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Alan Strudler
University of Pennsylvania

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The Moral Problem in Insider Trading

Abstract
This article identifies the moral wrongness of insider trading. It examines the leading arguments for treating insider trading as morally wrong and suggests that these arguments are unpersuasive because they either rely on dubious empirical premises or assume normative premises that are equivalent to their conclusions. It concludes that it is the unconscientious dealings involved in insider trading that is the most persuasive moral basis for wrongfulness of insider trading.

Keywords
insider trading, moral wrongness, unconscientious dealings, moral basis, normative premises

Disciplines
Applied Ethics | Banking and Finance Law | Business Administration, Management, and Operations | Business Intelligence | Business Law, Public Responsibility, and Ethics | Corporate Finance | Finance and Financial Management | Law | Portfolio and Security Analysis

Insider trading can have sensational results.[1],[2] Its perpetrators risk finding themselves behind bars for many years and vilified in popular opinion, while their firms and the people heavily invested in them risk financial ruin. Even so, doubt may be raised about our understanding of insider trading, a doubt that should prompt concern about the justice of insider trading prosecution and about the harsh moral judgments people often make of insider traders. The doubt comes from trying to identify the moral wrong in insider trading. Candidates for this wrong abound. One might, for example, identify the wrong in consequentialist terms, that is, in terms of the unfavorable balance of harms and benefits insider trading causes. But scholars disagree deeply about whether insider trading in fact causes social harm, and even those who think it does concede that their evidence is weak.[3] One might, alternatively, say that insider trading is wrong on deontological grounds, arguing that the act of insider trading is itself wrong in ways that cannot be understood in terms of the harms and benefits it produces. As we will see, the deontological alternative has its own problems.

I will argue that the judicial treatment of insider trading aligns with a deontological interpretation: courts have consistently identified insider trading as securities fraud; the heart of securities fraud is fraud, a kind of wrongful deception; and deception is a paradigmatic deontological wrong. Establishing these claims is difficult. The deceptive element in insider trading can be elusive. To make matters worse, several moral principles, other than that proscribing deception, are commonly invoked in arguments against insider trading, including principles that proscribe theft, breach of trust, and unfair dealing. It is not obvious how insider trading might violate any of these principles, or how one should understand the relation (p. 389) ship among them as they bear on insider trading. In this chapter I try to resolve these issues. I contend that insider trading is in fact wrong because of the deception it involves, and that establishing that contention requires establishing corollaries about other moral wrongs.

Before investigating what might make insider trading morally wrong, I mention a preliminary problem. Insider trading resists simple characterization. The standard legal analysis of insider trading says that it occurs when a corporate insider engages in a securities transaction on the basis of material, nonpublic information.[4] This analysis is schematic, relying on ideas that often seem treacherous in application: a corporate insider, material information, nonpublic information. Moreover, it excludes a perplexing and practically important class of insider trading cases, namely, those committed by so-called outsider traders—tippees (people who wrongly receive stock tips from corporate insiders) and others who wrongly trade on inside information even though they are not themselves corporate insiders. Fleshing out the standard analysis by explicating and extending the ideas in the traditional analysis would be distracting and require more space than I am allotted. I undertake much of this task elsewhere.[5] For simplicity, I will therefore restrict this discussion to cases in which the standard legal analysis of insider trading proves unproblematic. Perhaps the most famous such case is *SEC v. Texas Gulf Sulphur*, in which officers of Texas Gulf Sulphur learned of their company's rich ore strike in Canada and traded on this information before the news became public.[6] These officers, who engaged in securities transactions on the basis of material, nonpublic information, are paradigm insider traders, at least under the standard analysis. It is clear that they committed a legal wrong. We will find more challenging the matter of identifying the moral wrong in their conduct.

In the remainder of this chapter, I critically examine the leading arguments for treating insider trading as morally wrong, including arguments that insider trading is wrong because it is harmful, deceptive, unfair, constitutes theft, or breaches fiduciary duties. I conclude that these arguments, as ordinarily formulated, are unpersuasive—they either rely on dubious empirical premises or assume normative premises that are equivalent to their conclusions. But then I suggest a way to salvage at least some of the arguments. I consider a society in which insider trading was not legally prohibited, and ask about the moral viability of contracts among firms, employees, and stockholders that would license insider trading. I argue that such contracts would be unconscionable, and that facts about this unconscionability show why insider trading should always be regarded as involving morally wrongful deceit.

Harm

The argument from harm, popular among the law-and-economics scholars who dominate securities scholarship in law schools, is not a deontological argument. (p. 390) Instead, it maintains that insider trading is wrong because of the social harm it causes, given that we understand "causing harm" expansively, as causing a failure to attain optimal social welfare or social good.

In a securities market there are winners and losers, people who get good prices and people who get bad prices. Other things being equal, the person with the best information about what is being bought or sold stands in the best position to find bargains and get the best price. Competing against corporate insiders, who possess superior information, thus increases the risk that one loses. Ordinary traders will balk at the risk of trading against insiders, and insider trading, then, will undermine confidence in securities markets and deter investment, increasing the price a firm must pay to raise capital and hindering both a firm's development and a society's economic growth more generally, according to the argument from harm.[7] As a society, we have good moral reason to protect ourselves against this kind of economic harm, and laws prohibiting insider trading afford the relevant protection. On this view, insider trading is wrong because it fails a cost/benefit test, depriving us of a peculiar kind of benefit, a social good whose continued existence requires the cooperation of many people in maintaining a credible securities market. The harm in insider trading may be seen as resembling the harm that occurs when people damage other social goods, for example, by gratuitously burning a forest or spoiling a lake. Healthy forests, clean lakes, and thriving securities markets all serve the social good only because we as a society protect them. It is wrong to damage the social good. The wrong in insider trading is in its compromise of this good.[8]

An empirical claim forms the core of the argument from harm: that insider trading will significantly deter investment. Influential research lends some supports to this claim. A leading article on insider trading compares the cost of capital (the price that firms must pay to raise money in a securities market) in (mostly developing) countries both before and after they begin enforcing insider trading laws, and it concludes that because this cost generally decreases after insider trading laws are enforced, social welfare improves when insider trading diminishes.[9] Does the article show that insider trading is socially harmful? Its authors acknowledge that they locate no causal link between insider trading and changes in social welfare, but merely noncausal correlation. For all we know, the securities law enforcement practices upon which these scholars focus may be mere epiphenomena reflecting more significant social forces, including economic development or the broad adoption of a securities regulation framework. Even the best social science research, then, expresses no confidence about whether insider trading deters investment in ways that prove socially harmful. Moreover, there is good reason to wonder whether insider trading will deter investment. Securities traders are accustomed to the idea that other traders may possess advantages in information, even if it is not inside information, and hardly seem deterred by this idea. Most investors do not believe that the quality of their information is as good as Warren Buffet's—or that of the stock market wizards at Goldman Sachs. If the investment public is willing to trade against Warren Buffet and the wizards at Goldman Sachs, perhaps it will not be deterred by the prospect of trading against corporate insiders, either.

