BOOK REVIEWS

THE ECONOMICS OF INSIDER TRADING RECONSIDERED *

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It is hardly surprising that lawyers do not attach much, if any, weight to considerations of resource allocation when they direct their attention to securities markets problems. In their encounters with the securities markets, malfunctions loom large. Securities transactions are rarely dealt with in the courts unless damage has been incurred because the price of securities failed to reflect their "proper" value. Lawyers are on guard against manipulation and other actions designed to prevent one of the parties to a transaction from being aware of the value of the security involved. Of the millions of transactions that occur daily, the lawyer focuses on the few improper ones, and their importance in the market as a whole is magnified. In the lawyer's training, no significant attention is given to the evaluation of capital investment proposals. The lawyer seems unaware of the importance of securities markets in allocating resources. He knows that business is not very dependent on the capital markets for funds. Thus, it is natural for him to overlook the effects of securities regulation on resource allocation.

Lawyers are misguided in these respects. There is evidence that the capital markets do a reasonably good job of keeping the prices of securities in line with their earning power and riskiness, and that the capital markets do indeed influence capital expenditures. In a recent article,¹ I argued that management does weigh the impact of capital expenditures on the market value of a corporation's securities, and is

* The subject of this review is *INSIDER TRADING AND THE STOCK MARKET*, by Henry G. Manne. New York: The Free Press, 1966. Pp. xiii, 274. \$6.95.

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¹ Mendelson, *Payout Policy and Resource Allocation*, 116 U. PA. L. REV. 377 (1968). It should be noted that this article on payout policy is itself evidence that some lawyers feel that capital markets influence resource allocation. The problem dealt with in the article was posed to me by members of the University of Pennsylvania Law School faculty. The Wharton School and the Law School of the University of Pennsylvania are currently exploring the possibility of offering a joint course in the economics and law of securities regulation so that the effect of securities regulation on resource allocation and other problems involving both economics and law will not be overlooked. For another expression of concern in this area, see Mundheim, *Book Review*, 114 U. PA. L. REV. 1101 (1966). It should be noted that the University of Chicago Law School has been publishing *The Journal of Law and Economics* since 1958.

sensitive to the cost of funds implied in the market's evaluation of its securities. The capital markets influence capital expenditures through the relationship of the market cost of funds to the merits of investment proposals considered. Although some securities are not properly priced in relation to their earning power and riskiness, such mispricing is the exception rather than the rule. If mispricing were truly common, investors with adequate research resources would be able to select the underpriced securities and realize a rate of return superior to that earned on the market as a whole. But the systematic investigations made to date have turned up no convincing evidence that the investment institutions with such resources *consistently* realize a superior return.² Although it is tempting to interpret such findings as a reflection on the quality of the research departments of institutional investors, I prefer the more charitable interpretation that attributes the failure of the research departments to perform better to the efficacy with which the capital markets price securities. In general, mispricing is corrected with such speed that the opportunity to realize rates of return above the average is limited.³

To Henry Manne's credit, when he addressed himself to the question of insider trading and brought economic analysis to bear upon the problem,⁴ he included considerations of resource allocation. However, when one carefully scrutinizes the implications of insider trading for resource allocation, one does not find, as Manne did, that the legal restraints on insider trading are unjustified. To the contrary, one finds that the restraints are inadequate and that there is little economic justification for insider trading, for any investment by officers in the shares of their company, or for the repurchase of common stock by the company itself.

I argue below that insider trading is harmful to the normal operation of the securities markets in allocating resources. In developing my argument, I describe what I think are the economic consequences of

² See, e.g., I. FRIEND, F. BROWN, E. HERMAN & D. VICKERS, A STUDY OF MUTUAL FUNDS, H.R. REP. NO. 2274, 87th Cong., 2d Sess. 17-18, 294-358 (1962). Friend & Vickers, *Portfolio Selection and Investment Performance*, 22 J. FIN 391 (1965); Sharpe, *Mutual Fund Performance*, 39 J. BUS. 119 (1966). For a contrary view, see Cohen and Pogue, *An Empirical Evaluation of Alternative Portfolio Selection Models*, 40 J. BUS. 169 (1967).

³ Of course in the short run the market as a whole may be inflated or depressed, and rates of return will vary from the average.

⁴ H. MANNE, *INSIDER TRADING AND THE STOCK MARKET* (1966) [hereinafter cited as MANNE].

Manne also considers the legal and equitable grounds for the prohibition of insider trading. As an economist I have a special interest in Manne's economic arguments, and my discussion will be confined to them. For an excellent treatment of the other elements in Manne's thesis, see Schotland, *Unsafe at Any Price: A Reply to Manne, Insider Trading and the Stock Market*, 53 U. VA. L. REV. 1425 (1967).

In this paper I do not deal with the propriety of security firms simultaneously making a market in a security and having a representative on the board of directors of the issuer. This is a problem that arises largely in connection with over-the-counter securities and involves special considerations that were apparently sufficiently weighty to induce the SEC to refrain from asking that such directorships be brought within the scope of § 16(b) of the 1934 Act, 15 U.S.C. § 78p(b) (1964).

insider trading in part I. In part II, I examine the merits of Professor Manne's contention that the outsider suffers no economic harm from insider trading. His case depends upon a view of the stock market that I find to be distorted. After examining Professor Manne's theory of the stock market in part III, I demonstrate in part IV that even under his theory, insider trading results in net damage to the stockholder. In part V, I examine and reject his contention that the opportunity for insider trading provides necessary compensation for the entrepreneur. Finally, in part VI, I discuss Professor Manne's argument that the existence of a market for information makes it impossible to prohibit insider trading effectively, and point out the reasons why this argument is unconvincing.

I. THE ECONOMIC CONSEQUENCES OF INSIDER TRADING

Cutting through a maze of complicated qualifications, we may say that resources are optimally allocated when no alternative allocation would improve the economic well-being of the community. Error introduced by the decision-making processes makes it unlikely that perfect allocation of resources can be achieved except by chance. However, if there are no biases in the allocative mechanisms, misallocations will be random. At times too many resources will be allocated to one industry, and too few to others. But given a properly functioning economic system, there will be nothing in the decision-making process itself that will persistently allocate an excessive quantity of resources to any one industry. Insider trading is harmful from an economic point of view because it introduces a specific bias, and thus contributes to a persistent misallocation of resources.

The Source of Insider Trading Profits

Within the framework of classical economic theory, it can be argued that since the insider⁵ presumably has both inside information and insight superior to that of most outside investors, he should be better able to forecast prices. With superior forecasting ability, the insider should be able to recognize market pricing errors and realize a better return than outsiders. Therefore, the argument goes, his transactions should create market pressure in the direction of the correct price. The market will flash the proper signals more quickly to management, evaluation of investment proposals will be more accurate, and resources will be more properly allocated.⁶

The insider's profit in such trading can come from any of three sources. First, he may be better able than outsiders to determine the

⁵ To avoid confusion over antecedents, the insider will be referred to in the singular, and investors in the plural.

⁶ If the market rate of return to which the management tries to gear the rate of return on capital expenditures is the long-run rate of return, the more rapid price adjustment allegedly brought about by insider trading will not affect the decisions made.

implications of new information and the effect it will have on the company's future earnings. Second, he may be able to capitalize on information that could have been made available to the investing public, but which has not. Finally, he may be able to capitalize on information that could not have been made public in any event.

If the insider's superior insight gave him an edge, a similar edge should be available to the security analysts who thoroughly familiarize themselves with the insider's corporation. If that edge were available, the institutions for which they work would realize better returns than the market as a whole. We have already seen that there is no evidence that such returns are realized.⁷ Since, however, even the institutional analyst may not be quite as familiar as the insider with the industry in question, and since the analyst may be concerned with a narrower range of considerations, some advantage from superior insight may accrue to the insider. We may, nonetheless, question the extent of that advantage.

Inside Information That May Be Made Public

The insider's superior information may be either of the type that could be made available to the investing public but is delayed, or of the type that could not be made public. If the insider capitalizes on information that could be made public, he violates the policy of disclosure that underlies federal securities regulation.⁸ But there are also sound economic reasons for prompt disclosure. If the capital markets are to allocate resources efficiently, the prices of securities must reflect, as accurately as possible, the prospects of the corporate issuers. If information bearing on those prospects is withheld, the implications of that information cannot be reflected in market prices, and the allocative function of the capital markets is impaired. Barring manipulation or fraud, the insider cannot generally realize a return superior to that of the market as a whole until the information is sufficiently widespread to sustain a higher or lower price level.⁹ Thus the insider can only profit if his activity is unnecessarily delaying the adjustment of the market price of the stock to its appropriate level.

Mispricing is a relative concept. If a security becomes underpriced, the lower price will result in both an increase in the investment of exist-

⁷ See note 2 *supra* and accompanying text.

⁸ "[T]he basic premise of the federal securities laws . . . is that the condition for trading securities should be such that investment decisions can be made after consideration of all relevant information." Mundheim, *The Texas Gulf Sulphur Complaint*, 1966 J. BUS. LAW 284, 287.

⁹ If the inside information does not become generally known, there will be no change in the market price of the securities except for the temporary fluctuations caused by the insider's market activity. While an occasional insider can profit from pushing the price up by buying and selling before the price returns to its previous level, on the average the market impact of his buying and selling must be roughly the same. His average purchase and selling prices must also be roughly the same. The price change can be sustained only if the information becomes general. Obviously, the adjusted price will be achieved more quickly if the information is released earlier.

ing holders of the stock and an increase in the number of holders. However, the shift to that security will be *from* other securities. The price of these other securities will fall. Assuming that all investors have the same expectations regarding securities,¹⁰ prices will not stabilize until all securities with the same risk are earning the same rate of return.¹¹ However, when mispricing occurs, it is relatively quickly eliminated.

If an insider acquires information that leads him to believe that the stock of his company is underpriced, his attempt to acquire securities tends to push the price up. As long as other investors do not have the information, they have no reason to change their opinions of the value of the stock. But because the price has been pushed up by the insider's trading, those who have the stock in their portfolios will substitute other securities of comparable risk for those of the insider's company. Substitution will reverse the price effect of insider buying and cause a rise in the prices of the substituted stocks. Even if the insider disposes of some of his portfolio securities in order to acquire more stock in his own company, his net investment is likely to increase so that there may be a general rise in the price of stock, resulting from the infusion of new funds. The general rise will affect the whole market, not just the stock of the insider's company, and the impact of the insider trading will be dissipated considerably. The impact may not even be statistically detectable. More important, while insider trading may have increased the price of the stock of the insider's company, the price will not be *relatively* higher than the price of the stock of other companies. As long as the market does not have the inside information, investors will not find it worthwhile to include the stock of the insider's company in their portfolios at the increased price, and they will substitute lower-priced securities of comparable risk. Stocks of comparable risk must have the same yield. As we shall see, however, in the longer run insider trading will cause the stock to be relatively underpriced.

If we assume that investors have different earnings expectations, the price an investor is willing to pay becomes a function of his opti-

¹⁰ This is not inconsistent with the preceding sentences. Diversification requirements limit the amount of any single security that a risk-averting investor can include in his portfolio. A fall in the price of that security will enlarge the amount consistent with those requirements and will induce other investors to substitute that security for others of comparable risk.

¹¹ As a first approximation, the rate of return on a share of stock can be defined as the discount rate the stockholders use to determine the present equivalent of the next dividend and the liquidation value of the stock in question one year hence. The liquidation value of the share one year hence is equivalent to the present value one year hence of the dividend to be received in the second year plus the liquidation value of the share at the end of the second year. Similarly, the expected liquidation values of the shares at the end of the second year, third year, fourth year and so on, can be decomposed. Thus the shareholder's expected rate of return can be more precisely defined as the discount rate that translates the stream of all future dividends into the current value of the share. In a perfectly adjusted portfolio all securities with a given degree of risk will have the same rate of return. If the price of any security falls, its rate of return will rise relative to others of the same degree of risk. Investors can then substitute the "cheap" security and increase the yield while leaving the risk unchanged. If they can do so, they will.

mism: stocks with the same earnings and risk may not command the same price. Under the assumption of heterogeneous expectations, the market price of one security relative to another depends largely upon the array of expectations that exist with respect to each security. If we assume heterogeneous expectations, insider trading may affect price independently of the dissemination of information. However, if earnings and risk do not determine the price, there is no such thing as mispricing, and one cannot say that insider trading "corrects" the price, even though the increased price resulting from the insider's trading will eventually be matched by increased earnings. The underlying assumption implies that the capital markets themselves may be malfunctioning seriously, and it is doubtful that insider trading can contribute to proper adjustment.

