²⁹⁶ In particular, they may limit by contract the class of insiders permitted to engage in price-decreasing insider trading. They may decide, for example, that senior managers, who are best able to create bad news, should not be permitted to engage in such trading. Capital market pressure will lead them to adopt the trading restrictions most favored by investors.

III. THE LEGAL FEASIBILITY OF AN ASYMMETRIC INSIDER TRADING REGIME

Part II argued that an asymmetric insider trading regime, in which price-decreasing insider trading is treated more leniently than the price-increasing variety, is the majoritarian default—the bargain managers and investors would likely strike were they able to negotiate freely. This Part argues that such an asymmetric regime is feasible under current insider trading doctrine, even if unclear issues raised by current doctrine are resolved in a manner that is fairly hostile to efforts to contract out of insider trading liability.

In order to articulate this legal argument, I must begin with a brief summary of insider trading doctrine. Readers familiar with the relevant legal rules may wish to skip Part III.A, which describes current insider trading doctrine, and proceed directly to Part III.B, which explains why an asymmetric insider trading regime would be permissible under current law.²⁹⁷

296. Of course, a corollary to this position is that the ban on price-increasing insider trading should also be waiveable. If a corporation were to discover that the costs associated with price-increasing insider trading (e.g., the potential for squandered corporate opportunities, *see supra* notes 218-23 and accompanying text) were outweighed by benefits (e.g., lower salary requirements for managers, *see supra* notes 28-31 and accompanying text), the corporation should be permitted to opt out of the ban on price-increasing insider trading. Carlton and Fischel have argued for this type of private contractual approach to insider trading. *See* Carlton & Fischel, *supra* note 3, at 861-66. While I am entirely sympathetic to their position, my point here is merely that an asymmetric insider trading policy permitting price-decreasing but not price-increasing insider trading is likely the policy most corporate constituents would bargain for if legally and practically able to do so and therefore ought to be adopted as the default policy. Moreover, for reasons explained below, the asymmetric insider trading policy proposed herein could be adopted under current law. *See infra* notes 343-69 and accompanying text. By contrast, the purely contractual approach advocated by Carlton and Fischel probably is not achievable under current law. *See infra* note 358 and accompanying text.

297. While current law would permit authorized price-decreasing insider trading, the SEC, which has a long history of seeking to expand the insider

A. *Prevailing Legal Doctrine*

Insider trading, generally defined as trading in securities while in possession of material, nonpublic information,²⁹⁸ may run afoul of several provisions of federal law. In addition to Section 16(b) of the Securities Exchange Act,²⁹⁹ which posits a prophylactic ban on “short-swing profits” earned by certain insiders trading in their own companies’ stock,³⁰⁰ there are three basic theories under which trading on inside information may violate federal law.³⁰¹ Two of these theories, the “disclose or abstain” rule (also called the “classical theory”) and the misappropriation doctrine, derive from Securities Exchange Rule 10b-5,³⁰² which is a general anti-fraud rule that was promulgated pursuant to Section 10(b) of the Securities Exchange Act.³⁰³ The third theory derives from Securities Exchange Rule 14e-3,³⁰⁴ a more narrowly tailored rule that was promulgated under Exchange Act Section 14(e).³⁰⁵

1. *The Disclose or Abstain Rule*

When it applies, the disclose or abstain rule requires a trader possessing material, nonpublic information either to disclose her inside information before trading or to abstain from trading altogether.³⁰⁶ The rule had its genesis in *Texas Gulf Sulphur*,³⁰⁷

trading prohibition, would probably pursue legal action against corporations that attempted to authorize such trading and/or against the insiders who traded pursuant to such authorization. See BAINBRIDGE, *supra* note 4, at 583-86 (discussing regulators’ zeal to expand insider trading prohibition beyond limits of enabling statute). Accordingly, corporations are unlikely to authorize price-decreasing insider trading, despite the likely legality of such trading, absent express approval of such trading by regulators.

298. Bainbridge, *supra* note 3, at 773.

299. 15 U.S.C. § 78p(b) (2000).

300. Section 16(b) requires a defined set of corporate insiders (directors, officers, and shareholders possessing at least ten percent of voting securities) to disgorge profits on any set of purchase and sale transactions occurring within a six month period. *Id.* § 78p(b). This disgorgement requirement applies regardless of whether the statutory insider traded on the basis of, or even possessed, material nonpublic information. It therefore is not an insider trading ban per se.

301. Insider trading may also violate federal mail and wire fraud laws, but the theory of fraud under those provisions mirrors the two theories under Section 10(b)/Rule 10b-5 and will not be discussed here. See 18 U.S.C. § 1341 (mail fraud); *id.* § 1343 (wire fraud); LOUIS LOSS & JOEL SELIGMAN, *FUNDAMENTALS OF SECURITIES REGULATION* 741-43 (3d ed. 1995).

302. 17 C.F.R. § 240.10b-5 (2006).

303. 15 U.S.C. § 78j(b) (2000).

304. 17 C.F.R. § 240.14e-3(a).

305. 15 U.S.C. § 78n(e).