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In addition to doubt about the harm insider trading causes, there are other reasons for skepticism about the argument from harm: credible economic arguments purport to show that insider trading, if it causes some harm, also creates benefits—perhaps these benefits are more significant than any harms that insider trading causes.[10] Some scholars find these benefits in the idea that insider trading facilitates getting insider information to market quickly. Arguably, when market information improves, so does market performance. One may also argue that insider trading benefits the firm and hence society more generally by providing a cheap compensation device: if a firm gives its employee the valuable perquisite of a right to trade insider information, it costs the firm nothing, but it should feel warranted in asking the employee to give back some of his otherwise high salary. When the firm saves money in salary, it can pass on the benefit to others, one might think. An entirely different but equally plausible argument that insider trading is socially beneficial focuses on the costs of law enforcement. The argument is simple. If we as a society need not pay the costs of enforcing laws against insider trading, we save money. Government avoids the costs of policing and prosecuting insider trading, and firms avoid the costs of requiring their compliance programs to limit insider trading. These savings create economic benefits from which, presumably, everybody gains.

There are, then, arguments both that insider trading harms us and arguments that it benefits us. Which, if any, of these arguments should prevail in our decision making about insider trading? Scholars who examine the issue say that the economic considerations for and against insider trading seem both closely balanced and rest on speculative assumptions.[11] We should worry about accepting either the idea that insider trading is generally beneficial or that it is harmful. But that is not the largest problem for the argument from harm. Suppose that we know that allowing insider trading would create both harms (because of deterring investment) and benefits (because of facilitating information transfer, providing cheap compensation, and saving law enforcement costs). If we are to take these considerations seriously as a foundation for criminal policy and moral attitudes, we face a problem. There exists no measure for the magnitudes of these harms and benefits, and nobody knows that a reliable measure will ever emerge. So we do not know how to balance the good consequences of insider trading (if they exist) against the bad (if they exist).

So far I have been developing skepticism that our knowledge about the harm in insider trading warrants us in seeing a significant moral wrong in insider trading. There are limits to this skepticism. It does not impugn the intellectual value of the scientific project of finding causal connections between insider trading and changes to social welfare. The skepticism is limited to the idea that however interesting and important the scientific research project of understanding causal connections between insider trading and harm, the project seems not far enough along to serve as a foundation for either social policy or moral attitudes about insider trading.

If we cannot adequately explain the wrong of insider trading in terms of harm, then we must look elsewhere for a rational basis for criminalizing insider trading and for our harsh moral attitudes against insider traders. I will explore the possibility that deontological arguments, which eschew empirical speculation about the social (p. 392) consequences of insider trading, and instead aim to explain the wrong in terms of the inherent character of certain acts by providing a more plausible basis for understanding the morality of insider trading than do analyses in terms of costs and benefits.

Deception

Courts have always seen insider trading as a kind of fraud, namely, securities fraud.[12] Historically, wrongful deception forms the heart of fraud. Hence we might look to the wrong in wrongful deception as the explanation of the wrong in insider trading. Recall *Texas Gulf Sulphur*. On the deception account, insiders deceived shareholders by buying stock from them while concealing material, nonpublic information relevant to the valuation of the securities.

The deception account allows a deontological interpretation that avoids the speculative pitfalls of the harm account. Deception can be understood as inherently wrong, apart from any harm it causes. Indeed, a standard philosophical analysis of the wrong in deception identifies it as a vicious kind of manipulation.[13] One person may wrongly deceive another when he intentionally causes that person to have a false belief in a way that compromises the autonomy of his decision making, even if doing so benefits that other person. Suppose, for example, that I intercept a phone call to you about a job offer, and hide from you the information about the call. I know that the job would be bad for you, but I also know that I cannot convince you that I am right. So I lie, telling you that no call was made. Arguably, I wrongly deceive you even if I make you better off by doing so. I manipulate you by the way in which I cause you to have a false belief. If insider trading is deceptive, then we might establish that it is similarly wrong, at least from a moral point of view, even if we cannot establish that it is socially harmful.

The deception account of insider trading has its problems. Most salient is the elusiveness of any deception that occurs in insider trading. Recall, again, the Texas Gulf Sulphur officers. As a matter of fact, these officers were responsible for a number of misstatements that appeared in the press and misled the trading public about their discoveries of ore, and these statements were used at trial against the officers. Yet insider trading law requires no false or misleading statement for a finding of liability. The law is clear that if corporate insiders trade on material, nonpublic information while silently failing to disclose the basis of their trade, their silence may ground a conviction. Thus imagine a variant on *Texas Gulf Sulphur, Texas Gulf Sulphur**. Texas Gulf Sulphur* differs from Texas Gulf Sulphur only in that Texas Gulf Sulphur* officers make no false or misleading statements about their ore find. Texas Gulf Sulphur* officers might nonetheless be convicted of insider trading. If deception is at the core of insider trading, whom do Texas Gulf Sulphur* officers deceive and how do they do it? They do not commit the most obvious kind of deception. They do not lie. Lying involves making a relevant false statement and (p. 393) they made none. This raises a difficulty for the idea that insider trading is wrong because it is deceptive: how can silence, saying nothing, be deceptive? In trying to resolve that difficulty, one may appeal to the fact that silence, in the right circumstances, may serve as a signal that causes false belief. Take a crude example: suppose that I tell you that if I learn that Tom is now angry, I will come to your party at 3 p.m. and then stay silent five minutes; I show up and stay appropriately silent, even though I know Tom is not angry. You believe he is angry on the basis of my silence, and you are deceived. Perhaps there are less crude examples of silence deceiving by causing a false belief. But even their possibility seems to raise a difficulty in the charge that Texas Gulf Sulphur* officers deceive. The difficulty is causal. Typically when one person deceives another, causation matters: whether by lying or not, the deceptive act causes a false belief in the deceived. Texas Gulf Sulfur* shareholders arguably do have a false belief when they buy. They falsely believe that Texas Gulf Sulphur* has no new rich ore strike that will lead to skyrocketing stock prices. But since Texas Gulf Sulphur* officers, we are supposing, say nothing relevant about this strike, it seems doubtful that they cause the relevant false belief or influence relevant shareholder beliefs in any way.