It is far more realistic to assume only partial heterogeneity of expectations together with aversion to risk. The latter requires portfolios to be diversified, so that even if an investor believed a security was underpriced, he would not buy it up until the price was wholly corrected. The assumption of partial heterogeneity of expectations means that although there are differences of opinion among investors regarding stocks with the same earnings and risk, there are large strata of investors who have the same opinion. The market for a given security is cleared by a member of the stratum containing those who are indifferent to the security in question. Not all members of that stratum will invest in that security and it will be largely a matter of chance which particular members of the stratum invest in the given stock.

If the stratum is dense, that is, if it contains a large number of potential investors or a large quantity of investible funds, the price of the stock will resist change except in response to new information. If an insider with restricted information temporarily drives up the price of stock by acquiring more for his portfolio, investors in the stratum in which the market had hitherto been cleared will find the security relatively unattractive. They will attempt to substitute other securities of equal risk for the security whose price has increased and whose yield (rate of return) has thereby fallen. Substitution will bring the yield of the security in question into line with the yield of comparable risk securities, and prices will stabilize when all securities with the same risk are earning the same rate of return.

Once the yields are brought back into line, the stock of the insider's company will be underpriced in relation to the price of other stocks. Again, the new level of prices may tend to be higher than the old. But from the point of view of resource allocation, it is the relationship of prices, not the absolute level that counts. From this point of view, insider trading does not correct mispricing. It is the dissemination of information that does so.

The stratum theory largely redeems the concept of mispricing. Corrections in relative prices must be made through the marginal

stratum, that is, the stratum containing investors who will either buy or sell upon the slightest fluctuation of price. For most analytical purposes the intramarginal investors can be ignored. Their presence or absence will be a factor in determining the general level of market prices, but their impact on relative prices will only be felt occasionally when a change in the volume of their investment alters the stratum in which the market is cleared.

There has been no research into the validity of the stratum theory of market expectations. However, we may indulge in casual empiricism and observe that most investors do not in fact formulate their expectations independently. In most cases, opinions are formed on the basis of information and projections supplied by the major financial advisory services.¹² Each service has a substantial following, and it is not unreasonable to believe that while there may be several strata of expectations with respect to each stock, many strata are quite dense, and there is a good chance that the marginal investor will be in such a stratum. In what follows, the assumed model of market behavior is the one just described, a market of partial heterogeneity of expectations in which investors are adverse to risk and will therefore attempt to diversify their portfolios.

Inside Information That May Not Be Made Public

The possibility that the insider's information may be of the type that could not be made public is not a fictitious one. In the *Texas Gulf Sulphur* case,¹³ for example, the release of news before the company bought the territory adjacent to its find would have resulted in the loss of considerable profit potential. In the case of a profitable contract or technological development, there may be good reason to delay release until the contract is signed or the development tested. There is, therefore, no question about the existence of information whose release may have to be delayed.¹⁴ But I strongly suspect that on the merits, the case for secrecy is questionable in many instances. To be sure, if the insider trades on information that must be delayed, the adjustment of market price may take place more promptly if the time between the insider's buying and the release of information is not too long. But if the insider were allowed to trade on this kind of inside information, there would

¹² The major services are supplemented by a host of minor ones. However, the minor ones depend upon the major services for a great deal of analysis. Thus the expectations generated by the small services are not necessarily different from those generated by the large ones. Obviously this whole stratum theory of stock pricing applies only to widely traded stocks. We must note that even in the case of such stocks, the stock may be held by a small fraction of the stratum and their reaction may not wholly offset the action of the insider. We may presume, however, that such failure would be relatively rare.

¹³ SEC v. Texas Gulf Sulphur Co., 37 U.S.L.W. 2126 (2d Cir. Aug. 13, 1968) (en banc).

¹⁴ I refer to the kind of information that enables those privy to it to make a large profit by purchasing the stock of the corporation, not to the kind of information on which an insider can capitalize by acting contrary to the interests of the corporation.

be a temptation to delay information when delay is unwarranted. The impairment resulting from delay must be offset against the improvement in market pricing, insofar as an improvement is realized. We have no evidence about the primary source of insider trading profits, but even if the profits from capitalizing on undisclosable information are large, there is no reason to believe that the improvement in market pricing will exceed the impairment resulting from delay. A similar argument can be made against permitting an insider to capitalize by trading on whatever advantage his superior insight may yield.

Inside Trading and the Cost of Funds

Capital budgeting is the process of deciding what investment opportunities should be undertaken. Capital budgeting procedures depend on estimations of future earnings and determination of the discount rate to be applied to expected income.¹⁵ The recommended discount rate is the weighted average cost of the different types of capital funds used by the corporation,¹⁶ and the cost of each type is the rate of return investors expect from it.

A principal characteristic of an equity security is the uncertainty of the return the investors are going to realize from it. Because of the high degree of risk that does in fact obtain in the case of equities, investors expect a high rate of return.¹⁷ But when insider trading is profitable, outside investors only partially share in the good fortunes of the company, while the losses are accentuated. This can be seen by considering two companies, *A* and *B*, which are alike in all respects except that insiders trade in company *A* and do not in company *B*.¹⁸ The stocks of the two companies will be referred to as security *A* and security *B*. Because insiders usurp an undue portion of the earnings stream of security *A*, the range of possible outcomes for outside investors in security *A* is depressed downward in relation to the range for holders of security *B*. Since outside investors ultimately determine the price of the stock, the rates of return to the outsiders on security *A* and security *B* must eventually be the same. The average rate of return to the totality of investors in *A* must be greater than the rate of return to the totality of investors in *B*, because the totality of investors in *A* includes the inside trader who has a higher rate of return than the outsiders. Thus the price of security *A* will fall until the rate of return for *A* matches the rate of return for *B*. In other words, the price of

¹⁵ See Mendelson, *supra* note 1, at 390-92.

¹⁶ E. SOLOMON, *THE THEORY OF FINANCIAL MANAGEMENT* 69-75 (1963).

¹⁷ It can be argued that the rate of return investors demand has been excessive in light of the risks that actually obtain in the equity market. One of the considerable contributions of the movement of institutional investors into the equity market may have been to decrease the differential rate of return on equities and other types of securities.

¹⁸ The extreme assumption that there is no insider trading in company *B* stock is made only to simplify the discussion. The distortions subsequently described will occur as long as there is more insider trading in company *A*.

security *A* will be less than it would have been in the absence of insider trading.¹⁹

If this were not so, the rate of return on security *A* to outside investors would be less than the rate of return to investors in *B*. But then the range of possible outcomes for security *A* relative to its rate of return would be greater than the range of possible outcomes for security *B* relative to its rate of return.²⁰ This would make security *A* less attractive than security *B*, and rational investors would shift from *A* to *B*. The process of shifting would depress the price of *A* and increase the price of *B* until the returns on the two securities were in line. At that point the rate of return to the totality of investors in *A* would exceed the rate of return to the company. The cost of funds would therefore be higher for company *A* than for company *B* and there would be underinvestment in company *A* relative to company *B*. Even if the actual range of possible outcomes was not increased, it would be increased *relative to* the rate of return realized by the outside investors if the rate of return they realized was not commensurate with that earned by the company. In the absence of an adjustment in the rate of return, the security will not be as attractive as it would be without insider trading.

Empirical Evidence on the Profitability of Insider Trading

There have been three published investigations by economists to determine whether or not insider trading is in fact profitable.²¹ In addi-

¹⁹ One must distinguish between the short-run and long-run effects of insider trading. In the short run the insider's activity may push prices up without having any lasting effect on the relative prices of the stock in his company and the stock of other companies. But in the long run his trading has a depressing effect on the price of his company's stock for the reasons given in the text.

²⁰ Technically speaking, the coefficient of variation is greater for security *A* than for security *B*. The coefficient of variation is a statistic widely recognized as a measure of risk. I have assumed that the range of possible outcomes for security *A* was simply shifted downward and that the width of the range remained unchanged. But because the range we are concerned with is the range of outcomes the investors *think* is possible, it is possible that the lower end of the range will be depressed more than the upper end. However, for the purpose at hand, there is no need to make the more tenuous assumption that the range is widened. It should be noted that the effect discussed here is distinct from the effect discussed in the text accompanying notes 17-19 *supra*. There, underpricing was attributed to discounting a decreased income stream at an unchanged capitalization rate. Here the effect on the price of the security is compounded because the smaller income stream is capitalized at a higher rate.

Against this increase in risk we must offset any stabilizing effects the insider trading may have. In most cases the information upon which the insider traded will be released fairly quickly, and the price to which the insider's trading pushed the stock—insofar as such trading did affect the price—will be sustained by market action. Where the nature of the information was such that some delay in its release was mandatory, insider trading may bring the price of the stock in line with the true prospects of the firm somewhat more rapidly than would otherwise have been the case. This kind of price action is stabilizing, and such stabilization reduces the riskiness of the stock. However, it is difficult to believe that this effect would be anywhere near as significant as the possible mispricing effect.

²¹ F. SMITH, *MANAGEMENT TRADING: STOCK MARKET PRICES AND PROFITS* (1941); Wu, *Corporate Insider Trading Profits and the Ability to Forecast Stock Prices*, in *ELEMENTS OF INVESTMENTS* 442 (H. Wu & A. Zakon eds. 1965); Lorie & Niederhoffer, *Predictive and Statistical Properties of Insider Trading*, 11 J. LAW & ECON. 35 (1968).

tion there are at least one unpublished dissertation²² and two unpublished theses on the question.²³ O'Donnell studied the relationship between the prices of insider's transactions and subsequent changes in the prices of the stocks of their companies. Wu, Smith and Driscoll examined insider trading profits. Neither Smith nor Driscoll found sufficient evidence to indicate that insider profits exceeded outsider profits. In one of Wu's two experiments, the results were not statistically significant, although the insider performance was superior to that of the market. But Wu's more significant experiment suggests that insider trading is profitable, and the findings of both O'Donnell and Lorie and Niederhoffer suggest the same conclusion. The preponderance of the evidence seems to suggest that insider trading is profitable.

Should There Be Any Insider Trading?

The prohibition of insider trading can be defended on the economic grounds given above. Any time any portion of the investing public has its earnings reduced by the action of insiders, the required rate of return will be increased.²⁴

It is difficult to see the justification even for long-term insider trading.²⁵ There is nothing magical or sacred about six months. If insider trading in a six month period is harmful, a seven or eight month turnaround is just as harmful. Whenever the insider profits from the use of inside information, he does so at the expense of other shareholders.

The Corporation as an Insider

It might seem that an exception to any prohibition of insider trading has to be made when the insider is the corporation itself. To be sure one group of investors benefits at the expense of another group. The gains of the winners completely match the losses of the losers and the investors' chances of being among the winners, at first glance, are not biased downward because any particular group has an inside track. There is no reason to change expectations.

Unfortunately, this view is deceptive. The insider does have an inside track. He knows what the corporation is doing. He is not likely to surrender the stock, and the outside investors' chances of being

²² H. Wu, *Corporate Insider Trading, Profitability, and Stock Price Movement*, —, 1963 (unpublished Ph.D. dissertation, University of Pennsylvania).

²³ T. Driscoll, *Some Aspects of Corporate Insiders' Stock Holdings and Trading under Section 16 of the Securities Exchange Act*, —, 1956 (unpublished M.B.A. thesis, Wharton School, University of Pennsylvania); T. O'Donnell, *The Stock Market Activity of the Corporate Insider, and Future Price Movements of his Stock*, —, 1960 (unpublished M.B.A. thesis, Wharton School, University of Pennsylvania).

²⁴ In order to realize a rate of return commensurate with the risks, the outsiders will have to get the stock at a lower price so that the average rate of return to all stockholders may rise.

²⁵ The objections raised here are to trading, not owning. Indeed, even trading on account of an insider would not be objectionable if the investment decisions were adequately insulated from the insider's discretion.

among the winners are not the same as the insider's. It is also to be noted that by simply sitting tight the insider increases his control over the company. How important that point is depends upon a number of factors, including how much stock the present management has, how much the corporation repurchases, and how entrenched the present management is.