306. See generally BAINBRIDGE, *supra* note 4, at 531-37 (discussing the

discussed above,³⁰⁸ in which the Second Circuit held that insiders of a corporation that owned land upon which a valuable mineral deposit was discovered had violated Rule 10b-5 by purchasing stock of their company prior to public disclosure of the ore strike.³⁰⁹ This duty to disclose or abstain, the court reasoned, was inherent in Rule 10b-5's underlying policy of protecting "the justifiable expectation of the securities marketplace that all investors trading on impersonal exchanges have relatively equal access to material information."³¹⁰

In *Chiarella v. United States*,³¹¹ the Supreme Court expressed approval of a disclose or abstain rule, but found it to be based not on some implicit policy of equal access to information but instead on the fiduciary relationship existing between a corporate insider and her trading partner.³¹² The Court reasoned that Rule 10b-5's prohibition on fraud is violated when a corporate insider, who owes a fiduciary duty to the corporation's shareholders, purchases stock from a shareholder without first informing her of material, nonpublic information of which the insider is aware.³¹³ The fraud, of course, is not an affirmative misrepresentation (assuming the insider did not actually lie about the information to which he was privy), but is instead failure to speak in the face of a duty to do so.³¹⁴

disclose or abstain rule). In a face-to-face transaction, the information must be disclosed, prior to trading, directly to the insider's trading partner. If the transaction is accomplished on an impersonal stock exchange, as most securities transactions are, the information must first be publicly disclosed via some broad medium (e.g., a newswire).

307. *SEC v. Tex. Gulf Sulphur Co.*, 401 F.2d 833, 848 (2d Cir. 1968).

308. *See supra* notes 217-22 and accompanying text.

309. *Tex. Gulf Sulphur*, 401 F.2d at 852.

310. *Id.* at 848 (holding that, in light of Rule 10b-5's underlying policy of equal access to information, "anyone in possession of material inside information must either disclose it to the investing public, or, if he is disabled from disclosing it in order to protect a corporate confidence, or he chooses not to do so, must abstain from trading in or recommending the securities concerned while such inside information remains undisclosed.").

311. 445 U.S. 222 (1980).

312. *Id.* at 235 ("We hold that a duty to disclose under § 10(b) does not arise from the mere possession of nonpublic market information."); *id.* at 233 (declining to recognize "a general duty between all participants in market transactions to forgo actions based on material, non-public information" because "[f]ormulation of such a broad duty, which departs radically from the established doctrine that duty arises from a specific relationship between two parties . . . should not be undertaken absent some explicit evidence of congressional intent").

313. *Id.* at 227-30 (explaining how fraud may result from nondisclosure by corporate insider who is a fiduciary of his trading partner).

314. *Id.* at 228 ("[O]ne who fails to disclose material information prior to the consummation of a transaction commits fraud only when he is under a duty to

The duty to speak, the Court reasoned, arises from the fiduciary relationship between insider and trader.³¹⁵ Accordingly, the *Chiarella* defendant, an employee of a printing firm hired to assist the buyer in a corporate acquisition, could not have violated Rule 10b-5 by purchasing stock of the target corporation, for he was not a fiduciary of the target corporation's shareholders and thus had no duty to disclose the nonpublic information in his possession.³¹⁶ The Court's reasoning implied, though, that corporate insiders possessing material, nonpublic information *would* violate Rule 10b-5 if they traded in their company's stock without first disclosing their inside information.

The *Chiarella* Court's conclusion that a fiduciary relationship created the insider's duty to disclose or abstain reined in *Texas Gulf Sulphur*, which would have imposed such a duty whenever anyone with material, nonpublic information traded with anyone else. A subsequent Court decision showed, however, that the disclose or abstain duty still applies fairly broadly. In *Dirks v. SEC*,³¹⁷ the Court posited two rules that expanded the reach of the disclose or abstain rule. First, the Court noted that nominal outsiders whose relationship with the corporation is sufficiently close (e.g., lawyers, underwriters, consultants) may be deemed "constructive insiders," and therefore may be subject to the disclose or abstain rule.³¹⁸ In addition, the Court reasoned that under certain circumstances the rule will apply to outsider "tippees" who receive material, nonpublic information from actual or constructive insiders.³¹⁹

Despite its expansion in *Dirks*, the disclose or abstain rule left a substantial loophole in the insider trading liability scheme. If the duty to disclose or abstain, and thus potential insider trading liability, arises from the fiduciary relationship between a corporate

do so.").

315. *Id.* at 227 ("That the relationship between a corporate insider and the stockholders of his corporation gives rise to a disclosure obligation is not a novel twist of the law.").

316. *Id.* at 231-35 (explaining basis of reversal of defendant's conviction).

317. 463 U.S. 646 (1983).

318. *Id.* at 655 n.14 ("Under certain circumstances, such as where corporate information is revealed legitimately to an underwriter, accountant, lawyer, or consultant working for the corporation, these outsiders may become fiduciaries of the shareholders.").

319. The Court explained:

[A] tippee assumes a fiduciary duty to the shareholders of a corporation not to trade on material nonpublic information only when [1] the insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee and [2] the tippee knows or should know that there has been a breach.