Shareholders will have had their false belief even before the officers decided to buy, and the sellers will have not been influenced at all by the action of the officers. Perhaps no deception occurs.

One might understand Texas Gulf Sulphur* officers' silence as deceptive, however, even if it does not in fact influence beliefs. Suppose that these officers have a moral obligation to inform shareholders of significant firm developments before they trade on firm stock. Then, before making a trade, they have an obligation to say, if true, that there has been an important strike. By their silence they license the inference that no new strike occurred. Had the officers discharged their obligations, shareholders would have had very different beliefs—fewer relevantly false beliefs—about Texas Gulf Sulphur*. Perhaps that suffices to show that they deceive shareholders. The underlying principle, though counterfactual in form, seems appealingly realistic: If one has an obligation to be truthful to a person, and breaches that obligation in a way that leaves the person with more relevantly false belief than he would have had if one had been truthful, then one deceives that person, even if one fails to make a false or misleading statement. The queerness of this underlying principle is in its suggestion that one may do something (that is, wrongly deceive) by inaction (that is, by staying silent). Assessing this queerness would require a foray into the metaphysics of inaction and its relation to moral obligation, too much to attempt here. Luckily there seems to be a way around the metaphysical issues. We may distinguish between deception as it ordinarily occurs, which involves a discrete deceptive act, and a failure of candor, which need involve no discreet deceptive act. We may then criticize Texas Gulf Sulphur officers for their failure of candor. We may say that sometimes minimal decency requires not merely that one not conceal the truth, but instead that one reveals the truth. If your car has a massively defective engine, or if your house has a cracked foundation, it seems wrong not to disclose the fact to a prospective buyer. Indeed, the law will treat such nondisclosure as fraud, and it is no moral or legal defense that you did not lie or mislead the (p. 394) buyer. You should have volunteered the truth. Sometimes morality requires candor. Perhaps that is so in cases of insider trading, such as Texas Gulf Sulphur*. Having distinguished deception as it is ordinarily understood from a mere failure of candor, we may then stipulate an interpretation of "deception" to be used in discussions of fraud, including securities fraud. According to this interpretation, deception in fraud includes not only deception as it is traditionally understood but also some failures of candor. This stipulation will, I think, simplify our discussion of insider trading and track well with judicial treatment of insider trading. But it hardly solves our deeper problem of finding the moral wrong in insider trading.

No doubt Texas Gulf Sulphur* officers were not as candid as many might like. But it would be too quick to infer, without further explanation, that they should have been more candid, or that they showed a wrongful lack of candor. In a competitive business environment, one need not always be entirely candid. Suppose that you work for The Walt Disney Company, which assigns you the task of purchasing land for a new theme park. You need acquire one more plot of land to complete your assignment. On that plot sits the home of a savvy used car salesman. Should you disclose to the homeowner what Disney intends to do with his land, or even that you work for Disney? If you disclose, you risk that the homeowner, knowing how valuable the land is to Disney, will insist on an unfairly high price, and you will have no choice except to pay it.[14] I suggest that although it would plainly be wrong for you to lie to the homeowner about what you will do with the land, morality does not require you to be forthcoming. Reflection on the Disney case shows that honesty does not always require full disclosure in a competitive business environment, even when a failure to disclose denies benefits to others. How, then, do we know that Texas Gulf Sulphur* officers should disclose?

The judgment that the officers' stock sale is deceptive, even in our expansive interpretation of that term, makes little sense unless one also finds that they fail in some duty to disclose the truth. So we are left with the question: what is the moral basis for this duty to disclose? Nothing in the argument from deception begins to answer this question. In the next section, I investigate fiduciary duties, which are often invoked as the basis of a duty to disclose in securities transactions.

Fiduciary Duties

A fiduciary duty is, roughly, a duty of utmost loyalty and trustworthiness that an agent may be said to owe to his principal. These duties are a staple of legal analysis, have rich moral content, and consistently play a role in judicial thinking about insider trading. As I mentioned, a common argument in insider trading jurisprudence says that fiduciary duties form the basis of the duty to disclose that is breached when insider trading occurs.

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Fiduciary duties play a central role in the “traditional theory” of insider trading, which understands insider trading as a kind of wrongful deception.[15] The traditional theory employs the notion of fiduciary duties in this way:

1. Corporate insiders stand in a fiduciary relation to shareholders.
2. Because of (1) an insider must disclose all relevant information to his principal before engaging in a securities transaction with that principal.
3. An insider's failure to disclose in a securities transaction (insider trading) constitutes wrongful deception.
4. Insider trading is wrong.

I will eventually argue that a version of this argument can be salvaged, but the argument as presented is flawed, because it relies on an idea expressed in (2), the idea that a fiduciary must always be forthcoming with his principal.

An example shows why (2) may seem attractive. Consider a paradigmatic fiduciary relationship, that between a lawyer and his client. When Fred buys property from his real estate lawyer, Ed, the lawyer must be completely forthcoming, or make himself vulnerable to an action for fraud. He cannot conceal any information that Fred might reasonably find relevant to the deal. The obligation to be candid to one's principal, legal and moral tradition argue, forms an essential part of the fiduciary's task. Suppose that the real estate would be a great purchase for Fred, but Ed does not want to tell Fred that he owns it, because he suspects that doing so would make Fred worry unreasonably about the deal, and lose money. As a matter of law, Fred must nonetheless disclose because of his fiduciary relationship with Ed.