Corporate repurchases of shares to effect an acquisition are objectionable on other grounds as well. The corporation takes advantage either of its own selling stockholder or of the stockholders of the selling firm. The insider corporation either buys the stock quietly and fails to supply the seller with some relevant information or publicly announces its intention to buy, in which case the price of the stock is driven up, to the disadvantage of the stockholders of the acquired firm, who are usually paid in stock of the acquiring corporation according to a schedule based on market value. In the former situation, the corporation's actions favor the corporate insider. In the latter, there is a very real possibility of price distortion. The only justification for such corporate repurchases is that the company is saved some of the expenses associated with new issues. The net saving cannot be significant. The potential harm is substantial.

If the object of corporate repurchases is to utilize spare cash, the corporation is in effect evading taxes for its stockholders by undue retention. The after-tax rate of return to the stockholders is artificially biased upward,²⁶ thereby reducing the firm's cost of capital and expanding the range of projects acceptable to management. The management now finds itself in the position of accepting investment proposals that could not survive a less biased test of profitability.

Insider Trading as Compensation and the Pricing System

The economic case against insider trading is not confined to its impact on the cost of funds. Professor Manne argues that in very special circumstances, to be discussed later, insider trading plays the crucial role of furnishing special compensation to employees who provide dynamic thrust in our industrial society, and who are identified as entrepreneurs.²⁷ It is his premise that entrepreneurs will be attracted by the profit potential of insider trading. But if the entrepreneur is compensated by being allowed to trade as an insider, a monkey wrench is thrown into the pricing mechanism. The social cost of using the entrepreneur and the corporation's cost diverge. Unless the divergence

²⁶ So-called growth firms also take advantage of this aspect of the tax structure by design or otherwise. Their opportunities to invest are so great that they are niggardly with dividends and plow the bulk of their earnings into new investments. Without approving of the tax structure, we may note that the depressing effect on the cost of funds is not as harmful in this situation as in the case of repurchasing shares. As long as the growth company expands rapidly enough to live up to its label, it is hardly likely to be overinvesting. To the contrary, the high rate of return earned by growth companies suggests that they underinvest.

²⁷ Entrepreneurs are not to be confused with suppliers of capital.

is uniform throughout the economy, the pricing system's effectiveness as an allocative mechanism is impaired. That might be a small price to pay in order to have a dynamic society, but Professor Manne has not established that it is indeed the price we have to pay.

The disruption of the pricing mechanism is compounded by the inefficiency of insider trading as a method of compensating the entrepreneur. For one thing, insider trading cannot be confined to entrepreneurs. It is hard to believe that to create an incentive we must scatter rewards broadside in the direction of the entrepreneur, hoping that he will catch some and tolerating the unfortunate consequences for allocative efficiency.

II. HARM TO THE OUTSIDER²⁸

In defense of the proposition that the outsider is not harmed by insider trading, Professor Manne argues that (1) the selling shareholders do not lose what the insider gains, (2) even if the selling shareholders do lose, outsiders as a group do not necessarily lose, and (3) investors (defined as long-term holders) lose proportionately less the longer they hold their shares.

Creation vs. Capture of Value

Professor Manne's argument that the outsiders do not lose what the insider gains is relatively simple. According to him, buying shares on insider information is the equivalent of selling information directly. As the insider buys, the price of the shares rises. When the price rises to a level commensurate with the information he has, the insider has exchanged the value of the information for the appreciation in the value of his shares. But the exchange by the insider is not a sale. In a sale the recipients of benefits surrender something in exchange. In this case, the stockholders who still hold their shares participate in the increment in value without surrendering anything, because new value has been created. The insider gains part of the new value that has been created, and his gain is not made at the expense of anyone.²⁹

The weakness of this argument is that it attributes the creation of value to the insider's use of the information at his disposal.³⁰ Whether

²⁸ I must candidly admit bias. Although I refrain from moral judgments in the body of the text, I cannot help but observe that the number of practices that I consider unsavory and that Professor Manne is willing not only to condone but actually to defend has probably affected my willingness to accept some of his speculations.

²⁹ MANNE 61. Professor Manne recognized that the insider may profit from bad news as well as good. In connection with the argument described in the text, Manne notes that "it is simply a matter of convenience to use only one illustration instead of two." *Id.* at 244 n.4. This is nonsense. An analogous argument is that the insider has profited because he destroyed value. If one translates Professor Manne's discussion into one dealing with insider trading on bad news, the passage becomes an exceedingly odd one.

³⁰ This is not to say that information is not valuable, but much of the value of information to the insider stems from the artificial scarcity that results from not making it public.

the market recognizes it or not, the stock has increased in potential value when the productivity of the firm increases in fact or prospectively. Insider purchasing is an attempt to capture unrecognized value, not a creation of value. The price of the stock would respond to purchases by the insider whether he had information or not. If he were buying because of an erratic whim, the price would fall back to its original level shortly after the purchases by the insider ceased. There is nothing in the transaction itself to sustain a new price level. The new level can be maintained only if the purchasing is accompanied by release of the new information. Moreover, the price rise would come about with the dispersal of the new information even if the insider did not buy a single share.

Since the information by itself would have caused an increase in the price of the stock, the shareholders who sold their stock to the insiders would have shared the benefits from the price increase with the continuing holders if the insider had not been buying. It makes no difference that some shareholders might have sold the stock anyway.³¹ The question is how gains are divided between the insider and outsiders. To the extent that investors sell their stock to buyers other than the insider, the gains will accrue to outsiders rather than the insider.

The weakness in Professor Manne's case is that he measures the damage to outsiders by how much more the selling stockholders would have had if the information were not made public at all. But surely the appropriate measure is how much more the sellers would have had if the information had been made public from the beginning.³²

We must postpone evaluation of Professor Manne's contention that outsiders as a group do not lose even if shareholders who sell to the insider do until we have examined his view of how the stock market operates. As will be shown in part III, the stock market is not quite as he sees it, and his conclusions regarding outsider losses do not hold. The delay will not be long because Professor Manne's argument about the triviality of investor losses can be disposed of quickly.

The Fate of Investors

In dealing with the problem of investor losses, Professor Manne has in effect defined an investor as a long-term holder. It is extremely hard to draw a sharp dividing line between the investor and the speculator, and the usefulness of the distinction is doubtful. It implies that moving in and out of a security is speculation. But even an investor must constantly check the relationship between the price and income of a security, and deem a security worth holding only as long as the

³¹ It is doubtful that they would have sold at the lower price if the information had been available. Certainly some would have held out.

³² The only instance in which the kind of comparison Manne makes has any legitimacy is the case in which the insider is trading on superior insight, which by its very nature cannot be transmitted to the public.

price is within a given range. The range may change, but since the price can move out of the range at any time, even an investor may find himself holding some securities for only a short period of time.

Thus not only the short-term traders, who Professor Manne seems to think should receive no sympathy, but also conscientious investors may very well unload securities if the price rises above the critical level without their receiving any news that would warrant reconsidering the value of the security. It makes absolutely no difference how long investors have held their stock. If they lose money as a consequence of insider trading, they have suffered. It is irrelevant to argue, as Professor Manne does, that the amount lost as a result of insider trading may be small in comparison with the amount gained over the long run, unless there is sufficient justification for any losses being incurred.

III. PROFESSOR MANNE'S VIEW OF THE STOCK MARKET

The stock market that Professor Manne describes is a strange and unfamiliar place. It consists essentially of four sets of investors. Some *know* what stocks are worth, are unlikely to be hurt, and can therefore be ignored. Other investors know nothing and will buy or sell in reaction to random events such as the death of a President. Manne correctly anticipates that their purchases and sales will be random. The third and fourth groups are chartists, who are also essentially "know-nothings." Members of the third group will buy or sell according to their interpretation of changes in prices. The fourth group consists of those who react to the rate of change in prices.

The Neglected Traders

These are the players on the stage that Manne builds. The "know-it-alls" naturally have a perfectly elastic demand for a given stock. They will quickly purchase any stock for sale at a price lower than what they know the stock to be worth, and they will dump their stock if the price rises above that level. They cannot be influenced or hurt by insider trading. If all the other traders in the market were indeed "know-nothings," Manne's point about the net damage to outsiders would have more validity. But Manne specifically excludes the vast body of traders who know more than nothing but less than everything. Indeed, Manne himself notes that "the truth for most traders lies between these two extremes."³³ Institutional investors, for example, are implicitly excluded from Manne's view of the market.

Such "know-something" investors do not know exactly what stocks are worth but do try to estimate their value. Some may consider a stock worth more than its existing market price but will limit their investment in that stock in the interest of diversification. For the same reason many investors will curtail their holdings of securities they do

³³ MANNE 94.

not consider overpriced. The two tendencies just mentioned will make the demand curve for equities slope downward. As the price of a given security falls (functionally), existing holders are willing to expand their position in this stock to a limited extent even though their diversification may diminish as a result. Other investors on the margin who had previously excluded the stock from their portfolios may be brought into the market. If an insider starts buying there will be corresponding liquidations that would not have otherwise taken place.

Do "Know-Nothings" Lose Nothing?

The net loss from insider trading will certainly not be zero when there exists an intermediate group. However, even if the "know-it-alls" and the "know-nothings" were the only traders in the market, the net loss would not be zero.

Manne's argument that the net loss to the "know-nothings" from insider trading is likely to be zero is based upon the Random Walk theory of the stock market.³⁴ That theory suggests that inferences drawn about future price changes from the history of price changes will not enable one to profit on trading. The gross profits made by using past prices as a guide for trading will probably not significantly exceed the cost of transactions.³⁵

Manne's case hinges upon the proposition that insider trading changes the pattern of sales. As a result of insider trading, some of the "know-nothings" who would otherwise have sold will not sell and will be better off. Some "know-nothings" who would have bought but do not buy because of insider trading are worse off. Finally, the market behavior of some "know-nothings" will not be affected by insider trading.

In dealing with the third group of investors, the "know-nothings" who buy or sell according to their interpretation of price changes, Manne again seems to compare the gains or losses resulting from insider trading with the gains and losses resulting from withholding the news without insider trading. This is not a wholly legitimate comparison. Except in those relatively rare instances where the welfare of the corporation would have been jeopardized by disclosure, the release of the information must have the same effect as insider buying or there is not much point in insider buying. Thus it is not accurate to say that "without insider trading one cannot assume that the price would have progressed" ³⁶

This conceptual error also permeates his argument that the gains and losses for the outsiders who sell to the insider tend to cancel out.

³⁴ See *THE RANDOM CHARACTER OF STOCK MARKET PRICES* (P. Cootner ed. 1964).

³⁵ This is quite different from saying that future prices cannot be predicted. The value of a stock is determined by the underlying health of the issuing firm and by its prospects. One can make reasonable predictions about the future prices of stocks without being able to specify the time path of the price of the stock. It is logically possible to make such predictions over an extended period of time without being able to infer the sequence of price changes.

³⁶ MANNE 101.

Professor Manne claims that some outsiders sold at higher prices than they otherwise would have, and others, influenced by price changes, sold where they otherwise would not have sold. He correctly attributes a loss of potential profit to the second group, but he mistakenly assumes that in the absence of insider trading, the first group would not have had a higher price at which to sell.

There is one situation in which the stock sold to an insider might have been sold in any case. The broker receiving an order from an insider may well turn to institutional order departments to see if they are in the market to sell the stock in question. Order departments do not make the basic decisions of what to buy or sell. These decisions are made by investment committees or other management personnel. The order department merely executes the decisions, and if it sells the stock bought by an insider it is selling stock that would have been sold anyway. Here again, however, the insider is not buying from a "know-nothing." Presumably the decision to sell was carefully formulated on basis of the best information available. If the decision-makers had had the information that the insider has, the decision to sell might not have been made.

IV. DAMAGE UNDER THE RANDOM WALK THEORY

The available evidence does not make it possible to dismiss the Random Walk theory lightly. It does not follow, however, that security evaluation has to be abandoned. One must still determine whether the rate of return is commensurate with the risk. The theory itself is premised on the proposition that all information is promptly analyzed and reflected in the price of the stock.