Id. at 660.

insider and her trading partner, individuals who are neither insiders (actual or constructive) nor tippees (“inheritors” of an insider’s fiduciary duty) may freely trade on the basis of material, nonpublic information. For example, an attorney representing the bidder in a forthcoming tender offer could freely purchase stock of the target corporation prior to the announcement of the tender offer, for the attorney would not owe her trading partner a duty to disclose and thus could not be liable for fraud. To respond to this loophole, the SEC adopted Rule 14e-3 and pressed the Supreme Court to approve the “misappropriation doctrine.”

2. Rule 14e-3

Rule 14e-3,³²⁰ adopted pursuant to the SEC’s statutory authority to “prescribe means reasonably designed to prevent” fraud in connection with a tender offer,³²¹ prohibits anyone with knowledge of a forthcoming tender offer from trading on that information prior to public disclosure of the offer.³²² The rule thus closes the loophole left by *Chiarella* and *Dirks*, but only with respect to inside information related to tender offers. The rule does not ban trading by outsiders on the basis of nonpublic information that is not related to a forthcoming tender offer.

3. The Misappropriation Doctrine

The misappropriation doctrine aims to close the loophole left by Rule 14e-3. Under the misappropriation theory, a person who receives material, nonpublic information via a fiduciary or confidential relationship defrauds *the source* of her information if she trades upon it without first informing that source of her intention to do so.³²³ The SEC had articulated the misappropriation theory in *Chiarella*, arguing before the Supreme Court that the defendant’s secret trading amounted to fraud against the source of his nonpublic information and thus gave rise to a violation of Rule

320. 17 C.F.R. § 240.14e-3 (2006).

321. 15 U.S.C. § 78n(e) (2000).

322. Specifically, the rule states that if an offeror has taken “a substantial step” toward making a tender offer, anyone who has learned of the forthcoming offer from the offeror, the offeree, or an agent of either must refrain from trading in the securities of either (unless one of the narrow, enumerated exceptions applies) until there has been public disclosure of the offer “by press release or otherwise.” 17 C.F.R. § 240.14e-3(a). Moreover, insiders of a bidder or target may not divulge confidential information about a tender offer to persons who are likely to violate the rule by trading on the basis of that information. *Id.* § 240.14e-3(d).

323. See *infra* notes 336-40 and accompanying text.

10b-5.³²⁴ While four justices accepted the theory,³²⁵ the *Chiarella* majority declined to base liability upon it because it had not been presented to the jury.³²⁶ The Second Circuit, however, approved the misappropriation theory as a basis for Rule 10b-5 liability in *United States v. Newman*³²⁷ and relied upon the theory in several other insider trading cases.³²⁸

The Supreme Court eventually approved the theory in *United States v. O'Hagan*.³²⁹ Defendant O'Hagan's law firm, Dorsey & Whitney, had been retained to assist Grand Metropolitan PLC with a possible tender offer for Pillsbury Company.³³⁰ Because of his position at the firm, O'Hagan learned of Grand Metropolitan's plans and, unbeknownst to his partners or Grand Metropolitan, purchased Pillsbury call options and shares.³³¹ When the tender offer was announced, Pillsbury stock soared, enabling O'Hagan to reap a \$4.3 million profit.³³² The government quickly charged O'Hagan with insider trading.³³³ It could not, however, establish a claim under the classical disclose or abstain rule approved in *Chiarella*, for O'Hagan was not a fiduciary of his trading partners (Pillsbury shareholders and call writers) and thus could not have defrauded them by failing to speak in the face of a duty to do so.³³⁴ The government therefore charged O'Hagan with violations of federal mail fraud statutes and Rule 14e-3.³³⁵ It also asserted that he violated Rule 10b-5 by deceiving the sources of his inside information—his law firm (Dorsey & Whitney) and its client (Grand Metropolitan), both of whom he owed fiduciary duties.³³⁶ A jury convicted O'Hagan on all counts.³³⁷

In affirming O'Hagan's conviction, the Supreme Court expressly approved the government's assertion that "a person commits fraud

324. See Brief of the United States at 28-37, *Chiarella v. United States*, 445 U.S. 222 (1980) (No. 78-1202), 1979 WL 199454.

325. *Chiarella*, 445 U.S. at 239-46 (Burger, C.J., dissenting).

326. *Id.* at 235-36.

327. 664 F.2d 12, 16 (2d Cir. 1981).

328. See, e.g., *U.S. v. Carpenter*, 791 F.2d 1024 (2d Cir. 1986), *aff'd on other grounds*, 484 U.S. 19 (1987); *SEC v. Materia*, 745 F.2d 197 (2d Cir. 1984), *cert. denied*, 471 U.S. 1053 (1985).

329. 521 U.S. 642 (1997).

330. *Id.* at 647.

331. *Id.*

332. *Id.* at 648.

333. *Id.*

334. *Id.* at 653 n.5 ("The Government could not have prosecuted O'Hagan under the classical theory, for O'Hagan was not an 'insider' of Pillsbury, the corporation in whose stock he traded.").

335. *Id.* at 648-49.

336. *Id.* at 648, 653.

337. *Id.* at 649.