Law and morality demand that Fred be perfectly forthcoming. There are strong reasons to doubt that fiduciaries should always be so forthcoming. Consider a standard economic argument. The fiduciary obligation that officers owe to shareholders is, we are told, to devote their utmost allegiance to advancing shareholder interests. Hence, whether a practice of insider trading should be regarded as a breach of fiduciary duty depends on whether it is socially harmful or beneficial. This argument cannot be dismissed. Why think that a fiduciary should always disclose all relevant information? In the real estate lawyers case discussed above, the answer is easy: the lawyer is hired as a counselor, a person whose task is to aid his principal in making a reasonable and informed choice; providing relevant information is essential to his task of advancing his principal's interest in making an informed judgment of his principal. But the role of corporate officers as fiduciaries seems fundamentally different, one might argue: it is not to counsel shareholders, but to make money for them, within reason. If a practice of insider trading tends to benefit shareholders, then perhaps it violates no fiduciary duty after all. At a minimum, we need some argument to regard respect for fiduciary duties as requiring not trading on insider information. A mere appeal to fiduciary duties, in the absence of argument for a specific interpretation of those duties, goes nowhere. It begs the question.

(p. 396) Unfairness

The argument from unfairness contends that insider traders get an unfair advantage over people with whom they engage in securities transactions and that their trades are therefore wrong on grounds of justice.[16] The supposed unfair advantage is in their use of insider information, which stock market competitors lack. The unfairness argument differs crucially from the harm argument because it does not rely on speculative empirical premises about the consequences of insider trading. It instead looks at the comparative position of buyer and seller of stock and declares these positions unacceptable on grounds of justice.

The idea that market actions can be unfair, and hence wrongful no matter what their social consequences, has ancient lineage. The Bible bans charging unfairly high prices, declaring that “when you sell something to your fellow, or buy from the hand of your fellow, don't oppress each other.”[17] Aquinas asserts that it is wrong to sell something for more than it is worth.[18] Even today, courts will declare a contract to be unconscionable and hence unacceptable if its substance is acutely unfair to one party. Proponents of the unfairness objection to insider trading echo this nonconsequentialist tradition, maintaining that the wrong in insider trading can be identified apart from reflection on the social consequences of insider trading.

The unfairness argument against insider trading identifies the relevant unfairness in terms of an acute inequality of information separating buyer and seller in a securities transaction. There are certainly cases, outside the securities realm, in which an asymmetry casts doubt on the legitimacy of a sales transaction. Typically these cases involve the kind of dishonest action discussed earlier in the deception section of this essay. Hence, again, if you have a car that has a massively defective engine, or if your house has a cracked foundation, it seems wrong not to disclose the fact to a prospective buyer. One might think that the asymmetry of information that separate insider traders and parties on the other end of a securities transaction is similarly problematic.

But not all asymmetries of information are unacceptable. Suppose that Edna, an engineering genius, studies internal combustion engines for years and finds a deep design flaw in Toyota's favorite engine. She alone knows that soon most Toyotas in the world will cease functioning abruptly, as their engines melt, creating billions of dollars of liability for Toyota, and ruining its name and stock value. So Edna sells short the stock. Even though there is an acute asymmetry of information between Edna and those at the other end of her securities transactions, she does nothing wrong. Not all acute asymmetries of information in securities transactions present unfairness. Why, then, should one think that an acute asymmetry arising from inside corporate information in a securities transaction is a problem?

One might try to bolster the unfairness argument by conceding that an acute asymmetry of information does not suffice to establish the relevant unfairness, but by saying that some instances of asymmetry are problematic; in particular, one might say that the relevant unfairness occurs in instances of asymmetry that result **(p. 397)** from an unequal access to information. In general, of course, corporate insiders have greater access to corporate secrets than do outsiders. So the appeal to unequal access may appear to mark progress for the proponent of the unfairness argument. But this appearance is illusory, I believe. Sometimes the existence of unequal access does not seem to render problematic an asymmetry of information. Suppose that I am the brother of Engineer Edna, and she refuses to tell anyone but me about the defective Toyota engine. Then I have unique access to the information about the bleak future of Toyota stock. Other traders do not have access that equals mine. Yet I do nothing wrong by trading on the information Edna gives me. So the unfairness argument so far seems unconvincing.

A final modification of the unfairness argument may seem more promising. This argument identifies the unfairness in insider trading not in terms of a simple asymmetry of information between the buyer and seller of a security, or in terms of an asymmetry stemming from unequal access, but instead in terms of an asymmetry stemming from wrongly unequal access. Put more simply, the argument is that insider trading is unfair because one party trades on information stolen from the firm. The argument relies on the idea that inside information is owned by the firm. When Texas Gulf Sulphur officers use their inside information about an ore strike to get a bargain in Texas Gulf Sulphur stock, they use valuable information that belongs not to them, but to their firm. They steal something valuable, information that belongs to the firm, and hence to its shareholders. They have no right to use the information. When they do so, they act unfairly and hence wrongly.

A difficulty for the theft argument lies in explaining why one should regard the firm as possessing the relevant property rights in information. One might reason on Lockean grounds that since it is the firm's labor and investment that produces the information, the information is owned exclusively by the firm. A troubling feature of this argument is its contingent nature and hence its limited scope. The soundness of the argument depends on contingencies regarding certain contracts. Suppose that a firm's board of directors, operating in a different legal regime than the United States, legally tells managers that as a reward for their excellent performance, it grants them the right to trade on insider information. Indeed, the firm might even warn prospective shareholders of its policy to grant employees this right. It would seem that these managers do not steal anything when they trade on inside information: the owners agree to their use of the property. Thus this version of the unfairness argument has limited scope. It cannot show that it is always wrong, either legally or morally, for insiders to trade on material, nonpublic information. It would at most show that it is wrong for insiders to trade on such information unless the firm has agreed to the trades. On this argument, firms would have the authority, in the absence of legal regulation, to render legitimate insider trading. The legal acceptability of insider trading would be a matter of contract; the moral acceptability would be a matter of the validity of promises that underlie the contract. To say, however, that insider trading is wrong unless permitted by contract or promise is to find nothing inherently wrong with insider trading.

