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### The Problem with Consenting to Insider Trading

Leo Katz

*University of Pennsylvania Carey Law School*

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# The Problem with Consenting to Insider Trading

LEO KATZ\*

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## I. INTRODUCTION

Professor Anderson argues that so long as insider trading is consented to by all market participants, it is hard to find a strong moral objection to it.<sup>1</sup> I agree that explaining *why* we prohibit consensual transactions is always a tall order.<sup>2</sup> Nonetheless, the fact remains that the law outlaws a remarkable number of mutually beneficial arrangements that all participants have agreed to.<sup>3</sup> Issuer-licensed insider trading is just one of these. Should the law ban it? Professor Anderson is unconvinced by an argument I have given elsewhere to explain why the law should ban it.<sup>4</sup> Here, I will try to restate that argument in what I hope is a more congenial way.

Many years ago, Amartya Sen proved a famous theorem in the theory of social choice,<sup>5</sup> closely related to Kenneth Arrow's famous impossibility result.<sup>6</sup> It holds that there is a deep incompatibility between rules that create rights and the Pareto principle.<sup>7</sup> The theorem's significance for the law has gone surprisingly unappreciated. My argument about insider trading is really just an application of Sen's theorem

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\* Frank Carano Professor of Law, University of Pennsylvania Law School.

1. See John P. Anderson, *What's the Harm in Issuer-Licensed Insider Trading?*, 69 U. MIAMI L. REV. 795 (2015) [hereinafter Anderson, *What's the Harm in Issuer-Licensed Insider Trading?*]; John P. Anderson, *Anticipating a Sea Change for Insider Trading Law: From Trading Plan Crisis to Rational Reform*, 2015 UTAH L. REV. 339, 384–85 (2015).

2. See LEO KATZ, *WHY THE LAW IS SO PERVERSE* 18 (2011) ("There are many . . . cases where we strongly feel that consent should not count but that cannot be explained on the grounds of coercion, deception, incompetence, or effects on innocent third parties . . .").

3. See *id.* at 15–18 (2011). The first chapter of this book is titled "Things We Can't Consent To, Though No One Knows Why," and discusses several examples where consent is irrelevant to the law.

4. See Anderson, *What's the Harm in Issuer-Licensed Insider Trading?*, *supra* note 1, at 795.

5. See AMARTYA K. SEN, *COLLECTIVE CHOICE AND SOCIAL WELFARE* 80 (1970).

6. See generally Kenneth J. Arrow, *A Difficulty in the Concept of Social Welfare*, 58 J. POLT. ECON. 328 (1950).

7. SEN, *supra* note 5, at 79–81.

to a specific context. In this response, I will illustrate Sen's argument with a very specific example. I will then show how that example explains why assumption of risk arguments so often fail in law. I will conclude by pointing out that allowing someone to consent to be at the other end of issuer-licensed insider trading is to let him assume a risk under circumstances that pose a Sen-type problem. I will avail myself of examples I have used in *Why the Law Is So Perverse* to discuss related problems.<sup>8</sup>

## II. SEN'S THEOREM ILLUSTRATED<sup>9</sup>

A man and his wife, Al and Chloe, are brought to an emergency room with injuries they have suffered in a car accident. Al's injuries are the most severe: if he does not immediately receive treatment, he will probably lose the use of both of his legs. Chloe's injuries are much less severe: only some banging up of her hand, which might lead to a slight impairment of manual dexterity if she does not receive immediate medical attention. Alas, there is only one doctor on duty, and needless to say, he immediately directs his attention toward Al. Chloe however is extremely worried about her hand. She is a passionate hobby pianist and being able to play the piano well means everything to her. Moreover, Al is totally besotted with Chloe and is so supremely concerned about her welfare that he asks the doctor to attend to Chloe's needs first. The doctor balks at first, but when Al absolutely refuses to let himself be treated until Chloe has been taken care of, he has no choice but to relent.