'in connection with' a securities transaction, and thereby violates § 10(b) and Rule 10b-5, when he misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information."³³⁸ Such a trader "deal[s] in deception," the Court stated, because he feigns loyalty to his source while actually using confidential information for his own self-serving purposes.³³⁹ Because this feigned loyalty occurs "in connection with" a sale or purchase of a security, the Court reasoned, it violates Rule 10b-5.³⁴⁰ The Court thus recognized the misappropriation theory as a "complement" to the classical disclose or abstain theory. In the latter, securities fraud occurs because the trader fails to disclose information to his trading partner, of whom he is a fiduciary; in the former, securities fraud occurs because the trader "feign[s] fidelity to the source" of his information, a source to whom he owes fiduciary duties.³⁴¹ The Court was careful to note, though, that there can be no liability under the misappropriation theory when the trader first informs his source of his intention to trade on the source's information.³⁴²

B. The Permissibility of (Authorized) Price-Decreasing Insider Trading Under Current Legal Doctrine

The liability scheme described in Part III.A leaves open two questions that affect the legality of authorized price-decreasing insider trading. First, does Rule 10b-5 prohibit only "deceptive" insider trading, or does the rule reach all instances of classical insider trading that involve a breach of fiduciary duty?³⁴³ Second, if

338. *Id.* at 652.

339. *Id.* at 653-54.

340. *Id.* at 655-56 ("This ['in connection with'] element is satisfied because the fiduciary's fraud is consummated, not when the fiduciary gains the confidential information, but when, without disclosure to his principal, he uses the information to purchase or sell securities. The securities transaction and the breach of duty thus coincide.").

341. *Id.* at 655. The Court explained:

The two theories are complementary, each addressing efforts to capitalize on nonpublic information through the purchase or sale of securities. The classical theory targets a corporate insider's breach of duty to shareholders with whom the insider transacts; the misappropriation theory outlaws trading on the basis of nonpublic information by a corporate "outsider" in breach of a duty owed not to a trading party, but to the source of the information.

Id. at 652-53.

342. *Id.* at 655 ("Because the deception essential to the misappropriation theory involves feigning fidelity to the source of information, if the fiduciary discloses to the source that he plans to trade on the non-public information, there is no 'deceptive device' and thus no § 10(b) violation . . .").

343. See BAINBRIDGE, *supra* note 4, at 548-49 (observing that *O'Hagan* left

the latter, are the relevant fiduciary duties purely contractual in nature?³⁴⁴ Part III.B examines the legality of authorized price-decreasing insider trading given the possible answers to these two open questions of law. It concludes that such trading is legally permissible under all three possible legal scenarios: where the law forbids only deceptive insider trading (Part III.B.1); where even candid (i.e., non-deceptive) classical insider trading is forbidden but fiduciary duties are contractual in nature (Part III.B.2); and where the law forbids candid classical insider trading and fiduciary duties are *not* purely matters of contract (Part III.B.3).

1. *If Only Deceptive Insider Trading Is Forbidden*

Professor Saikrishna Prakash has argued persuasively that “candid” insider trading—insider trading in which the insider has stated up front that she may trade on the basis of material, nonpublic information—cannot violate Rule 10b-5.³⁴⁵ Prakash reasons that Rule 10b-5 and its enabling statute prohibit only intentional misrepresentations, not mere breaches of fiduciary duty.³⁴⁶ Thus, insider trading that involves a breach of fiduciary duty to a trading partner or information source, but does not involve feigned fidelity to that person, simply cannot violate Rule 10b-5 (unless, of course, the trading involves some other form of fraud).³⁴⁷

open whether a “brazen misappropriator” could violate Rule 10b-5 and whether “authorized trading” could give rise to liability under the classical theory).

344. See Larry E. Ribstein, *Fiduciary Duty Contracts in Unincorporated Firms*, 54 WASH. & LEE L. REV. 537, 539 (1997) (discussing “the long-standing debate between those who have argued that fiduciary duties are and should be essentially contractual in nature and those who argue for some restrictions on waiving those duties”) (footnote omitted).

345. See Saikrishna Prakash, *Our Dysfunctional Insider Trading Regime*, 99 COLUM. L. REV. 1491, 1495 (1999).

346. *Id.* at 1510 (“*O’Hagan* correctly reaffirms that a breach of fiduciary duty is simply not enough for misappropriation or Rule 10b-5 liability; a *deception* is necessary.”). The Supreme Court first established that § 10(b) and Rule 10b-5 do not prohibit mere breaches of fiduciary duty in *Santa Fe Indus. v. Green*, 430 U.S. 462, 473-74 (1977), in which the Court held that controlling shareholders who breached a fiduciary duty to minority shareholders by offering allegedly inadequate consideration in a short-form merger would not, absent deception, transgress Rule 10b-5. *Id.* The Court explained:

The language of § 10(b) gives no indication that Congress meant to prohibit any conduct not involving manipulation or deception. . . . Thus the claim of fraud and fiduciary breach in this complaint states a cause of action under any part of Rule 10b-5 only if the conduct alleged can be fairly viewed as “manipulative or deceptive” within the meaning of the statute.

Id. at 473-74.

347. Prakash, *supra* note 345, at 1510-12.

Such trading may be punishable under state laws governing fiduciary duties, but it is not fraudulent.