The unfairness argument thus fails to show that insider trading is wrong in any significant sense. But the construction of the argument that appeals to contract (p. 398) suggests a promising twist: that we look at the contracts that might license insider trading as a way to assess the morality of insider trading. In the next section I will argue that any contract sanctioning insider trading will be morally defective, and that reflecting on the defects suggests a path to salvaging some of the traditional arguments against insider trading.

Unconscionable Contracts

The argument I make in the remainder of this chapter is simple at its core, though its execution requires patience. The core idea is that insider trading acceptably occurs only if people could legitimately make contracts transferring property rights in inside information from the firm to corporate insiders. But these contracts could never be legitimately made, I will argue. Any such contract would be unconscionable and hence both legally and morally wrong. So insider trading cannot acceptably occur. Indeed, I will maintain that because insider traders can have no right to use the information on which they trade, their trades involve deception, as the traditional theory of insider trading provides. In the remainder of this section, I argue simply that contracts for insider trading would be unconscionable. In the next section, I examine the relevance of the unconscionability argument to more general arguments that insider trading is wrong.

To begin the unconscionability argument against insider trading, set aside the law of insider trading. Imagine that all jurisdictions simultaneously strike from the books all bans on insider trading. Some firms might then insist on contracts that prohibit the practice of insider trading, either because they believe that doing so will somehow create a competitive advantage over other firms, or because they find the practice objectionable; other firms might allow the practice, perhaps because of its value as a cheap compensation device. In such a strange world, whether any particular corporate officer might *permissibly* engage in insider trading would appear to be a matter of contract. But this appearance is not veridical, I will argue. A contract permitting insider trading will unavoidably have an objectionable feature: it will be unconscionable; it will therefore also be in relevant part unenforceable.

What is unconscionability? Theorists discuss two varieties—substantive and procedural. Only the substantive variety will prove relevant here. Procedural unconscionability involves cognitive or volitional defects in a contracting party, something arguably not present in common insider trading cases, because involved parties are quite sophisticated.[19] Then what is substantive unconscionability? A contract is substantively unconscionable when its terms are exploitative or grossly unfair, that is, when it requires one party to pay an unreasonably high price for the benefit the contract confers on him. This can be simplified, and it will be useful to do so, because the idea of unconscionability plays so important a role in future discussion. So let us say, “A contract is substantively unconscionable when it requires one (p. 399) party to pay an unreasonably high price for the benefit that the contract confers on him.” Obviously, this characterization of substantive unconscionability will not by itself suffice for picking out instances of substantive unconscionability; it relies on a notion of unreasonability that I leave unanalyzed and that different people will interpret differently. Even so, the concept of unconscionability, as I characterize it, is common enough in legal reasoning and everyday moral reasoning. Consider *Hume v. U.S.*, a legal case concerning a contract for corn; the contract requires that the buyer pay the seller what amounts to forty times the market value of the corn.[20] Because of the disparity in value the contract assigned to the parties, the court upheld a lower court's decision that the contract was unconscionable and hence unenforceable with respect to the price provision. The most plausible reading of cases such as *Hume* is that courts, when reaching their legal judgments about unconscionability, rely on a moral judgment of unconscionability. I will soon contend that insider trading contracts would involve similar, though more complex, judgments of unconscionability.

Suppose that I am correct in arguing that insider trading contracts would be unconscionable. So what? Why should the law not enforce these contracts? Paternalism provides a common answer. Courts may refuse to enforce an unconscionable contract, at least with respect to its unconscionable term, on the paternalistic account, to protect a person from the consequences of his own mistaken decision to enter the contract.[21] In *Hume*, for example, the court may be understood as protecting the buyer from the consequences of his bad decision on how much to pay for corn. However plausible this paternalistic account may seem generally (and the jury is out on that question), paternalism does not seem useful in providing an explanation for why one should regard insider trading contracts as unconscionable. A paternalistic intervention seems relevant only when a person is not competent to protect his own interests, either because of his ignorance or because of problems in voluntariness.[22] The paternalistic paradigm hardly seems well suited for participants in securities markets, who tend to be comparatively sophisticated and to have a wealth of choices available to them. In the scenario I have painted, market participants are informed when a firm permits insider trading—presumably they have other investment opportunities. Their choices thus seem neither relevantly uninformed nor coerced.

Even if one resists endorsing paternalistic intervention in securities markets, there is reason to balk at unconscionable contracts. Seana Shiffrin argues that enforcing unconscionable contracts is wrong because it involves facilitating wrongdoing.[23] Her argument is not paternalistic; it does not turn simply on what courts might do to advance the welfare interests of victims in unconscionable contracts. It instead turns on government's role in the process: the government should not facilitate wrongful contracts. Shiffrin's position relies on the idea that we can distinguish between refusing to do what a person asks out of concern for his interests and refusing to do what a person asks out of respect for one's own integrity. I believe that the cogency of this distinction is needed to provide a sound nonpaternalistic explanation of our reticence to enforce unconscionable contracts, and that it illuminates (p. 400) social values in other realms of choice. Consider another example Shiffrin gives. One may interfere with a person smoking a cigarette out of concern for his health—doing so is paternalistic. But even a person put off by paternalism may refuse to provide cigarettes to a smoker because he does not want to assist the smoker in his objectionable activity. Similarly, our society, through the courts, may refuse to assist people in creating their unconscionable contracts.

Assume that Shiffrin is correct in asserting that courts should not enforce unconscionable contracts because it would be wrong for them to facilitate wrong doing. There are implications for contracts that would allow insider trading, because, I will contend, these contracts should be regarded as unconscionable. Insider trading contracts would be unconscionable because of the kind of disparity of benefits they confer on shareholders and corporate insiders. The involved disparity is complex, however, and not analyzable in purely financial terms. I hope that an analogy will help make clear the nature of this complex disparity.