I have postulated a significant number of investors on the margin of indifference at the prevailing price. Some will already hold stock, some will not. It is a matter of chance how many will instruct their brokers to sell at a given price. The amount by which the specialists or traders will raise or lower the price depends upon the extent of the imbalance. This in itself is sufficient to create a substantial random element in price changes. It in no way interferes with the fundamental pricing process.³⁷

Every time the price changes, the composition of those on the margin of indifference changes. However, while it is a matter of chance whether a particular holder of stock sells at a particular price, if the price rises, some formerly indifferent investors will sell their stock. Of course, insider trading will tend to raise the price. But some investors

³⁷ This is not the theoretical foundation of the Random Walk theory. The proponents of the Random Walk theory assume that the market accurately evaluates stock, and that new information is quickly reflected in prices, so that it is practically impossible to ride even short term trends. Price changes are thus random because news comes to the market in a random fashion. If the market responded to insider trading as slowly as Manne implies it does, and if insider trading were prevalent, the Random Walk theory would not hold.

who sell their stock in response to the price movements induced by insider buying would not have sold their stock if the insider information had been made public. The indifferent sellers are indifferent only in light of the prevailing information. If they had had access to the inside information, they would not have been indifferent.

Investors do not behave quite as irrationally as Professor Manne suggests. By and large, securities are reasonably well evaluated. Although stories of stock market killings are common, no one has ever produced evidence that any particular subset of investors has been able to realize consistently better rates of return than could have been earned on randomly selected stocks. It seems that the market recognizes mis-priced securities quite rapidly and promptly corrects pricing errors. This is perfectly compatible with random price changes. It means that information reaching the market is translated into appropriate price adjustments. It is not the insider's trading alone that brings about price changes.

V. INSIDER TRADING AS COMPENSATION FOR THE ENTREPRENEUR

Professor Manne's case for insider trading does not rest solely upon the proposition that it is not harmful. He maintains that it is positively beneficial because it provides an incentive to the entrepreneur.

The Entrepreneur

Professor Manne's view of the dynamics of capitalism is largely that of the great economist Joseph Schumpeter.³⁸ Schumpeter thought that the thrust of modern capitalism was provided by the entrepreneur, who in Schumpeter's lexicon was an innovator, not simply the proprietor of a business. The entrepreneur's genius lay in his ability to recognize the economic advantages of combining the factors of production in new and different ways. Innovation could involve introducing a new invention into the productive process, utilizing existing equipment in more efficient ways, developing products, introducing new marketing techniques, or reorganizing jobs within a firm. The economic advantages of innovation lay in being the first on the market with a new product, the first on the market with a significant modification of a product or the first with significant reductions in costs. Schumpeter theorized that once an innovation had proved itself, an increasing number of imitators would copy the innovation, closing the gap between prices and costs through competition, until the innovation yielded no more than any other business activity.

Schumpeter labeled the extraordinary but temporary return from innovation "profit." It was income that accrued to the entrepreneur, not necessarily to the capitalist. Schumpeter believed that the entrepreneur received a higher income than he actually required as an in-

³⁸ See J. SCHUMPETER, *THE THEORY OF ECONOMIC DEVELOPMENT* (1949); J. SCHUMPETER, *CAPITALISM, SOCIALISM AND DEMOCRACY* (1950).

centive for supplying society with innovations. He also believed that with the growth of large modern corporations, the entrepreneurial function would be routinized, the entrepreneurial psychology would fade, and the dynamic force of capitalism would end. On these last two points, Professor Manne parts company with Schumpeter.

There is little doubt that Schumpeter misread the future of large corporations. His celebrated colleague, John Kenneth Galbraith, has now advanced the theory that without large corporations our modern economic system would have lost its thrust.³⁹ In the postwar period we have witnessed a fantastic technological and organizational revolution. The impetus for this revolution has come from the technologically oriented management of large corporations that had both the resources and the motivation to develop large and expensive innovations.

In the development of the large corporation, Galbraith sees a decline in the influence of the owners of capital and a convergence of the structures of all highly industrialized economic systems. Unlike Schumpeter, Galbraith foresees the demise of capitalism as a process of creative growth, not of decay.

Where our system goes from here is not of particular concern to Professor Manne or the problem at hand. But Professor Manne does feel that there is room for the innovator in modern giant corporations; that the innovator has not traditionally been overpaid; and that if he is not adequately compensated in the future, capitalism will indeed lose its dynamic thrust.

The Entrepreneur's Compensation

The innovator is part of the corporate organization, and, like all members of the organization, he receives a salary. To Manne this salary is an inadequate incentive to induce the potential innovator to stick his neck out. An essential feature of innovation is that it has never been tried before. The innovator faces the substantial uncertainty of whether the development he proposes will prove profitable or turn out to be a bust.

Manne maintains that neither bonuses nor stock options are adequate salary supplements. He finds the bonus inadequate for a number of reasons, including that it may prove embarrassing to disclose a substantial bonus. Furthermore, Manne argues that because the amount of the bonus is decided entirely by someone other than the recipient, the bonus may not take account of all the beneficial effects of innovation. The amount of a bonus depends upon the welfare of the entire company, and even a very profitable innovation may fail to bring a company out of rough waters.

The difficulty with options is that if they are granted before disclosure of the innovation, but after management knows about it, management again determines the reward the innovator is to be given before

³⁹ J. GALBRAITH, *THE NEW INDUSTRIAL STATE* (1967).

the real value of the innovation is known. If the option is granted prior to the innovation as an incentive, there is no way of knowing whether it is commensurate with the prospective innovation or not. To Manne, the only solution is to permit the innovator to trade on his inside knowledge. The innovator is then able to compensate himself with a reward that he considers commensurate with the worth of his innovation.

Professor Manne is not unaware that there are some objections to the use of inside information as compensation. Among the possible drawbacks he notes and dismisses are fraudulent manipulation, intentional creation of bad news, delay in disclosures, stock pools, profiting from bad news, and profiting by the wrong persons. The quality of his treatment of the various objections is uneven, but all his arguments are premised on the underlying assumption that there is a need for entrepreneurial compensation that cannot be supplied in any other way.

Professor Manne correctly points out that salary and promotion are available to other members of the corporate organization besides entrepreneurs. It does not follow, however, that salary increases and promotion cannot be considered adequate compensation for innovation. Salary increments and promotions are granted for a wide variety of services rendered to the corporation, and there is no reason why entrepreneurial activity cannot be one of them. More important, in our society the advantages of moving up in the corporate hierarchy are not confined to increased income. The status, the prerogatives, and the power that go with promotions are also highly valued. Even the physical appointments of an office have acquired an extraordinary importance in our society. If innovation is one method of achieving the increased pay and other appurtenances of promotions, it is ridiculous to argue that the potential entrepreneur will cease to innovate for lack of incentive.

It is likely that a great many innovations have been made by people who never dreamed of making a fortune on the stock market as a result. The market in which the scientist can translate scientific advances into substantial stock market gains is a fairly recent product of the growth orientation of the stock market.

The typical killing from the use of inside information regarding innovations is usually made in small and moderate-sized firms. The major technological innovations of our age have usually been made by the industrial giants, and the possibility of profiting from inside information in an industrial giant is relatively small. The typical innovation affects only a small segment of the company, and has a minor effect upon the earnings per share. If we depended upon insider trading to motivate innovators, most innovations would probably never have been made.

Professor Manne is so concerned with distinguishing between profit and other forms of income that he loses sight of an important

economic truth. He notes, "Only the value of the innovation at the moment of creation reflects profit, and the return to the entrepreneur. Subsequent income . . . is never profit in this sense."⁴⁰ He neglects the present value concept of the flow of money. The total increment to the innovator's income stream that may result from being rewarded with salary increases and advances within the corporate hierarchy may also have a very substantial present value.

It is wholly unrealistic to assume that if insider trading were completely prohibited, the corporate world would find no way to compensate the entrepreneur. If the entrepreneur's contribution to the corporation is truly valuable and the corporation is shortsighted enough to fail to recognize and reward the innovation, there will be a competitor interested in attracting the entrepreneur.

Professor Manne's case for the use of inside information as entrepreneurial compensation is unconvincing. We may therefore look at his dismissal of the objections to using information as compensation without allowing him the premise that the need for entrepreneurial compensation cannot be supplied in any other way.

We must grant that delays in disclosure may sometimes be necessary to the well-being of the corporation. But the elimination of insider trading would minimize the inducement to delay disclosure, whereas the authorization of insider trading would maximize the inducement to delay disclosures. The only party to gain from such delay would be the insider.

Manne dismisses the objection that permitting insider trading might lead to the formation of manipulative stock pools with the incredible argument that "the pool, that alleged arch villain of the pre-1933 stock market, was an efficient device for exploiting information."⁴¹ This has an element of truth. The men that ran the pools were out to make money. But since they were willing to take advantages of lies, their perversity would have been phenomenal if they had failed to take advantage of the truth when an advantage was to be taken. The pools are hardly redeemed thereby.

Oddly enough, in defending the profiting by entrepreneurs from bad news, Manne substantially undermines his own entrepreneurial case. Manne clearly recognizes and accepts that if insider trading is allowed, the entrepreneur may benefit not only from knowledge of his innovations, but also from any other valuable information that may come his way. Professor Manne argues:

Competition for entrepreneurs does not take the usual form of offering a specific amount of money. Rather, entrepreneurs will be attracted to those positions offering the greatest opportunity for them to make large, indefinite gains.

⁴⁰ MANNE 120.

⁴¹ *Id.* at 153.

. . . Because the cost to the corporation for this form of compensation is so low, competition among corporations for entrepreneurs would quickly *force* all of them to allow their insider entrepreneurs to trade in bad news as well as good.⁴²

In answer to this argument we should note first that there is no reason to believe the "positions offering the greatest opportunity . . . to make large, indefinite gains" are positions in companies for which entrepreneurs can effectively introduce innovations. Second, the principal force that will induce corporations to offer this kind of emolument is that other corporations do so. When viewed in this way, the rewards to entrepreneurs seem to be a form of rent. Society will not suffer without such inducements. Finally, once insider trading is permitted, there is no way of confining the rewards to the entrepreneur when innovation is institutionalized as it is in a large corporation. The information will inevitably be known by many people. It is a feeble answer to argue that it is "extremely difficult to identify individuals performing the entrepreneurial functions or to know the precise moment at which an individual performs an entrepreneurial act."⁴³ It is even more feeble to argue that "the contribution of an individual may be so subtle . . . and yet so critical that we must be very cautious in concluding that no reward is deserved."⁴⁴ The plain fact of the matter is that not everybody who may gain from insider trading has participated in the innovation. And there is no real chance that the respective rewards to the various persons engaging in insider trading will be commensurate with their contributions to the innovation.

VI. THE MARKET FOR INFORMATION

The objections to insider trading would be of little avail unless such trading could be effectively prohibited. Manne denies that it can, maintaining that if insiders cannot trade on their own information they will trade on that of others. According to him, information can be exchanged with other insiders so that the community of insiders can trade in securities on the basis of information other than their own. Of course, this can only be done if there exists an effective mechanism for trading information. Manne maintains that a market for information exists, but his case is not convincing.⁴⁵

The market for information, as Manne conceives it, consists of two basic parts: the social circles in which company executives move, and the investment banking community.

According to Manne, while an executive may not be able to benefit from the knowledge that his company has made significant advances in improving its product, there is nothing to prevent him from passing

⁴² *Id.* at 155-56 (emphasis added).

⁴³ *Id.* at 156.

⁴⁴ *Id.* at 157.

⁴⁵ I do not mean to imply that I think *all* insider trading could be effectively prevented at little expense.

this information on to an executive of a different corporation at the nineteenth hole. It would be naïve to maintain that such informing is never done, but it is hard to believe that there is any significant systematic exchange of information in this fashion. An executive is much more likely to inform a close personal friend than his counterpart in another corporation. Industrial espionage is a serious problem, and corporate officers are extremely circumspect in passing along information about their corporation.

In addition, it is extremely difficult to establish a *quid pro quo* in this type of exchange. There is no reasonable guarantee that the recipient will ever have information of comparable value or that he will pass it along to the informer. It is hard to see why a corporate officer would take a risk with such a small possibility of receiving adequate return. Really worthwhile information must be relatively rare, and it seems that golf course *trading* in information would involve more hazard than it would be worth.

The second component of Manne's alleged information market is the investment banking community.⁴⁶ Investment bankers are looked upon as clearing houses of information, which presumably comes both from the various directorships that members of investment banking houses hold and from their frequent contacts with company executives.

There exists a cleavage in the investment banking community with respect to directorships. Some investment banking houses, and some major ones at that, are quite reluctant to accept directorships.⁴⁷ Other investment banking houses actively seek directorships. If the information clearance function is as significant as Manne maintains it is, the investment banking houses that tend to refuse directorships would presumably find themselves at a significant disadvantage in attracting business, and it is unlikely that they would take the stand that they do.