The primary basis for Prakash's claim that Rule 10b-5 does not reach candid trading is the reasoning of the Supreme Court's *O'Hagan* decision.³⁴⁸ In that decision, the Court (1) reiterated that the deception involved in insider trading is what causes such trading to run afoul of Rule 10b-5;³⁴⁹ (2) clarified that the deception at issue in a misappropriation case is the trader's "feigning fidelity" to the source of her information;³⁵⁰ and (3) conceded that a misappropriator who informed her source of her intention to trade before actually doing so could not violate Rule 10b-5 (though she might be liable for breach of fiduciary duty).³⁵¹ Prakash concludes that such reasoning must similarly apply in classical (i.e., disclose or abstain) insider trading cases: since deception must be present for there to be a violation of Rule 10b-5, and since the deception at issue in a classical insider trading case is feigned fidelity to the trading partner, an insider may avoid liability under Rule 10b-5 by stating prior to trading that she intends to trade on the basis of material,

348. *Id.* at 1510 ("Properly understood, [*O'Hagan*] indicates that classical insiders may avoid Rule 10b-5 liability even when they trade on material, non-public information on an anonymous exchange, so long as they do not deceive their shareholders."). Prakash also cites pre-*O'Hagan* appeals court cases in support of his decision. *See id.* at 1507-09 (citing *Jensen v. Kimble*, 1 F.3d 1073 (10th Cir. 1993); *McCormick v. Fund Am. Cos.*, 26 F.3d 869 (9th Cir. 1994)). In *Jensen*, the Tenth Circuit held that a purported insider's failure to disclose certain material, nonpublic information prior to trading did not violate Rule 10b-5 because the trader openly revealed his "failure to disclose" further information. *Jensen*, 1 F.3d at 1078. The court explained that when "the non-disclosing party explicitly informs the other party of his failure to disclose [material, nonpublic information], an omission will not be misleading in the absence of special circumstances." *Id.* In *McCormick*, the Ninth Circuit concluded that a company's candid refusal to disclose all material, nonpublic information prior to purchasing its shares did not mislead a "sophisticated" seller. *McCormick*, 26 F.3d at 884. Prakash argues that the reasoning of *Jensen* and *McCormick* adds further support to the view that candid insider trading, even if it violates a fiduciary duty, cannot violate Rule 10b-5. Prakash, *supra* note 345, at 1509.

349. *United States v. O'Hagan*, 521 U.S. 642, 655 (1997) ("§ 10(b) is not an all-purpose breach of fiduciary duty ban; rather, it trains on conduct involving manipulation or deception.").

350. *Id.* ("[T]he deception essential to the misappropriation theory involves feigning fidelity to the source of information . . .").

351. *Id.* ("Because the deception essential to the misappropriation theory involves feigning fidelity to the source of information, if the fiduciary discloses to the source that he plans to trade on the non-public information, there is no 'deceptive device' and thus no § 10(b) violation—although the fiduciary-turned-trader may remain liable under state law for breach of a duty of loyalty.").

nonpublic information.³⁵² Such an admission, which would preclude the feigned fidelity that gives rise to Rule 10b-5 liability, could be made by the insider to her trading partner in a face-to-face transaction or by the insider to the market in general (via public disclosure) in an exchange transaction.³⁵³ Moreover, if the corporation announced generally that its agents may trade on the basis of material, nonpublic information, then the agents, in doing so, would not be feigning fidelity to their trading partners, who would be on notice that corporate agents *might* buy from or sell to them on the basis of inside information.³⁵⁴ Under Prakash's interpretation of post-*O'Hagan* insider trading doctrine, then, a corporation would be free to adopt a policy authorizing price-decreasing insider trading, and an insider who traded pursuant to such policy would not violate Rule 10b-5.

While Prakash's understanding of insider trading doctrine is intuitively appealing (and would appear to be the only interpretation that can make sense of *O'Hagan's* dictum regarding authorized trading³⁵⁵), it has not garnered a wide following. No post-*O'Hagan* decision has approved Prakash's reasoning, and most commentators that have considered his position have suggested that it would not be accepted by the Supreme Court, which would likely confine *O'Hagan's* reasoning to misappropriation cases.³⁵⁶ Thus, we

352. Prakash, *supra* note 345, at 1515 ("After disclosing an intent to trade on material, non-public information to the shareholders, any insider breach can no longer be considered concealed or deceptive. It is out in the open.").

353. *Id.* at 1516-18 (discussing various ways disclosure of intent to trade might occur).

354. *Id.* at 1516 ("[I]f company Y authorizes X's insider trades, later trades certainly cannot be considered fraudulent."). Moreover, if the corporation had previously announced that its insiders may trade on the basis of material, nonpublic information, then an outsider trader's reliance on any belief regarding insiders' "fidelity" would not be justifiable and thus could not support a fraud claim.

355. *See supra* note 351.