As the doctor is about to treat Chloe, a third patient is wheeled into the ER, Bea, who has also been in a car accident, but whose injuries are intermediate between those of Al and Chloe. If she is not immediately attended to, she stands to lose the use of *one* of her legs—less serious than Al's threatened loss of *both* legs, but more serious than Chloe's loss of some manual dexterity. What should the doctor do? He is clearly in a quandary. If he continues to treat Chloe, Bea will protest that surely she has a stronger claim to his help than Chloe, since a one-leg injury is a more serious matter than Chloe's hand injury. But if he acquiesces to Bea's protest, Al will object that he surely has a stronger claim to being treated than Bea. And if the doctor thereupon redirects his efforts to Al, Al will then proceed to tell him that frankly he would prefer if Chloe got treated rather than he, and that he should not worry himself too much about Bea, because Bea is not going to get treated no matter what: if the

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8. KATZ, *supra* note 2.

9. The following hypothetical illustration involving "Al," "Chloe," and "Bea" comes from my book, *WHY THE LAW IS SO PERVERSE*. See *id.* at 25–27.

doctor should continue to refuse to treat Chloe, he, Al, will insist on his priority.

What we have here is a curious cycle, arising from the fact that when the doctor decides on the relative priority of Chloe and Bea, a rights-based argument tells him he should give Bea priority.<sup>10</sup> When he decides on the relative priority of Bea and Al, a rights-based argument tells him he should give priority to Al.<sup>11</sup> But when he decides between the relative priority of Al and Chloe, the Pareto principle tells him he should choose Chloe (Al and Chloe benefit and Bea is unaffected).<sup>12</sup> This is the essence of Sen's claim about the incompatibility between rights and the Pareto principle.<sup>13</sup>

Some people have so internalized the Pareto principle and its legal counterpart, freedom of contract,<sup>14</sup> that it will seem obvious that the Pareto principle should prevail over the rights-based claims, thus implying that the doctor should choose Chloe.<sup>15</sup> But that view has many implications that would appear highly counterintuitive.<sup>16</sup> To be sure, there are also many counterintuitive implications that flow from rejecting the Pareto principle.<sup>17</sup> The point, however, is that one can go either way in this example. It is no less plausible in this context to reject, as it is to endorse, freedom of contract. To get a sense of what makes it so counterintuitive to allow Al to alienate his priority over Bea to Chloe, consider the following situation. Imagine a friend were to ask you for some money to help with a medical treatment that he needs. Suppose you feel strongly inclined to help him, because you feel that his long-standing friendship with you gives him a strong claim upon you. Imag-

10. *See id.* at 28.

11. *See id.*

12. *See id.* at 27–28.

13. *See* SEN, *supra* note 5, at 78–86.

14. *See, e.g.*, MICHAEL J. TREBILCOCK, *THE LIMITS OF FREEDOM OF CONTRACT* 7 (1993) (“[I]f two parties are to be observed entering into a voluntary private exchange, the presumption must be that both feel the exchange is likely to make them better off, otherwise they would not have entered into it. Thus, in most exchanges, the economic presumption is that they make all the parties thereto better off, that is, they are Pareto superior.”).

15. *See* Leo Katz, *Choice, Consent, and Cycling: The Hidden Limitations of Consent*, 104 MICH. L. REV. 627, 665 (2006) (“It seems hard to resist the idea that someone has more of a claim to not being harmed than to receiving affirmative help in some calamity.”).

16. For example: “[I]f we are to assume that over a lifetime everyone will end up being a victim as often as he will end up being a tortfeasor . . . we [c]ould say that there should probably not be any compensation for tortious injuries . . . because everyone will be paying out as much as he will be taking in, and since the process of litigating such cases . . . will cost money, everyone would be better off if all injuries are simply allowed to lie where they fall. . . . [T]he fairness theorist . . . will, of course, insist on compensation in every one of these cases because that is what he in general would insist on. Yet in this case it squarely puts him into conflict with the Pareto principle since everyone would be better off if no such compensation were paid.” *Id.* at 658.