It can reasonably be argued that investment bankers accept directorships because they think that there is money to be made by such participation and to see to it that the companies in which they have advised their customers to invest are properly run. There can be little doubt that many investment bankers also take on directorships as a means of acquiring intimate knowledge of the firms and industries, as a means of establishing contacts with other companies whose directors sit on the same board, and as a means of determining the availability of merger opportunities.

Investment bankers probably do pass on some information. They may give important customers significant investment advice, occasionally, though not consistently based on a *quid pro quo* exchange of information. In spite of the persistence of corporations in dealing with the same investment bankers, rivalry among banking institutions is

⁴⁶ I am a little surprised that the investment banking community has not been up in arms at being portrayed in this particular role.

⁴⁷ SEC, REPORT OF SPECIAL STUDY OF SECURITIES MARKETS, H.R. Doc. No. 95, 88th Cong., 1st Sess. pt. I at 432 (1963).

nevertheless substantial, and good investment suggestions may tend to keep corporate officers content with existing investment banker relationships. But supplying this kind of investment advice, even if it is done, is quite different from the clearing house function that Manne envisions.

Another difficulty with viewing the investment banking community as an information clearing mechanism is that the typical investment banker deals with only a small number of the corporate employees who have significant inside information. There are too many company officers and corporate directors who would be left outside the privileged circle who could deal in the inside information of others. This kind of a market does not provide the entrepreneurial compensation that Manne alleges to be the major justification for insider trading except to the very top management.

I have serious doubts about how effective the investment banking community could be as a clearing house for insider information. Much significant information must be capitalized upon quite quickly if at all. There is usually no justification for withholding the information from investors for any extended period of time. It is one thing to imagine investment bankers dropping hints to clients at social functions, or even, *on occasion*, systematically alerting a "preferred" list to a new development. It is quite another and more serious matter to visualize investment bankers making a practice of treating information in this way. The only evidence that Manne presents to support the existence of this kind of activity is from the Pecora hearings, dealing with practices before the prohibition on insider trading.⁴⁸

VII. CONCLUSION

Manne's defense of insider trading must be dismissed. My own attack on insider trading is nevertheless sufficiently speculative to warrant caution in advocating extension of insider trading prohibitions. We seem to be reasonably comfortable with the price we pay for the existing degree of tolerance toward insider trading. But there is no doubt in my mind that the economic objections to insider trading, reinforced by considerations of fairness, require stricter restraints.⁴⁹

⁴⁸ This review was prepared long before the SEC accused Merrill, Lynch of alerting selected customers to a forthcoming decline in earnings of a company before the information had been released to the public. It may be that such informing was more common than I believed when I originally wrote the paper. One may surmise, however, that the practice was a short-lived one. The recipients of the favored treatment seem to be institutional buyers, so the practice is probably relatively recent in origin, and the SEC charge against Merrill, Lynch presumably brought about a severe attrition of the practice. Whether or not the practice will be resumed will of course depend upon the outcome of this case. It must be noted, however, that the list of alleged recipients of the news in the pending case did not include possible sources of inside information. Thus the *quid pro quo* could not have been information, and even this development is not evidence of a market in information.

⁴⁹ There is some cause for reservations about hasty recommendations. A prohibition on long-term insider trading is tantamount to a severe curtailment of managements' investment in the stock of their companies. Such a prohibition would sever one of the few threads that link capital expenditures to the capital markets, and might weaken an already frail discipline.

PROXY CONTESTS FOR CORPORATE CONTROL. SECOND EDITION. BY EDWARD ROSS ARANOW AND HERBERT A. EINHORN. New York: Columbia University Press, 1968. Pp. xviii, 692. \$35.00.

Abraham L. Pomerantz †

The proxy fight has many attributes of military warfare. The corporate citadel to be assaulted must first be reconnoitered to ascertain its pregnability. The strength of incumbent management must be determined. How many shares can management mobilize, that is, how many does it own or—that highly fluid conception—control? What is the likely voting attitude of uncommitted shareholders? If the corporation is faring badly, it can be assumed that the insurgent group will do well, for in corporate life, as in politics, when things are going badly, one sometimes votes in favor of the challenger as a way of voting against the incumbent.

If it is determined that existing management is vulnerable, the attacking group girds for battle. It lines up a general staff, usually consisting of a public relations team, a professional proxy soliciting organization, security analysts, and one or more lawyers, at least one of whom must be expert in SEC rules, regulations, and attitudes. The general staff determines the strategy and tactics of the campaign, including especially the content and timing of the propaganda barrage to be laid down against the incumbents. The infantry consists of proxy solicitors who, by phone and by foot, accost the shareholders for their votes.

Then there are the sinews of war. Costs vary from about \$40,000 to \$1,000,000 and more. Proxy contests are not for the poor or the faint of heart. Nor, it may be added, are they for the practitioner who prefers a placid existence. The outcome of many a proxy contest has been determined by the resourcefulness of the lawyers for the contending factions, and by their ability to maneuver within the rules of the game. There are abundant opportunities for the ingenious, and as many pitfalls for the unwary.

Perhaps the most interesting, valuable, and entertaining aspect of the second edition of *Proxy Contests for Corporate Control*¹ is a discussion of the strategy and tactics of the proxy combatants. An extended description of the many devilishly clever schemes dreamed up

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¹ E. ARANOW & H. EINHORN, *PROXY CONTESTS FOR CORPORATE CONTROL* (2d ed. 1968) [hereinafter cited as *PROXY CONTESTS*].

by the proxy specialists would be prohibitively long, but a few items discussed by the authors may be noted to suggest the flavor.

Management may undertake various preventive measures to discourage proxy contests. One of the most effective inhibiting devices is classification of directors. Classification consists of arranging directors' terms of office so that the terms of various groupings expire at different times. For example, if the board has nine members and is divided into three classes, three directors will come up for election in 1969, three in 1970, and three in 1971. The insurgents now have a long hill to climb. To gain the prize of majority control, they must win not just one contest but two, over a period of two years—a very expensive and time-consuming prospect calculated to dampen the ardor of even the most passionate suitors. Another effective device to discourage insurgents is the repeal of cumulative voting provisions directly before the counting of votes when management feels it has won the election and wants to prevent even token dissident representation on the board.

If one of the contesting sides, usually management, does not want the other side even to present its position to the voters, it is sometimes possible to tie up and monopolize the outstanding proxy soliciting concerns, thereby denying the insurgents all practical means of going after the stockholders' votes. This is roughly equivalent to cutting off the oxygen supply lines of a deep sea diver. In the Metro-Goldwyn-Mayer contest, in which I was retained by the insurgents, we were the victims of this tactic when the incumbent management, sensing trouble, tied up all the top soliciting organizations.

As the day of the stockholders' meeting approaches, desperation breeds invention. At some point before the vote is to be counted, the embattled groups generally have a pretty good idea of who's ahead. Often, in a close election, a week's adjournment of the meeting to pursue additional proxies, or to secure revocation of the opponents' proxies, can be decisive. One device used to compel adjournment is to artificially create the absence of a quorum. The simplest method is to stay away from the meeting altogether. But there are many more subtle ways in which the absence of a quorum has been procured to gain time. These methods and the reaction of courts to them are described in a highly readable and instructive part of *Proxy Contests*.²

In any proxy contest, perhaps the most important service a lawyer can render is to get the corporation to pick up the tab of his client's group, be it incumbent or insurgent. It would seem only fair that each side should pay its own expenses. But the courts have unwittingly opened an avenue by which the skillful lawyer can impose his client's expenses on the corporation. Several courts have held that if a proxy contest involves corporate "policy," then the contestants may cause the

² PROXY CONTESTS 317-30.

corporation to pay the bill, but that if the contest involves only "personalities," then each side must stand its own costs.³

The subtle distinction between "policy" and "personality" sounds good in print. But just try to apply it. For example, in *Selama-Dindings Plantations, Ltd. v. Durham*,⁴ it was held that management could spend corporate funds "to investigate the character of minority directors who had been accumulating corporate stock and were preparing a proxy fight for control at the next annual meeting."⁵ The investigation, the lawyer testified, was "in good faith." (How we lawyers love to characterize our motives—never uncharitably.) The court found this a "policy" situation because "the directors of a corporation have a duty to investigate any corporation or person whom they, in good faith, believe to be attempting to gain control of the corporation"⁶

As so often happens when the courts enunciate fluid and amorphous standards, advocacy is given lots of elbow room in the policy-personality dichotomy. The astute lawyer lays a foundation for the corporation's assumption of his client's expenses by making sure that some sort of "policy" issues are referred to in the proxy literature.

In reflecting my own interest in the Machiavellian ploys and devices that are sometimes used in proxy fights, I do not want to give the unfair impression that *Proxy Contests* is just a bag of tricks. Nothing could be further from the truth. The book is in fact a comprehensive and lucid treatment of the technical and practical aspects of proxy fights. The authors are no mere hornbook practitioners, but are themselves scarred veterans of many proxy battles.

Like its predecessor, this second edition is an extraordinarily useful manual for both the proxy lawyer and the lay combatants. It sets forth, *in extenso*, all the important laws and rules relevant to proxy contests. It presents a comprehensive condensation of case law and sets forth quotations from authorities to illuminate the text. The book contains a large variety of forms that are especially useful when time is of the essence—and when is it not in a proxy contest? A well-constructed index makes the book's information easily accessible.

Of special value to the proxy practitioner is a discussion of the sensitive role played by the SEC in these contests. All statements made, mailed, or published by the contestants in the propaganda battle must be "processed" by the SEC. (It is a mortal sin to refer to anything as being approved by the SEC.) *Proxy Contests* offers valuable

³ PROXY CONTESTS 549 and cases cited *id.* n.11.

⁴ 216 F. Supp. 104 (S.D. Ohio 1963), *aff'd per curiam*, 337 F.2d 949 (6th Cir. 1964), cited in PROXY CONTESTS 550 n.17.

⁵ PROXY CONTESTS 550.

⁶ *Selama-Dindings Plantations, Ltd. v. Durham*, 216 F. Supp. 104, 114 (S.D. Ohio 1963), *aff'd per curiam*, 337 F.2d 949 (6th Cir. 1964), quoted in PROXY CONTESTS 551.

suggestions about what will go, and what will not go, through the SEC sieve.

The SEC processor's lot is not a happy one. His is the endlessly dreary and difficult task of trying to draw lines between legitimate enthusiasm and illicit exaggeration. His is the thankless job of tearing the heart out of the deathless prose of the proxy statement by deleting what he conceives to be untrue, unsupported, or unfair statements. ("What is truth?" asked jesting Pilate, but would not wait for an answer.) Then, having wielded his scalpel, the SEC processor must defend his surgery in endless debate against his bleeding victim. To the everlasting credit of the SEC, the greatest of governmental agencies, it is doing its difficult job with extraordinary skill and unquestioned impartiality.

A recently popular form of contest for control, while not technically a proxy contest, is discussed in the chapter on the takeover bid or tender offer.⁷ A tender offer occurs when an aspirant to control extends an invitation to the stockholders of a corporation to tender their shares to him for purchase. This mode of procedure has, as the authors point out, several advantages over the classical proxy contest. There is, at least for the time being, far less regulation by the SEC.⁸ Aside from the cost of buying the shares tendered, the tender offer is considerably less expensive than the proxy struggle. The contestants avoid the acrimony and the tarnished images that often result from hard-fought proxy contests. Finally, the tender offer is over and done with more quickly.

But those representing management have, as might be expected, found counter-moves to defeat the takeover bid or tender offer. In order to avoid the unwanted suitor and perpetuate their own control, management may try to make a match with any eligible partner. Recently there have been several cases where shotgun mergers were hurriedly arranged for no other purpose than to thwart tender offers. The authors discuss this technique and others by which management may attempt to frustrate tender offers. For example, business associates of management can often be persuaded to buy the company's stock in the market, thereby driving the market price up over the tender-offer price and leaving the offer to die on the vine. Corporate funds are employed to persuade shareholders not to succumb to the blandishments of the tender offer. As with the proxy contest, numerous maneuvers are conjured up by the fertile minds on both sides of the takeover bid. The practicality and legality of these maneuvers are discussed by the authors.

The proxy lawyer carries *Proxy Contests* around with him as a tool of his profession. I recently had a conference with three other

⁷ PROXY CONTESTS 585-99.