Consider *Hooters of America, Inc. v. Phillips*, a legal case involving an arbitration agreement in an employment contract that made it extremely difficult for Hooters employees to pursue sexual harassment grievances.[24] Appealing to the unreasonable obstacles that the contract created for an employee seeking redress for sexual harassment, the court decided that the contract was unconscionable. A narrow interpretation of *Hooters* would see it as about the unconscionability of denying a person a remedy when a contract goes awry. I concede that the *Hooters* court focuses on the remedial issue: doing otherwise might seem poor judicial craftsmanship, since the remedial issue fits so neatly within legal precedent. But there is a less technical and more revealing way to think about the case, from a moral point of view. What makes Hooters contracts terrible goes beyond remedies. Hooters contracts make employees unreasonably vulnerable to sexual harassment, because they leave the employer unworried about how employees would react to harassment, in effect protecting employers. The creation of that vulnerability provides independent reason for deeming the contract unconscionable; it transforms the value of the contract for an employee in ways that cannot be translated into monetary terms or compensated by increases in salary. So there is an insurmountable disparity in the value that the contract confers on Hooters employees and the Hooters firm; while Hooters gets the benefit of diminished litigation costs and liability, the employees on the other end of the employment contract receive something much worse, even if they receive some benefits in increased pay: these employees get a package deal that includes a substantially increased vulnerability to sexual harassment. Because Hooters contracts cause one party to pay an unreasonably high price for the benefit the contract confers, they are unconscionable.

In analyzing how unconscionability makes Hooters contracts wrong, I mentioned the costs that these contracts impose on Hooters employees. Despite my reliance on the idea of costs, the analysis of unconscionability in *Hooters* cannot be understood in cost-benefit terms. If a cost-benefit analysis were correct, then it would have been appropriate for the *Hooters* court to assess the contract by asking whether the benefits that the contract created for the firm and society more **(p. 401)** generally somehow compensated for the burden imposed on Hooters employees. Yet clearly a focus on these social benefits would have been repugnant in *Hooters*. Making a person vulnerable to sexual harassment is wrong even if the Hooters firm or society more generally somehow benefits from it, and the court should play no role in facilitating this wrong. Hooters contracts were wrong as a matter of moral principle because it is wrong to make Hooters employees so vulnerable to abuses of power and control by their employers, no matter what the prospects are that the employers will actually act abusively.

The lesson I draw from *Hooters* is that when agreement to a contract causes one party to suffer vulnerability to a substantial wrong committed by the other party, there is an insurmountable disparity in benefits that the contract confers on the parties, a disparity amounting to unconscionability. This lesson has great relevance for insider trading. Insider trading contracts, like Hooters contracts, would create an environment that makes a contracting party vulnerable to wrongdoing. Of course, in the insider trading case, the relevant wrong would not be sexual harassment. It would instead be wrongs of the sort canvassed in our earlier discussion of insider trading as a breach of fiduciary duty, for example, the mismanagement that consists of creating damaging rumors in order to manipulate stock prices. Judicial enforcement of insider trading contracts would, then, facilitate wrongdoing just as enforcement of Hooters contract would facilitate wrongdoing. No court should be willing to enforce a contract that so needlessly exposes shareholders to wrong. So insider trading contracts are unconscionable.

A natural objection can be made against the unconscionability argument. One might say that the argument cannot be correct because it would implausibly undercut not only insider trading contracts but also a broad range of unquestionably legitimate contracts. The objection stems from the fact that the unconscionability in insider trading contracts, as I have argued, occurs because these contracts leave a party vulnerable to abuse. In an important sense, one may contend, most contracts leave a party similarly vulnerable to abuse: if one party performs his part of the contract and the second party thereby benefits, but then the second party opportunistically does not do his part, abuse occurs. Consider a contract that a storekeeper makes to have a new roof installed on his store. Typically a roofer requires a substantial payment before he begins work. If the roofer takes the payment, choosing to flee with the money rather than install the roof, abuse occurs. Yet from that fact, it would be rash to infer that all roofing contracts are unconscionable, even though all such contracts create the possibility that a roofer will abscond with a storekeeper's money or do a poor job. A contract may therefore make a party vulnerable to abuse, even though contracts of its kind are not generally unconscionable. So why should one think that insider trading contracts, as I have been conceiving them, are unconscionable?

Two elements seem particularly important in the analysis of vulnerability arising from contracts: a person is vulnerable to the extent that he lacks the power or information to respond to a threat. So characterized, vulnerability seems a matter of degree; some contracts make a person more vulnerable than others. The (p. 402) vulnerability in insider trading contracts is acute, exceeding that in the roofing contract example. Stockholders in an insider trading regime cannot protect themselves against the wrongful harm that insiders traders cause, at least in part, because it is too hard for them to get timely knowledge that it occurs. Suppose, for example, that an insider trader wishes to sell short his company's stock, and so creates unfavorable information about this firm, either by spreading false rumors, or by secretly compromising the quality of his firm's product in ways that will soon hurt the firm's reputation. In the case of spreading rumors, it is hard to trace the origins of rumors and often too late to mitigate damage when one does so; in the case of intentionally degrading product quality, it is hard to know whether the action occurs because of poor judgment or bad intent. Because it is so hard to know whether the insider trader engages in misconduct aimed at affecting stock prices, it is hard to take action to limit his misconduct or mitigate its consequences. The situation is entirely different when one is trying to protect oneself against a roofer who does not do his job. As a general matter, a person protects himself against the roofer not doing the job at all by either paying him through an escrow account or by paying him in increments as he makes progress on the job. And a person protects himself against the roofing job being done poorly through the use of warranty; indeed, courts are loathe to allow parties to make a contract that contains no warranty. The vulnerable party in a roofing contract typically has information and resources to protect himself against abuse. The stockholder in an insider trading contract we have been envisaging does not have these resources. As a practical matter, then, the vulnerability that renders an insider trading unconscionable does not affect ordinary contracts like roofing contracts. We may safely conclude that insider trading contracts would be unconscionable without embracing absurd conclusions about contracts being generally unconscionable.

The Wrong in Insider Trading

So far I have argued that contracts permitting insider trading would be wrong because they would be unconscionable. But that argument is purely counterfactual—it is about contracts that do not in fact exist. It does not say anything about actual insider trading, which does not rely on insider trading contracts. It does not show why insider trading, as it now exists, is wrong. In this section I aim to establish a connection between the unconscionability of counterfactual insider trading contracts and the moral wrong in actual insider trading. I will argue that facts about counterfactual unconscionability help show that insider trading involves both theft and wrongful deception.