356. *See, e.g.*, Stephen M. Bainbridge, *Insider Trading Regulation: The Path Dependent Choice Between Property Rights and Securities Fraud*, 52 SMU L. REV. 1589, 1647-48 (1999) (acknowledging that *O'Hagan's* reasoning would seem to suggest that candid classical insider trading does not violate Rule 10b-5, but predicting that the Supreme Court would eschew such a position); Stephen J. Choi, *Selective Disclosures in the Public Capital Markets*, 35 U.C. DAVIS L. REV. 533, 568 n.141 (2002) (noting Prakash's position and responding that "it is doubtful that courts would accept a one-time blanket statement of an intent to trade as equivalent to the disclosure of the actual material non-public information upon which insiders seek to trade"); Zohar Goshen & Gideon Parchomovsky, *On Insider Trading, Markets, and "Negative" Property Rights in Information*, 87 VA. L. REV. 1229, 1262 n.108 (2001) ("A proper reading of *O'Hagan* implies a key distinction between inside information in the classic

should consider the legality of authorized price-decreasing insider trading under a legal regime in which classical insider trading liability is not limited to *deceptive* insider trading.

2. *If Even Candid Classical Insider Trading Is Forbidden, but Fiduciary Duties Are Contractual in Nature*

If the law imposes liability for classical insider trading even if the possibility of such trading is disclosed in advance (so that the trader is not feigning fidelity to her trading partner), then the basis of liability must be something other than fraud. Most likely, the basis for liability would be some fiduciary duty breach that would be taken to violate Rule 10b-5.³⁵⁷ If the gravamen of a classical insider trading claim is breach of fiduciary duty, rather than fraud, then even authorized price-decreasing insider trading could violate Rule 10b-5 if the trading at issue involved a breach of the requisite duty.

But this assumes that fiduciary duties cannot be altered by contract, a point upon which legal scholars vehemently disagree.³⁵⁸

sense—information originating from the affected firm used by one of its insiders—and a different type of inside information—information generated by outsiders who are not employees of the affected firm. While the prohibition on trading involving classic inside information is clearly mandatory, and cannot be contracted around, the prohibition on trading involving information generated by outsiders is subject to contracting like any other property interest.”); Jeanne L. Schroeder, *Envy and Outsider Trading: The Case of Martha Stewart*, 26 CARDOZO L. REV. 2023, 2055 n.141 (2005) (“[Prakash’s position] is incorrect in that there is no case that follows Prakash’s analysis in the case of classic insider trading (i.e., where the source of the information is the issuer of the securities).”); Alan Strudler & Eric W. Orts, *Moral Principle in the Law of Insider Trading*, 78 TEX. L. REV. 375, 436 n.271 (1999) (“[W]e disagree with the insidious suggestion that a prior disclosure of an intention to trade on material nonpublic information or ‘candid insider trading’ should be countenanced as an exception.”).

357. Hinging Rule 10b-5 liability on a breach of fiduciary duty that does not amount to actual deception would seem to run afoul of the Supreme Court’s *Santa Fe* holding. See *supra* note 346.

358. Compare Carlton & Fischel, *supra* note 3, at 888 (“Fiduciary duties are standard-form contractual terms that govern agency relationships. They allow the parties to avoid excessively lengthy and detailed agreements, thereby reducing the costs of contracting.”) (footnote omitted), Frank H. Easterbrook & Daniel R. Fischel, *Contract and Fiduciary Duty*, 36 J.L. & ECON. 425, 427 (1993) (urging that there is nothing special about fiduciary obligations and positing that fiduciary obligations arise from “contractual” (and thus consensual) relations), John H. Langbein, *The Contractarian Basis of the Law of Trusts*, 105 YALE L.J. 625, 629 (1995) (“The rules of trust fiduciary law mean to capture the likely understanding of the parties to the trust deal . . .”), Ribstein, *supra* note 344, at 541 (characterizing fiduciary duties as “a hypothetical bargain—that is, contract terms the parties themselves would have agreed to in the absence of transaction costs”), and Henry N. Butler & Larry E. Ribstein, *Opting Out of*

Under the view espoused by the “contractarians,” who maintain that fiduciary duties are ultimately contractual in nature, a corporation could effectively legalize price-decreasing insider trading *even if* the gravamen of a classical insider trading violation were breach of fiduciary duty rather than deception based on feigned fidelity to the trading partner. By authorizing price-decreasing insider trading, the corporation would be contractually tailoring the fiduciary duties its agents owe to shareholders so that those duties would not include a duty to disclose material, nonpublic information before trading on it. A shareholder who purchased stock from an informed insider could not claim fiduciary breach, for the duty owed by the insider would have been contractually tailored to exclude a disclosure duty.³⁵⁹ Thus, authorized price-decreasing insider trading is legally permissible, even if the gravamen of classical insider trading is breach of fiduciary duty rather than a feigning of fidelity, if fiduciary duties are contractually alterable.

3. *If Even Candid Classical Insider Trading Is Forbidden, and Fiduciary Duties Are Not Purely Contractual*

Under the two legal scenarios considered so far, a corporation could authorize price-increasing, as well as price-decreasing, insider trading. Under the first legal scenario (only deceptive trading is prohibited), authorized price-increasing insider trading would be insulated because there could be no deception where the seller, in light of the corporation’s ex ante authorization, had no legitimate expectation that an insider would refrain from buying company stock on the basis of material, nonpublic information.³⁶⁰ Under the