⁸ But see recently enacted regulatory procedures, Securities Exchange Act of 1934, § 14(d), (e) & (f), 15 U.S.C.A. §§ 78n(d), (e) & (f) (Supp. 1969).

lawyers in a pending proxy contest. As if in a Peter Arno cartoon, each of us was armed with a copy of the book. We found it quite useful for quick group research.

The proxy insurgent has been the object of much abuse at the hands of smugly ensconced management. "Raider" is one of the more printable epithets hurled at him. Name-calling is typical when the corporate mighty are challenged, whether in a proxy fight or in a stockholder suit, where the fashionable insult is "strike suitor." But the truth is that the proxy contest is therapeutic for the body corporate, and in the best tradition of corporate democracy.

ORIGINS OF THE FIFTH AMENDMENT: THE RIGHT AGAINST SELF-INCRIMINATION. BY LEONARD W. LEVY. New York: Oxford University Press, 1968. Pp. xii, 561. \$12.50.

Milton Cantor †

"Legal development," Samuel Eliot Morison has written, "is probably the least known aspect of American colonial history. Judicial opinions were not recorded in the colonies, no year books were issued, and the printed materials for legal and judicial history have been so scanty as to preclude the more cautious historians from dealing with this important side of colonial life; while less cautious historians have indulged in generalization for which slight support can be found in fact."¹ Professor Morison's observations seem especially relevant when one examines the transmission of legal culture and, especially, of various procedural rights.

The application of English common and statutory law to a given colony, the impact of frontier conditions upon such law, and the extent to which the law of a colony was indigenous, are problems so complex, so obscure, so resistant to analysis as to have deterred most investigators. As Leonard Levy makes clear, the difficulties result from a number of factors, including the colony-to-colony variation in legal principles and practices as well as the lack of court and statutory records. Regarding the latter, it might be noted that while published sources germane to the study of colonial law remain scarce, the situation is being rectified. The nine volumes of *American Legal Records*,² extensive microfilming and publication programs, and significant monographs such as George Lee Haskins' *Law and Authority in Early Massachusetts*,³ have begun to open judicial and legislative sources to students of the subject, with a resulting increase in awareness of the opportunities for investigation in this field.

But the specialist is still confronted by the unyielding and almost insurmountable initial problem of diversity in legal principles and institutions. This diversity makes it necessary to engage in a study of individual colonies, which in turn leads to the disheartening conclusion that the colonies were by no means the neat, uncomplicated

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¹ Morison, *Records of the Suffolk County Court, 1671-1681*, unpagged preface to 29 COLONIAL SOCIETY OF MASSACHUSETTS, PUBLICATIONS (S. Morison ed. 1933), quoted in L. LEVY, ORIGINS OF THE FIFTH AMENDMENT 334 (1968) [hereinafter cited as LEVY].

² *E.g.*, COURT RECORDS OF PRINCE GEORGE'S COUNTY, MARYLAND, 1696-99 (J. Smith ed. 1964).

³ G. HASKINS, LAW AND AUTHORITY IN EARLY MASSACHUSETTS (1960).

societies some historians imagine them to have been. The findings of a page-by-page and law-by-law examination of colonial legal doctrine are in fact applicable only to the single colony examined.

The inability to generalize is, to be sure, as understandable as it is discouraging. The colonies, after all, were not only separated from the motherland by 3,000 miles of ocean, but also divided from one another by natural obstacles that made communication hazardous if not impossible. Consequently, localism was the dominant reality. Each colony regarded itself as a disconnected and virtually autonomous unit for the purpose of administration; each developed its own customs, traditions, usages; and, therefore, each must be investigated separately.

In *Origins of the Fifth Amendment*, Professor Levy is sensitive to colonial diversity. He recognizes that colonial legal culture is one of paradoxes, inconsistencies, and divergencies. He is aware of the lacunae in studies dealing with cisatlantic forms of English common law, and has written a superb account which goes a long way toward filling the gaps in our knowledge of the privilege against self-incrimination.

Professor Levy is conscious that the privilege, although essentially modern, was not created *ex nihilo* in the seventeenth century. Its roots lie deep in earlier thought and practices. Consequently, Professor Levy quite properly goes to historical sources, tracing the origin of the privilege back to the twelfth century and Henry II. He renders an account of the evolving privilege from then to Elizabeth's day and the Stuarts, always placing the development within its inextricable historical matrix. In illuminating the dark past of English constitutionalism, Professor Levy shows how such related procedural rights as trial by jury were shaped. In this connection, he explores the manner in which the concept of judgment by peers according to the law of the land took its place among what were later called "the immemorial rights of Englishmen." He explains the increasing substitution of jury verdicts for trial by battle; the importance of the inquest, which eventually led England along a road very different from that taken in Catholic lands, where the practice "left a trail of mangled bodies, shattered minds, and smoking flesh";⁴ and the role of the grand jury, which came to stand as a barrier between suspect and attorney general, and which brought England close to recognizable practices in criminal law by the fifteenth century.

Not unmindful of European developments and their impact across the Channel, Professor Levy discusses Papal policy, and illuminates the distinctions between English and "Romish" practices in a masterfully succinct section. The Fourth Lateran Council, he states, adopted a new code of criminal procedure that included an oath of self-incrimination in addition to procedures precursing the Holy Inquisi-

⁴ LEVY 20.

tion,⁵ while English criminal trials became increasingly fair and humane, especially after the Middle Ages. His conclusion is persuasive: England's legal and judicial practices were in "merciful contrast" to those dominated by the Catholic hierarchy.⁶

England, to be sure, "had by no means embarked on an official policy of toleration."⁷ Professor Levy notes that torture was not uncommon in matters concerning the state's security, even though it had never been recognized as legal by the common law. Furthermore, he wisely distinguishes between torture and the threat of torture. He does observe that torture remained in use in England, though it was employed more prudently than on the Continent, and never publicly. The oath *ex officio*, it might be added, continued to be the prime method of extorting evidence of heresy for four centuries after its introduction in 1236.⁸ Sir Thomas More, who supported the oath as a method of convicting heretics and protecting the Catholic faith,⁹ was put to death when he refused to swear a similar oath recognizing Henry VIII in place of the Pope as head of the Church of England.¹⁰ And the Catholic restoration under Queen Mary was prosecuted by a commission that was given complete procedural discretion except that it was expressly commanded to use the oath *ex officio*.¹¹

Heresy as a capital crime died with Mary, although Professor Levy rightly notes that Tyburn's gallows replaced Smithfield's fires. But the Marian inquisition had "provoked the first widespread attempt by criminal defendants—suspected heretics all—to refuse to answer for fear of self-incrimination."¹²

By the sixteenth century, the privilege against self-incrimination had been identified with a Latin maxim familiar to Canon Law, *nemo tenetur se ipsum prodere*; that is, no one should be required to accuse himself. Thomas More had based his refusal to take the oath of supremacy on this maxim; but it was not given legal force until the case of Thomas Leigh in 1568, when Chief Justice James Dyer invoked

⁵ LEVY 20.

⁶ LEVY 32.

⁷ LEVY 83.

⁸ The oath *ex officio*, also called the oath *de veritate dicenda*, was the inquisitorial oath "to tell the truth to all interrogatories that might be administered The accused, knowing neither the charges against him, nor his accusers, nor the evidence, . . . must take the oath or be condemned as guilty, yet if he took the oath he exposed himself to the nearly certain risk of punishment for perjury—and his lies were evidence of his guilt—or condemned himself by admission which his judge regarded as damaging, perhaps as a confession to the unnamed crime." LEVY 23-24.

⁹ LEVY 65.

¹⁰ LEVY 69. Professor Levy is careful to point out that More's refusal to swear the oath of supremacy was not literally heresy, and was therefore not strictly analogous to a refusal to take the oath *ex officio*. *Id.*

¹¹ LEVY 76-77.

¹² LEVY 77.

the maxim in granting habeas corpus to a Catholic attorney imprisoned for refusing to swear the oath *ex officio*.¹³

There is little point in reviewing the lamentable story of Anglican persecution and Puritan response. Suffice it to say that gradually, through Dyer, Sir Thomas Tresham, and Robert Beale, the privilege was becoming embedded in the English legal consciousness. Gradually, too, a growing number of men linked the right against self-incrimination to Magna Carta. In 1590, John Udall claimed a legal right against self-incrimination "at least in cases where the procedure did not comport with Magna Carta,"¹⁴ which guaranteed judgment by peers or by the law of the land.¹⁵ According to Coke among others, the privilege was at the vital center of Chapter 39, *per legem terrae*. Their arguments, to be sure, were historically unsound, but what is important is that Puritan lawyers generally challenged High Commission procedures as conflicting with the Great Charter, and charged that the oath *ex officio* could not be reconciled with the implications of "fundamental law," *judicium parium vel per legem terrae*. In the course of their arguments they took a feudal document and converted it into a talismanic symbol of freedom—the basis for English constitutionalism. For a half century or more the Charter enjoyed what one recent scholar has called "an Indian summer."¹⁶ During the 1570's and 80's the Puritans carried their cause into the political arena; and, as Professor Levy shows in a series of thoughtful aperçus, they invoked the principles of Magna Carta in their speeches and legislation.

It was Coke, of course, who became the most outspoken stalwart of the rule of law and the great champion of the privilege against self-incrimination. His magnificent stand against royal prerogative, highlighted by the noble maxims from Bracton and the Magna Carta, became an inspiration for the New World as well as the Old. Upholding the right of Burrowes and other Puritan laymen to refuse to take the oath *ex officio*, Coke maintained that the oath need only be taken in matrimonial and testamentary cases, though he never contested a voluntary confession.

One figure alone matches Coke in his defense of the right against self-incrimination: the militant Christian democrat and libertarian, John Lilburne. Professor Levy fully appreciates Lilburne's struggle for freedom of religion, speech, and press, and his contributions to more humane and democratic criminal procedures. "Lilburne . . . made the difference," and from his day the right against self-

¹³ LEVY 94-96.

¹⁴ LEVY 164-65.

¹⁵ Udall was the first defendant to invoke the privilege in a common law trial for a capital crime (seditious libel).

¹⁶ W. Dunham, Jr., *Magna Carta and British Constitutionalism*, in *THE GREAT CHARTER* 32 (1965).

incrimination was an established article of common law.¹⁷ More important, "the claim to a right against self-incrimination raised the generic problem of the nature of sovereignty in England and spurred the transmutation of Magna Carta from a feudal relic of baronial reaction into a modern bulwark of the rule of law and regularized restraints upon government power."¹⁸

Two-thirds of Professor Levy's book is devoted to English history. We are given a careful and lengthy account of the evolution of the right against self-incrimination from the ecclesiastical courts of the Middle Ages, through the Courts of High Commission and the Star Chamber (in which the procedure for binding a person to answer all interrogatories reached its climax), to the celebrated Penn-Mead trial of 1667 and the trial of Francis Jenkes two years later, to the virtual disappearance of the oath *ex officio* and compulsory extraction of evidence. Professor Levy has set down the record in language of exceptional vitality and precision, and with the scrupulous scholarship characteristic of all his work. The *Origins* is critical, penetrating, judicious, and irresistibly intelligent. It recognizes that law is not something separate from human behavior, and it gives us as much of great events and high drama as it does of the privilege itself. For Professor Levy sees the privilege as one factor in a set of fairly explicit legal prescriptions, and he tells us about them against the turbulent backdrop of English affairs. His is surefooted history: concise in argumentation, rich in narrative, clean and adroit in style. No one has ever examined the subject with comparable rigor and depth.

Surely, therefore, it is ungenerous to cavil. But I wish Professor Levy had amplified one aspect of the institutional scene which he neglects, namely, the judicial power struggle between the conciliar court system and the regular courts for the administration and execution of royal policy (from Richard III to Henry VIII).

The conciliar court system utilized "suggestions" or "information" in treason and felony cases. Common-law lawyers objected to the examination procedure employed in Council and Chancery, especially to the oath *ex officio* which, Professor Levy rightly tells us, derived from canonical procedures and operated to compel suspected non-conformists to answer truthfully all questions put to them before they were informed of the charges against them. "[T]here can equally be no doubt," declares E. M. Morgan (in a study unaccountably omitted from Professor Levy's otherwise exhaustive bibliography), "that to the common lawyers a system which required a person to furnish his own indictment from his own lips under oath was repugnant to the law of the land."¹⁹ Professor Levy discusses the manner in which

¹⁷ LEVY 313.

¹⁸ LEVY 331.