17. *See id.*

ine next, however, that he changes his mind. He explains to you that it would make him far happier to spend the money on a cruise than on medical treatment. Would you still feel inclined to give the money to him? No, probably not, or at least not as strongly. That is because his claim upon you for medical treatment is much greater than his claim upon you for a cruise. This is true despite the fact that the cruise would make your friend much happier. And that's how it is with claims. One cannot readily exchange one for another, even if it is the Pareto-optimal thing to do. It is the same with Al. He has a claim upon the doctor. He would like to exchange the claim he has to get his two-leg injury treated ahead of Bea's injury, for another claim, which would be Pareto-optimal, namely to get his wife's hands treated first. Claims just cannot be exchanged like that.

### III. SEN'S THEOREM APPLIED TO THE ASSUMPTION OF RISK CONTEXT

We can use this example to explain why we are so often inclined to refuse to recognize the validity of assumption of risk arguments.<sup>18</sup> Suppose a worker is asked to perform a hazardous task.<sup>19</sup> The employer offers to buy him an expensive type of protective suit. The worker volunteers to do the job without such a suit in exchange for a slightly higher wage. The wage increase being less than the cost of the suit, the employer acquiesces. This is the kind of agreement that often gets overturned.<sup>20</sup> Why? With the help of the "triage" example above, we can illuminate the basis for that.<sup>21</sup> The relationship between the worker and the employer can be thought of as analogous to that between Al and Chloe.<sup>22</sup> The worker has a strong claim upon the law to see to it that the employer subordinates his desire to economize to the worker's need for safety. But he is willing to alienate that claim in return for an increase in his wage. If we look carefully, though, we will be able to find a third party, who occupies a position analogous to that of Bea, whose presence renders that kind of a bargain unpalatable. The third parties here are the members of the public at large with whom the worker is going to inter-

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18. KATZ, *supra* note 2, at 37–39 (“consider[ing] the innumerable ways in which the law restricts our ability to assume certain risks”).

19. This example using a worker that will come in contact with hazardous materials is also taken from WHY THE LAW IS SO PERVERSE. *See id.* at 22–23.

20. *See, e.g., id.* at 23 (“The assumption of risk defense is considered problematic. Some jurisdictions recognize it; others once did but have abolished it . . . .”); *id.* at 37 (“If the employee is injured and proceeds to sue the employer for negligence, many jurisdictions will hold the employer liable for negligence.”).

21. *See id.* at 37–38.

22. This analogy is also made in WHY THE LAW IS SO PERVERSE. *See id.* at 37–39.

act when he is not doing his job.<sup>23</sup> All of them are being asked to observe the standard onerous precautions the law insists on—usually through the doctrine of negligence—in interacting with him.<sup>24</sup> They are required to see to it that they do not inadvertently or for that matter advertently injure him while they pursue their own projects.<sup>25</sup> But that puts them in the same position as Bea to object that the sacrifice they are being asked to make for the worker's sake is being squandered, as it were, when he acquiesces in a risk of severe injury, for the sake of a small increase in his wage.

#### IV. THE LESSON FOR INSIDER TRADING

The shareholder who buys shares in a company that endorses insider trading is assuming a risk.<sup>26</sup> That assumption of risk is analytically identical to the assumption of risk by the worker, and is problematic for the same reason. Do not misunderstand me. I am not suggesting that such a consensual transaction absolutely has to be banned in the assumption of risk case any more than it has to be absolutely banned in the “triage” case. It is just that in all of these cases there is enough of a tension between rights-based priorities and those based on the Pareto principle (and freedom of contract), that it seems perfectly understandable, and quite defensible, that the law should go with rights over Pareto, as it has done for a long time now in connection with insider trading.<sup>27</sup>

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23. *See id.* at 39 (“[T]he problem with letting people assume any risk they want to is that they are simultaneously imposing hefty burdens on others.”).

24. *See id.*

25. *See id.*

26. *See, e.g.,* LEO KATZ, *ILL-GOTTEN GAINS: EVASION, BLACKMAIL, FRAUD, AND KINDRED PUZZLES OF THE LAW* 173 (1996).

27. *See id.* at 171–73.