Fiduciary Duties: A Response to the Anti-Contractarians, 65 WASH. L. REV. 1 (1990), with Victor Brudney, *Contract and Fiduciary Duty in Corporate Law*, 38 B.C. L. REV. 595, 597 (1997) (“[T]o say that a relationship is contractual ‘only begins analysis; it gives direction to further analysis’”), Alison Grey Anderson, *Conflicts of Interest: Efficiency, Fairness and Corporate Structure*, 25 UCLA L. REV. 738, 781 (1978), Victor Brudney, *Corporate Governance, Agency Costs, and the Rhetoric of Contract*, 85 COLUM. L. REV. 1403 (1985), Robert C. Clark, *Agency Costs Versus Fiduciary Duties*, in PRINCIPALS AND AGENTS: THE STRUCTURE OF BUSINESS (John W. Pratt & Richard J. Zeckhauser eds., 1985), John C. Coffee, Jr., *The Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role*, 89 COLUM. L. REV. 1618 (1989), Melvin Aron Eisenberg, *The Limits of Cognition and the Limits of Contract*, 47 STAN. L. REV. 211, 249-51 (1995), Melvin Aron Eisenberg, *The Structure of Corporation Law*, 89 COLUM. L. REV. 1461 (1989), and Lawrence E. Mitchell, *The Death of Fiduciary Duty in Close Corporations*, 138 U. PA. L. REV. 1675 (1990).

359. Of course, a buyer who was not already a shareholder of the insider’s company would have no grounds for complaint, for the insider would not be her fiduciary (and thus would owe her no disclosure duty).

360. See *supra* note 354 and accompanying text.

second legal scenario (breach of fiduciary duty is the crux of the violation, but fiduciary duties are ultimately contractual), the corporation's express authorization of price-increasing insider trading would effectively tailor insiders' fiduciary duties to exclude any obligation to disclose nonpublic information before trading. Suppose, though, that the true state of the law is that (1) even candid insider trading is forbidden, and (2) fiduciary duties are not contractually alterable. Under that legal regime, which is maximally hostile to a liberalized insider trading policy and appears to reflect the status quo, authorized price-increasing insider trading would probably be illegal, but authorized price-decreasing insider trading would be legally permissible.

First consider why this most restrictive view of the law would permit authorized price-decreasing insider trading. It is a basic principle of corporate law that a corporate agent's fiduciary duty is ultimately owed *to the corporation itself*, not to individual shareholders.³⁶¹ Of course, most agent conduct that might injure an individual shareholder would also threaten some sort of injury to the corporation's business operations and/or financial prospects and would therefore be barred by the agent's fiduciary duty to the corporation. But where an agent's action might disadvantage an individual shareholder, *but would benefit the corporation as a whole*, the agent's fiduciary duties should not preclude him from taking

361. See *Gearhart Indus. v. Smith Int'l*, 741 F.2d 707, 721 (5th Cir. 1984) (“[D]irectors’ duties of loyalty and care run to the corporation, not to individual shareholders or even to a majority of the shareholders.”); *Freeman v. Decio*, 584 F.2d 186, 191 (7th Cir. 1978) (explaining that because fiduciary duties are owed to the corporation, not to individual shareholders, “the traditional common law approach has been to permit officers and directors of corporations to trade in their corporation’s securities free from liability to other traders for failing to disclose inside information”); *Schautteet v. Chester State Bank*, 707 F. Supp. 885, 888 (E.D. Tex. 1988) (“Officers and directors owe fiduciary duties only to the corporation.”); *Bessette v. Bessette*, 434 N.E.2d 206, 208 (Mass. 1982) (providing that fiduciary duty is owed to the corporation, not individuals); *Myer v. Cuevas*, 119 S.W.3d 830, 836 (Tex. App. 2003) (“Corporate officers owe fiduciary duties to the corporations they serve. However corporate officers do not owe fiduciary duties to individual shareholders unless a contract or special relationship exists between them in addition to the corporate relationship.”) (citations omitted); *Hoggett v. Brown*, 971 S.W.2d 472, 488 (Tex. App. 1997) (“A director’s fiduciary duty runs only to the corporation, not to individual shareholders or even to a majority of the shareholders.”); Eric J. Gouvin, *Resolving the Subsidiary Director’s Dilemma*, 47 HASTINGS L.J. 287, 296 (1996) ([A] director’s fiduciary duty runs to the shareholders as a class, and not to individual shareholders in their personal capacity.”). See generally CHARLES R.T. O’KELLEY & ROBERT B. THOMPSON, CORPORATIONS AND OTHER BUSINESS ASSOCIATIONS 260 (3d ed. 1999) (“Normally, directors owe fiduciary duties to the corporation, not to individual shareholders.”).

that action. After all, the agent's ultimate duty of loyalty is to the corporation itself.

With respect to disclosed price-decreasing insider trading, this is the situation an agent confronts: the agent's sale on the basis of negative inside information might injure an existing shareholder (assuming, of course, that the purchaser is a current shareholder; if not, there's no way the agent's action could involve any kind of breach of duty).³⁶² The corporation as a whole, though, would actually benefit from the agent's action, for the disclosed price-decreasing insider trading would tend to reduce equity overvaluation³⁶³ and the costs associated therewith.³⁶⁴ In short, the agent faces a situation where an individual shareholder's interest in candor conflicts with the broader interests of the corporation as a whole. Since the agent's fiduciary duty is ultimately owed to the corporation, not to individual shareholders,³⁶⁵ she would breach no duty by furthering the corporation's welfare (and, admittedly, her own financial interests)³⁶⁶ at the expense of an individual shareholder's financial interest. Thus, even if the gravamen of a classical insider trading claim is breach of a non-waiveable fiduciary duty, a corporate agent could engage in authorized price-decreasing insider trading.