¹⁹ Morgan, *The Privilege Against Self-Incrimination*, 34 MINN. L. REV. 1, 9 (1949).

High Commission shifted from its original policy as an administrative appendage of the Privy Council and took on a distinctly new complexion as one of the "Romish" conciliar courts. But he fails to emphasize the effective concern of common-law lawyers—how they vigilantly watched the Commission and how Puritan and lawyer made common bond, with the former fighting Commission attempts to enforce religious conformity and the latter seeking to restrict the Commission's burgeoning jurisdiction and procedures, which were clearly contrary to accepted due process.²⁰

A related set of institutional tensions that might profitably have been explored involves the political implications of the privilege against self-incrimination. It would have been a relatively simple chore to set out these implications, since the *Origins* does present the historical narrative: the rise of large towns and major trading centers, the impact of the new society upon the development of the jury, and the changes occurring in the administration of justice. Judicial controls were slowly being centralized, with the royal courts—in both civil and criminal cases—beginning to dominate a multitude of special jurisdictions by the late fourteenth century. A power struggle of monumental proportions occurred, according to Holdsworth, owing to the lack of distinct jurisdictional lines, a heritage of the medieval court structure. Court rivalry existed between Chancery and Admiralty on the one hand and the common-law courts on the other. Indeed, after the late fifteenth century, King's Bench and Common Pleas conducted a series of jurisdictional privateering expeditions against any tribunal that took business from them. Professor Levy neglects this competition as well as the struggle between common-law and ecclesiastical tribunals that gave the Puritans hope that the former courts would join their cause.

There is, as might be expected, an admirably complete discussion of how the Puritans, failing to obtain a common-law court alignment, concentrated instead on the Charter and its symbolism in the belief that it would ultimately bring Parliament to their side. Out of the procedural mandates outlined in the fourteenth-century version of Magna Carta came a more substantive understanding of the common law and of the constitutional heritage of Englishmen. Professor Levy does not fail us here, though he does not fully describe the efforts of the common-law courts to curb the prerogative courts of Chancery, Admiralty, High Commission and Requestes, or the common-law courts' attempts to confine ecclesiastical and local jurisdictions. The common-law courts, for example, were forever seeking to destroy,

²⁰ According to Holdsworth and Glanville, the common-law courts sought to keep ecclesiastical courts within jurisdictional bounds through the ancient writ of prohibition. As Professor Levy points out, the writ stopped all proceedings in the recipient court pending a common-law court's decision whether the cause was lay or ecclesiastical. LEVY 217.

erode, or restrict High Commission authority, and surely this is one compelling reason for common-law objections on procedural grounds to the oath *ex officio*, which dispensed with the regular indictment and trial so integral to the common law.

The Puritans, being most immediately affected by High Commission activities, understandably were most interested in finding and enlarging upon common-law practices that would restrain these activities. Much the same thinking, I suspect, was influential in common-law lawyers' objections to the ecclesiastical courts, where basic differences (not only jurisdictional rivalry) existed about what constituted proper trial procedures, and to various regional administrative wings of the Privy Council, such as the Councils of Wales and York.

After exploring the English background of the privilege against self-incrimination, Professor Levy turns to American developments, examining them with comparable rigor and penetration. Indeed, it is Professor Levy's presentation of the American *mise en scène*, which has not benefited from the luminous studies of Maitland and Holdsworth, that most deserves the overworked encomium, "a major contribution."

For some years now, there has been a major controversy among American colonial legal historians over the extent to which English common law was adopted in the colonies. Among those who profess to find little adoption are George Wythe, in his monumental 1803 edition of Blackstone's *Commentaries* and, more recently, Paul Reinsch, Roscoe Pound, and William T. Davis. On the other hand, Theodore Plucknett, Julius Goebel, Herbert Pope and John T. Farrell find that the English common law was adopted to a considerable degree. One thing is clear: no all-inclusive generalization can be made, and all claims and counterclaims must be scrutinized in the light of specific legal realities in each colony. For instance, Professor Haskins' study shows that Massachusetts dower law was based upon English rules, common-law rules, but interpreted by Bay Colony courts in a manner at variance with those rules.²¹ Hence the conclusion that the common law was less significant than local customs in seventeenth-century Massachusetts. In Virginia, the courts were bound in their decisions by the common law of England, the Parliamentary statutes passed prior to 1607, and the statutes enacted by the Virginia Assembly,²² but they relied to a great extent upon their own judgments for guidance in arriving at decisions. In New York, English common law predominated, fighting down the challenge of Dutch and Puritan forms, although the Mayor's Court, which operated under Dutch rules, sur-

²¹ Haskins, *Reception of the Common Law in Seventeenth-Century Massachusetts: A Case Study*, 97 U. PA. L. REV. 842-53 (1949).

²² Ordinances of May, 1776, ch. 5, § 6, in 9 W. HENING, *THE STATUTES AT LARGE, BEING A COLLECTION OF ALL THE LAWS OF VIRGINIA, 1619-1792*, at 127 (1821).

vived in New York City. Maryland's early legal history, like that of New York, was a legal patchwork. Relying in part upon Chancellor Kilty's extensive survey of English legal usage, Joseph Smith has concluded that many Parliamentary acts were accepted as part of Maryland's law.²³ But English common law and customs were also influential, particularly in criminal cases and in administering manorial justice.

The right against self-incrimination, Professor Levy declares, evolved in America as part of the reception of the common law and particularly of its accusatorial system. This is not to affirm that unlike the common law, the right was easily or uniformly adopted; quite the contrary, as Professor Levy concludes, "Its reception cannot be taken for granted in any colony" and inconsistencies are the rule.²⁴ Moreover, the evidence is so sparse that valid generalization is impossible. Like George Haskins, Professor Levy concludes that a limited privilege against self-incrimination existed in Massachusetts, embodied in the legal codes of 1641 and 1648. Both scholars note the prohibition against torture to extract confessions, and Professor Levy reiterates his finding that the abolition of torture is closely linked to the establishment of the right. Both Professor Haskins and Professor Levy also emphasize the importance of John Wheelright's trial and the violent reaction to the General Court's attempt to bind him by the oath *ex officio*.

In a survey of seventeenth-century usage Professor Levy concludes that the right was also recognized in other colonies, but the evidence is admittedly rather scarce. Virginia, for example, was one of several colonies in which the origin of the right was shrouded in mystery—with a reference cropping up only once, in the decade after Bacon's Rebellion. Pennsylvania's record is clearer. William Penn, the author of *The People's Ancient and Just Liberties Asserted* was, after all, co-defendant with William Mead in Old Bailey in 1670, and tract and trial suggest that he highly valued the right against self-incrimination. Professor Levy, confirming Erwin Griswold's account of William Bradford's trial in Pennsylvania, describes how Bradford sought to know his accusers and refused to incriminate himself. Sir Thomas Lawrence, a judge and secretary of Maryland, claimed the right in his trial for "high Crimes and Misdemeanours."²⁵ Even earlier, in a case that prefigured Sir Thomas' (and that Professor Levy fails to mention), there is a record of conviction of a Negro and an Indian who stood mute.

Professor Levy concludes that legal minds in colonial New York were well aware of the *nemo tenetur maxim*. Taking exception to the

²³ J. H. Smith, *The Foundations of Law in Maryland: 1634-1715*, in *LAW AND AUTHORITY IN COLONIAL AMERICA* 99 (G. A. Billias ed. 1965).

²⁴ LEVY 333.

²⁵ LEVY 364.

finding of Goebel and Naughton, he categorically rejects their claim "that the existence before the Revolution of a privilege of defendants is an illusion."²⁶ Self-incrimination, Professor Levy insists, was no exotic fruit of Westminster Hall. After a close analysis of provincial law books used by New York attorneys and of the cases of Alexander McDougall, Henry Townsend, and Sam Spicer, he makes a devastating *prima facie* case for the existence of the privilege.

Other scholars have worked in the field of seventeenth-century American legal history, exploring the adoption of Magna Carta in colonial charters and the various cases in which judicial or legislative bodies attempted to impose self-incrimination, but few have commented upon the eighteenth century. Professor Levy fills the gap. He brings to light the 1707 trial of Francis Makemie, in which the New York governor attempted to induce Makemie's friends to incriminate each other (though not themselves); the New York statute that compelled suspected fur traders to take an oath of purgation, which was a sworn statement of innocence; the refusal of Samuel Hemphill, a Presbyterian minister, to deliver deistic sermons to the Philadelphia synod, on the grounds that he had a right not to accuse himself; the drumhead trial of two Pennsylvania Anglicans, notable for the tender regard shown for the privilege against self-incrimination by the provincial Assembly, even though it grossly abridged most procedural rights; and the opposition to the writs of assistance, which gave the privilege a new respectability.²⁷ Increasingly, the right against self-incrimination came to be recognized, and Professor Levy argues that it was firmly fixed in the law books and legal procedures of most colonies even before the Revolution. The record remains incomplete, but there is now sufficient evidence to establish the claim that the right was well known to the average colonist by the early 1770's. Indeed, colonies and motherland differed little if at all on the right by 1776.

Professor Levy concludes his engrossing study with an exegetical analysis of the state constitutions. Nearly all, he finds, followed the memorable language of Virginia's Declaration of Rights. With typical healthy irreverence he declares: "The history of the writing of the first American bills of rights and constitutions simply does not bear out the presupposition that the process was a diligent or systematic one. Those documents, which we uncritically exalt, were imitative, deficient, and irrationally selective."²⁸ Carrying the story into the

²⁶ J. GOEBEL, JR. & T. NAUGHTON, *LAW ENFORCEMENT IN COLONIAL NEW YORK: A STUDY IN CRIMINAL PROCEDURE (1664-1776)*, at 656 (1944), quoted in LEVY 335.

²⁷ In this connection, Professor Levy lays to rest the claim that John Hancock was "compelled to give evidence against himself," O. DICKERSON, *THE NAVIGATION ACTS AND THE AMERICAN REVOLUTION* 244 (1951), quoted in LEVY 398, and points out that Hancock's counsel, John Adams, "referred neither to the right against self-incrimination nor to the illegality of writs of assistance" in his argument. LEVY 398.

1780's, he tells us how the founders, Mason and Madison in particular, shaped the right against self-incrimination and gave it status as an independent libertarian statement in the fifth amendment.

Thus Professor Levy concludes his superlative book. If I have felt compelled to take issue with a few points that he raises, I do not wish to leave a negative impression. The study has abundant merits. It is both definitive and a signpost, pointing the way for important work in other areas of colonial law. One may cavil at times, and another historian might have done sections differently, but I doubt if there is one living who would have done it half as well.

²⁸ LEVY 411.

UNITED STATES TAXATION OF FOREIGN INCOME AND FOREIGN PERSONS. SECOND EDITION. BY BORIS I. BITTKER AND LAWRENCE F. EBB, WITH COLLABORATION OF KENNETH M. DAVIDSON. Federal Tax Press, 1968. Pp. ix, 579; tables and index. \$12.50.

Roland L. Hjorth †

This book is the second version of a "preliminary edition" published by the same authors in 1960. The original bore the title *Taxation of Foreign Income—Cases and Materials*. It included foreign decisions, mostly from the United Kingdom and India, as well as materials on United States law. Although the preliminary edition emphasized taxation of income, it also gave attention to "sales, property, inheritance and other taxes impinging on international (or 'transnational') transactions."¹ Transnational income taxation has in intervening years become a matter of such scope and complexity that attention to taxes other than income taxes within the scope of one casebook has become increasingly unrealistic. Further, unless foreign tax law materials are arranged in such a way that the student can see the interrelationship between a foreign taxing system and our own, the inclusion of foreign materials in a casebook on transnational taxation, while it may give the student a comparative perspective, will do so at the expense of a thorough mastery of United States law.²

The present edition of the book largely discards foreign tax materials and materials dealing with taxes other than income taxes. The second edition is limited to the subject of its title: United States taxation of foreign income and foreign persons. Stated somewhat differently, the book is concerned with the basic problems involved in taxing income derived from sources outside the country of which the taxpayer is a resident or citizen. From the State's point of view, "foreign income" can be placed in two categories: (1) income of the

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¹ B. BITTKER & L. EBB, *TAXATION OF FOREIGN INCOME* iii (prelim. ed. 1960).