Earlier I contended that there is a problem explaining how insider trading might be theft. Insider information—whether trade secrets, such as information about proprietary technologies, or confidential information, such as information (p. 403) about ongoing negotiations—exists for the benefit of shareholders, and hence presumptively is the property of the firm. So when an insider trades on the information, he uses information to which he has no right, presumptively committing theft. The problem with the theft argument thus stated is its limited scope. It explains why insider trading is wrong when a firm insists on keeping inside information private, but not why the firm cannot give the information to the corporate insider, thus dissolving his status as a thief. The unconscionability argument fixes the scope problem. It provides that the firm cannot rightly give the relevant information to the insider, at least for the purpose of trading on it: an attempt to do so would rely on an unconscionable contract; the property rights are therefore relevantly inalienable. So insider trading is always theft, a wrong.

Theft is not the wrong U.S. courts typically invoke in their condemnation of insider trading. Instead they accuse insider traders of engaging in fraud. The heart of fraud is deception, as we have seen. There is a problem in finding these defects in the action of the insider trader, because typically he neither lies nor makes a misleading statement. Instead he fails to state or disclose a truth. But such a failure is deceptive or otherwise dishonest only if the insider has some duty to disclose, and earlier we found no basis for that duty. The unconscionability argument suggests a basis.

Recall, again, Texas Gulf Sulphur* officers. We have now established that they stole the information that they used in their stock trade. It belongs to the firm, and derivatively, the stockholders. The fact that they use information against stockholders that they stole from them helps show that they breach a duty to disclose. Consider an analogy. Fred is shopping in an antique store when a small earthquake occurs. Price tags fall off items for sale; Fred sees an inept clerk try to replace the tags but put the wrong tags on the items. A cup tagged as $1,000 before the earthquake now has a $25 tag on it. Fred grabs the cup, takes it to the cashier, and purchases it for $25. It seems clear, and law agrees, that Fred did something wrong. He should have told the clerk about the mistake in price; he breached his obligation to disclose. Fred's failure to disclose was dishonest. The unacceptability of Fred's contact suggests the following principle of disclosure: “(D) If you have information that rightly belongs to the other party in a sales transaction, and you know that he has somehow lost it, then you must disclose it rather than using it to your advantage.” Why believe (D)? Elsewhere I defend it at length,[25] but here I can only sketch the defense. Not to require disclosure is to allow Fred to deprive the antique dealer of something rightly his—not merely the information about the price of his antique cup but also the economic value of that information. That deprivation would be wrong. Now one might retort that it was not Fred but the earthquake or the incompetent clerk doing the deprivation. But that would be too generous to Fred. Absent his connivance, the value in the antique dealer's cup would lurk in his store, awaiting his next survey of merchandise. It is only when the cup leaves the store at the bargain price that the dealer loses the relevant value. The truth of (D) is, then, an implication of the antique dealer's right to retain the value attaching to information about the cup.

(p. 404)

The antique dealer example shows that before engaging in a sales transaction with a person, one must disclose to him valuable information that one possesses but that rightfully belongs to the other party. In a typical insider trading case, one covertly trades on information that rightfully belongs to the corporation, and derivatively to the shareholders. One has no right to keep that information from them. One owes a moral obligation to disclose the information. Insider trading breaches a duty to disclose and hence constitutes wrongful deception.

In the insider cases that we have been so far discussing, the corporate insider buys stock from his own shareholder. When insiders buy stock without disclosing, they violate principle (D), because in some morally significant sense shareholders have property rights in their firm and the information owned by the firm. But principle (D) is limited in scope. It helps us understand how the corporate buyer who trades on inside information, without disclosing, may treat his shareholder unfairly and, ultimately, how the insider deceives the shareholder. Principle (D) does not explain the wrong in many other insider trading cases, however. Consider the very common cases in which an insider does not buy stock, but instead sells it to a party who does not already own stock in the insider's firm. In such cases, it makes little sense to say that the insider steals information from the buyer of stock, even derivatively, because the buyer does not yet stand in an ownership relation to the firm. Principle (D) does not directly explain the wrong that occurs when a corporate insider steals information from his firm and then relies on this information in selling stock to someone outside the firm, a stranger to the firm. How, then, should we understand this wrong? This is a complex matter that I take up at length elsewhere.[26] The argument is roughly as follows. Principle (D) helps us understand that it is unfair to get a trading advantage by using information that one has no right to use. The unfairness remains whether one wrongly acquires the information from one's trading partner (as in *Texas Gulf Sulfur*) or from another source. When a corporate insider steals information from his firm and then uses it to trade with another party (even a stranger to the firm), he treats that party unfairly. To avoid the unfairness while still making a trade, one must avoid taking advantage of the wrongfully acquired information. So one must disclose. If one fails to disclose when one should, and one's disclosure would have cured relevant false beliefs, then one engages in morally wrongful deception. Insider trading is always morally wrong because of the deception it involves.

Conclusion

Inside information exists for the benefit of the firm and its shareholders. It is therefore presumptive theft for a corporate insider to trade on this information without the agreement of its owners. No firm could make a morally acceptable agreement with relevant parties—its management and shareholders—that would give corporate insiders a right to trade on material, nonpublic information. Any contract (p. 405) purporting to assign such a right would be unconscionable; it would leave shareholders with an unreasonably bad deal in which they were overly vulnerable to managerial abuse. It follows that when a corporate insider trades on material, nonpublic information, he trades on information he can have no right to use, and thus steals the information from its owners—the firm and its shareholders. One may not, then, as a moral matter, trade on insider information. If one wants to make the trade, one must first assure that the information becomes public, that it is no longer insider information. If an insider nonetheless insists on trading on such information, he trades on information he has no right to keep secret from the person on the other side. He engages in wrongful deception. Such deception is wrong no matter what the social consequences. It is wrong as a matter of principle; it is a deontological wrong.

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Notes:

(1.) For valuable discussion, I thank Tom Dunfee, Waheed Hussain, Eric Orts, Richard Shell, David Silver, and audiences at the Philosophy Department, University of Delaware, and Department of Legal Studies and Business Ethics, the Wharton School of the University of Pennsylvania. I also thank Katherina Glac for her research assistance; she would have been a coauthor had institutional barriers not complicated matters. For its generous financial support, I thank the Zicklin Center for Business Ethics Research.