With respect to insider trading that *increases* stock price, the situation is different. First, in every instance of price-increasing insider trading, the insider will be dealing with a shareholder of the firm itself; with price-decreasing insider trading, by contrast, the insider will frequently be dealing with a party who, at the time the trade is executed, stands at arms-length from the insider and is owed no fiduciary duties.³⁶⁷ Moreover, while the specific facts and circumstances of any instance of price-increasing insider trading would determine whether corporate damage could result, it is easy to envision situations in which such trading would harm *the*

362. See *supra* note 359.

363. See *supra* notes 260-80 and accompanying text (explaining why disclosed price-decreasing insider trading would reduce overvaluation).

364. See *supra* notes 132-217 and accompanying text (discussing costs of overvalued equity).

365. See *supra* note 361 and accompanying text.

366. The agent's receipt of trading profits would not, by itself, constitute a breach of fiduciary duty. While agents generally have a duty not to accept "secret profits" earned in connection with their work as agents, they breach no duty (and thus need not disgorge such profits) if their principals have consented in advance to their receipt of the profits. See RESTATEMENT (SECOND) OF AGENCY §§ 387-88 (1958). Here, the express authorization to engage in authorized price-decreasing insider trading would constitute consent by the principal that its agents could keep any profits thereby generated.

367. See *supra* note 359.

corporation itself, as well as the individual shareholder; as noted, price-increasing insider trading, unlike the price-decreasing variety, may thwart otherwise available corporate opportunities.³⁶⁸ Finally, the “good news” upon which the insider engaging in price-increasing insider trading bases his trade should likely belong to the corporation, whereas the “bad news” underlying an instance of price-decreasing trading should probably belong to the insider himself.³⁶⁹ There is, in other words, a more obvious property rights violation (and, thus, breach of fiduciary duty) involved in price-increasing insider trading. Accordingly, such trading probably cannot be authorized if the gravamen of a classical insider trading claim is the breach of a non-waiveable fiduciary duty.

CONCLUSION

Substantial equity overvaluation is bad for investors. Most notably, it tends to create significant agency costs that result in the destruction of corporate value. Recognizing this, legislators and regulators have recently imposed a host of “top down” measures aimed at preventing such overvaluation.³⁷⁰ Early evidence indicates that this top down approach, hastily implemented as a result of what Professor Larry E. Ribstein has dubbed “Sudden Acute Regulatory Syndrome,”³⁷¹ may create greater costs than benefits.³⁷² This Article has therefore proposed a market-oriented, “bottom up” approach to preventing or reducing equity overvaluation. The proposed approach would generally permit disclosed insider trading transactions that would tend to drive an overvalued stock’s price downward toward actual value, while generally banning insider trading that would increase a stock’s price. Given the benefits and costs occasioned by the different species of insider trading, this asymmetric insider trading regime is likely the policy most investors and managers would agree to if they were practically and legally able to do so. Securities regulators should therefore adopt it as the

368. See *supra* notes 218-27 and accompanying text (explaining why price-increasing insider trading could destroy corporate value by thwarting corporate opportunities, and why price-decreasing insider trading generally could not do so).

369. See *supra* notes 237-47 and accompanying text (explaining why property right to positive inside information should belong to corporation, whereas right to negative inside information should belong to corporate agents).

370. Those top down measures include required internal monitoring, stricter regulation of gatekeepers, more stringent rules on insider misconduct, enhanced disclosure requirements, and beefed-up regulation of securities analysts. See *Sarbanes-Oxley After Three Years*, *supra* note 5, at 6-7.

371. *Id.* at 7.

372. *Id.* at 7-14. See generally Romano, *supra* note 5.

default policy for corporations.

In asking what shareholders and corporate managers would bargain for were they practically and legally able to do so, this Article builds on the work of scholars who have argued that insider trading policy should be handled via contract—i.e., that corporate constituents should be allowed to allocate the right to inside information among themselves as they see fit.³⁷³ The Article makes two contributions to the work of these contractarians. First, by segregating the two types of insider trading (price-increasing and price-decreasing) and assessing the investor benefits and harms occasioned by each, the Article is able to predict the insider trading bargain corporate constituents would likely strike. That is an important contribution, for even if a purely contractarian approach were adopted, the law must select a default rule that will apply absent any express contractual provision, and that rule should reflect majoritarian preferences.³⁷⁴ Second, the Article proposes an approach that could be implemented under current law. Most insider trading scholars believe that current legal doctrine would not sanction a pure contractarian approach under which corporations may opt out of the disclose or abstain rule. By contrast, the asymmetric approach advocated herein, which essentially involves opting out of the disclose or abstain rule for publicly announced price-decreasing insider trades, could be adopted under current law. The approach therefore represents an immediately achievable first step toward the deregulation of insider trading.

373. See, e.g., Carlton & Fischel, *supra* note 3.

374. This Article is thus wholly consistent with the approach of the contractarians; it merely seeks to predict the dominant contract and proposes that that hypothetical bargain become the default.