(2.) Insider trading is illegal in the United States and in approximately one hundred other countries. In the United States and many other countries, it is treated as a felony, a serious crime. See Utpal Bhattacharya and Hazem Daouk. "The World Price of Insider Trading," *Journal of Finance* 57 (2002): 75–108. In some countries, however, insider trading is on the books as a crime, but the law is not enforced. The broad range of treatment of insider trading in different jurisdictions makes generalization difficult. For purposes of this discussion, I will limit myself to U.S. law. My discussion of insider trading as a crime will concern its status as a violation of criminal law. I will also and more fundamentally be concerned with insider trading as a moral wrong. Hence I will be concerned with whether there are good moral reasons to treat insider trading as a crime.

(3.) See Battacharya and Daouk, "The World Price of Insider Trading," and Andrew Metrick, "Insider Trading," in *The New Palgrave Dictionary of Economics*, 2nd ed., eds. Larry Blume and Steven Durlauf, (New York: Palgrave Macmillan, 2008).

(4.) For a simple overview of the legal issues, see Stephen Bainbridge, *Securities Law: Insider Trading* (New York: Foundation, 1999). The analysis of insider trading I give in the text is a partial specification of the concept, adequate for specifying paradigmatic instances of insider trading, but nothing as complete as a set of necessary and sufficient conditions for insider trading.

(5.) See Alan Strudler and Eric W. Orts, "Moral Principle in the Law of Insider Trading," *Texas Law Review* (1999): 375–437.

(6.) *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968).

(7.) For an unsurpassed survey of the economic issues, see Metrick, “Insider Trading.”

(8.) Because the existence of this social good may depend on social cooperation, nonconsequentialist reasons, including reasons rooted in fairness or reciprocity, may also be triggered. But those reasons are not my concern here. Instead, I am concerned with the purely consequentialist argument that we should promote and protect social goods to the extent that doing so satisfies the duty to bring about the best possible outcome.

(9.) Battacharya and Daouk, “The World Price of Insider Trading.”

(10.) Henry Manne, *Insider Trading and the Stock Market* (New York: Free Press, 1966).For an argument against Manne, see Roy A. Schotland, “Unsafe at Any Price: A Reply to Manne, Insider Trading and the Stock Market,” *University of Virginia Law Review* 53 (1967): 1425–1478.

(11.) For a survey of scholars reaching this conclusion see Strudler and Orts, “Moral Principle in the Law of Insider Trading,” 383n24.

(12.) Strudler and Orts, “Moral Principle in the Law of Insider Trading.”

(13.) See Christine M. Korsgaard, “The Right to Lie: Kant on Dealing with Evil,” *Philosophy & Public Affairs* 15 (1986): 325–349; Alan Strudler, “Deception Unraveled,” *Journal of Philosophy* 102 (2005): 458–473.

(14.) One might wonder how we know that Disney risks paying an unfairly high price, or how we know that any price is unfairly high. This is an enormously difficult issue that I cannot resolve here. In my view the seller in the Disney case, if fully informed, has so much leverage that he approaches the point of being able to engage in extortion and hence of being able to credibly demand much more than the property is worth at the time of sale. The seller is taking economic value that Disney creates and claiming it for his own. But I rely on my own subjective judgment, which I think would be widely shared. If a particular reader does not share this judgment, I ask him or her to accept for the sake of argument the idea that the well-informed buyer is in a position to ask an unfairly high price for the Disney property, and consider the argument that flows from the idea.

(15.) For elaboration of the traditional theory, see Strudler and Orts, “Moral Principle in the Law of Insider Trading,” 389–393. For skepticism that I echo here about the traditional theory, see Frank H. Easterbrook and Daniel R. Fischel, *The Economic Structure of Corporate Law* (Cambridge: Harvard University Press, 1991), 269–270.

(16.) The unfairness argument is defended, in different forms, in Victor Brudney, “Insiders, Outsiders, and Informational Advantage Under the Federal Securities Laws,” *Harvard Law Review* 93 (1979) 322–378; Kim Lane Scheppele, “It's Just Not Right: The Ethics of Insider Trading,” *Law and Contemporary Problems* 56 (1993): 123–173; Patricia H. Werhane, “The Indefensibility of Insider Trading,” *Journal of Business Ethics* 10 (1991): 729–731.

(17.) Leviticus 25:17.

(18.) Thomas Aquinas, *Summa Theologica*, II-II, q. 77, a. 4.

(19.) Caveat: courts strain hard to find both procedural and substantive elements of unconscionability in a contract before declaring the contract itself unconscionable. If both elements are in fact necessary for unconscionability in U.S. law, then I advocate a departure from U.S. law. U.S. law however, seems uncertain on this point. In my view, courts tend to make a purely perfunctory finding on the procedural element.

(20.) *Hume v. United States*, 132 U.S. 406 (1889).

(21.) For a discussion of in contract law, see Duncan Kennedy, “Distributive and Paternalist Motives in Contract and Tort Law, with Special Reference to Compulsory Terms and Unequal Bargaining Power,” *Maryland Law Review* 41 (1982) 563–658.

(22.) In the text I use the term “paternalism” to signify what philosophers call *soft paternalism*, which would justify interfering with a person's self-regarding choice when it is compromised by defects in information or defects in the reasoning and decision process. Another version of paternalism, *hard* paternalism, would justify interfering with a person's self-regarding choice even in the absence of such defects, so long as a person makes a bad choice about what is in his interests. I cannot do justice to hard paternalism in this chapter. Like many people, I find hard paternalism implausible because I find it offensive to interfere with the liberty of competent and well-informed adults to make choices about their own good.

(23.) Seana Shiffrin, “Paternalism, Unconscionability Doctrine, and Accommodation,” *Philosophy & Public Affairs* 29 (2000): 205–250.

(24.) *Hooters of America, Inc. v. Phillips*, 173 F.3d 933 (4th Cir. 1999).

(25.) Alan Strudler, “Moral Complexity in the Law of Nondisclosure,” *UCLA Law Review* 45 (1997): 337–384.

(26.) Strudler and Orts, “Moral Principle in the Law of Insider Trading.”

Alan Strudler

Alan Strudler, Department of Legal Studies and Business Ethics, Wharton School, University of Pennsylvania