² In no area is the interrelationship of foreign and domestic law so important as in transnational taxation. For example, the maximum amount of foreign tax that may be credited against United States tax under INT. REV. CODE OF 1954, § 901 [hereinafter cited as CODE] is that proportion of foreign taxes which foreign source income bears to worldwide income. See CODE § 904(a). Thus, if India treats a portion of the profits from the purchase of goods in India and the sale of those goods in the United States as income partly from Indian sources, but the profits are treated under United States law as exclusively from United States sources, a United States taxpayer might find that none of the Indian tax may be credited. See *J. Webb Sons & Co. v. Commissioner*, 38 All India Rptr. 347 (1951) (Punjab). But the United States tax advisor will probably rely principally on foreign counsel for advice on foreign law. His concern becomes immediate only when foreign law affects the results under United States law, as it can under the foreign tax credit.

State's nationals (citizens, residents, or domestic corporations) from sources outside the State; and (2) income of nonnationals (nonresident aliens or foreign corporations) from sources within the State. A nation has the power to tax the foreign income of its nationals. It also has the power to tax the local income of nonnationals. But if all nations exercised their taxing powers to the fullest extent, all "foreign" income of a taxpayer would be taxed twice. The study of transnational taxation, then, is a study of the ways in which nations separately (*e.g.*, by a unilateral foreign tax credit) or jointly (*e.g.*, by bilateral tax treaties) accommodate their legal systems to avoid double taxation, without surrendering completely their powers to tax income that is "foreign" as far as the taxpayer is concerned.

The United States has dealt with the basic problems of transnational taxation by adopting a complicated and detailed series of statutes and supplementary bilateral tax conventions with other nations. The Internal Revenue Code creates two distinct categories of taxpayers, with separate rules for each. The first category includes United States nationals (citizens, residents, and domestic corporations). As to these taxpayers, the taxing power of the United States is complete:³ all income, whether from domestic or foreign sources, is included in the tax base.⁴ The United States protects its nationals from double taxation by granting a foreign tax credit,⁵ and protects itself against the depletion of revenues that might result from the credit by entering into bilateral tax conventions limiting the foreign taxation of United States nationals.⁶ As to nonnationals, the United States generally limits the imposition of its taxes to certain items of income from United States sources, and even as to these items often imposes a special tax rate which may be lower or higher than the rates imposed on the income of nationals.⁷ The limitations are con-

³ *Cook v. Tait*, 265 U.S. 47 (1924).

⁴ The Code does not expressly so provide. However since § 61 imposes a tax on all income "from whatever source derived," it purports to tax the worldwide income of all taxpayers. Taxpayers claiming complete or partial exemption must bring themselves under more specialized provisions, such as CODE §§ 871 ("Nonresident Alien Individuals") and 881 ("Foreign Corporations Not Engaged in Business in United States").

⁵ CODE §§ 901-06.

⁶ See, *e.g.*, Convention with Japan for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion With Respect to Taxes on Income, CCH Tax Treaties ¶¶ 4403-23 [hereinafter cited as Japanese-American Income Tax Treaty]. Tax treaties preserve United States revenues in the following manner. If the taxpayer's United States effective tax rate is 40% and the normal foreign tax rate on his foreign source income is also 40%, the United States collects no revenue in respect to the foreign income because of the foreign tax credit. But if by treaty the foreign tax on such a United States taxpayer's foreign income is reduced to 10%, *see, e.g.*, Japanese-American Income Tax Treaty arts. VI, VIA & VII, the United States might be able to collect as much as 75% of the revenue from the foreign income, notwithstanding the tax credit.

⁷ Income taxation of nonnationals was the main concern of the Foreign Investors Tax Act of 1966. See CODE §§ 861-96.

tained in both the Internal Revenue Code and the bilateral tax conventions.

Recent years have seen the emergence of a third category of taxpayer under United States law: the foreign corporation controlled by United States taxpayers. Traditionally, all foreign corporations, whether domestically controlled or not, have been treated as non-nationals. But in some cases foreign incorporation is an artifice. To enable United States taxpayers to avoid or postpone United States taxation of foreign income by the simple expedient of foreign incorporation could nullify the basic rule that nationals are to be taxed currently on all foreign income, subject to the foreign tax credit. The taxation of controlled foreign corporations is understandably a difficult problem. To date, the United States has confined itself to taxing shareholders of controlled foreign corporations as if they were partners owning direct interests in the foreign enterprise.⁸ Even this procedure is limited to cases where foreign incorporation is utilized chiefly as a means of tax avoidance. But it can be assumed that taxation by the United States of the income of controlled foreign corporations is in a state of flux.

These basic problems of transnational taxation are not as clearly set forth in the book as I had hoped they would be. Without an introductory statement of basic problems, organization of the materials in an orderly, step-by-step manner that enables the student to appreciate the interrelationship of the basic concepts involved is an almost impossible task.⁹ The first chapter of the book does contain: (1) a 1923 League of Nations Report on Double Taxation,¹⁰ (2) excerpts from articles dealing with policy in taxing foreign income,¹¹ and (3) a five page "Bird's Eye View" of the present United States statutory and treaty framework dealing with income that is "foreign" as far as the taxpayer is concerned.¹² The statutory summary is concise, but I do not believe it introduces students to the subject in a meaningful way. In this case, a "Bird's Eye View" is not enough.

The remainder of the first chapter is concerned with "Jurisdictional Foundations for Taxing Income." Chapter II deals with "The 'Source' of Income." After this conceptual treatment, chapter III moves to a functional approach in discussing "Competing Methods of Engaging in Foreign Business and Investment." Chapters IV, V,

⁸ This is the approach adopted in CODE §§ 551-58 (foreign personal holding companies) and §§ 951-64 (controlled foreign corporations).

⁹ A superb statement of the basic problems of transnational taxation, though somewhat out of date in some details, may be found in chapter nine of E. OWENS, *THE FOREIGN TAX CREDIT* 518-92 (1961) ("Formulation of Income Tax Law With Respect to Foreign Source Income").

¹⁰ B. BITTKER & L. EBB, *UNITED STATES TAXATION OF FOREIGN INCOME AND FOREIGN PERSONS* 1-14 (2d ed. 1968) [hereinafter cited as BITTKER & EBB].

¹¹ BITTKER & EBB 15-25.

¹² *Id.* 26-30.

and VI are concerned with "Income Tax Treaties," "Foreign Currency Problems," and "Enforcement Problems," respectively.

I. THE JURISDICTIONAL BASES

"Jurisdictional foundations for taxing income" depend on whether the taxpayer is a national or a nonnational. As *Cook v. Tait*¹³ illustrates, the United States can tax its nationals on all income from whatever source derived. Whether or not a taxpayer is a national can be a troublesome issue,¹⁴ but most problems of jurisdiction relate to the taxation of nonnationals, and the jurisdictional bases for taxing nonnationals cannot be considered apart from sections 861 to 896 of the Internal Revenue Code. It is these sections of the statute, and not the cases selected by the editors, that determine how much of the income of nonnationals will be taxed by the United States, and at what rates. The cases included in the text are relevant to these sections, but the relevance is often difficult to see, particularly since many of the cases were decided under statutes no longer in force.

It would help the student to know, for example, that under section 871 the taxation of a nonresident alien individual depends upon whether the individual is engaged in a trade or business within the United States. If he is not, the United States taxes only certain types of his income from United States sources (mainly "fixed or determinable annual or periodical [sic] gains, profits and income"),¹⁵ at a flat rate of 30 per cent of the gross amount or at a lower rate (5, 10 or 15 per cent) that may prevail under an applicable bilateral tax convention.¹⁶ If the taxpayer is engaged in a United States trade or business, all income from United States sources is taxed at graduated rates based on net income, except that "fixed or determinable annual or periodical income" from United States sources may still be taxed at a flat 30 per cent or lower treaty rate as long as such income is not "effectively connected" with the operation of the United States trade or business.¹⁷ No income from sources outside the United States is taxed unless the nonresident alien has an "office or other fixed place of business" within the United States,¹⁸ in which case only certain

¹³ 265 U.S. 47 (1924) [BITTKER & EBB 31].

¹⁴ The problems arise in determining whether an alien is a resident. See *Commissioner v. Nubar*, 185 F.2d 584 (4th Cir. 1950), *cert. denied*, 341 U.S. 925 (1951) [BITTKER & EBB 34].

¹⁵ CODE § 871(a) (1) (A).

¹⁶ See note 6 *supra*. Under some treaties, this type of income may be tax exempt. See, e.g., Convention With the Federal Republic of Germany for the Avoidance of Double Taxation With Respect to Taxes on Income, arts. VII-VIII, CCH Tax Treaties ¶¶ 3003-24 [hereinafter cited as German-American Tax Treaty].

¹⁷ CODE § 864(c) (1).

¹⁸ CODE § 864(c) (4).

items of foreign income connected with that business will be subjected to United States tax.

Sections 871 and 881 (tax on foreign corporations) are the bases for the United States taxation of nonnationals. They raise many questions. What is meant by such terms as "trade or business within the United States," "office or fixed place of business," income "from sources within the United States," and "fixed or determinable annual or periodical income"? The first and second chapters of the casebook include cases interpreting each of these terms, but the cases all deal with prior statutes fundamentally different from the statute now in force. The material could have been presented more clearly through an analytical discussion of the basic statutory framework relating to taxation of nonnationals and a selection of cases more closely correlated with existing statutes.

II. SOURCE OF INCOME

Cases dealing with the source-of-income concept are included within a separate chapter, presumably because the concept serves "an exclusively definitional function."¹⁹ Source of income is relevant to all areas of transnational taxation, including one area not mentioned by the editors, namely, determining the maximum limitations on the foreign tax credit.²⁰ The book's treatment of source is thorough. In dealing with income from sales, chapter II begins with a 1920 Opinion of the Attorney General,²¹ ruling that income from goods manufactured or purchased in the United States and sold abroad is income from sources outside the United States.²² Following the opinion is a series of cases illustrating that the place of sale is the place where title to the goods passes.²³ The selection of cases dealing with "compensation for labor" starts from the assumption that the proper source is the place where the services are rendered and discusses the question whether an item is compensation for labor or something else, for example, whether royalties from the sale of artistic property are compensation or proceeds from a sale;²⁴ whether proceeds from a covenant not to compete are

¹⁹ BITTKER & EBB 113.

²⁰ The credit may not exceed that proportion of a United States national's total United States tax which income from sources outside the United States bears to worldwide income. CODE § 904(a)(2).

²¹ BITTKER & EBB 114.

²² The statute now provides that income from goods purchased in the United States and sold abroad is income from sources outside the United States. CODE § 862(a)(6). Income from goods manufactured within (or without) the United States and sold without (or within) the United States is treated as income from sources partly within and partly without the United States. CODE § 863(b)(2). An allocation formula provided in Treas. Reg. § 1.863-3(b)(2) (1957) is reproduced in BITTKER & EBB 143-45.

²³ BITTKER & EBB 117-38.

²⁴ *Ingram v. Bowers*, 47 F.2d 925 (S.D.N.Y. 1931), [BITTKER & EBB 155], *aff'd*, 57 F.2d 65 (2d Cir. 1932) [BITTKER & EBB 158].

compensation for labor rendered in the country where the covenantor has agreed not to compete;²⁵ and whether the premium given to a foreign sister corporation by a United States corporation for the privilege of serving the foreign corporation's foreign customers is compensation to the foreign corporation for services rendered in the United States.²⁶ In discussing the source of rents and royalties, the book uses cases involving copyrights and "know-how."²⁷ The chapter concludes with a treatment of the source of "Dividends and Interest," "Other Income," and a brief but good discussion of the "Source of Deductions and Losses."

The weakness of chapter II is that the "definitional function" served by the source rules is not clearly illustrated. Nor is this "definitional function" clearly illustrated in other chapters of the book. Source rules have prime importance in determining what income of non-nationals the United States will tax. As noted above, source considerations are also important in determining the maximum annual foreign tax credit of a United States national. One who teaches a course from this casebook must take care to illustrate the relation of source rules to such matters as the taxation of nonnationals and the foreign tax credit. The cases themselves do not do this, largely because so many of them were decided under statutes that have either been repealed or greatly modified. If no cases are available, perhaps the editors could have drafted problems illustrating the application of source rules to problems involving the Foreign Investors Tax Act of 1966, the foreign tax credit, and Western Hemisphere Trade Corporations.

III. FOREIGN BUSINESS AND INVESTMENT METHODS

After discussing jurisdictional bases and source rules, the book moves to a consideration of "Competing Methods of Engaging in Foreign Business and Investment."²⁸ This is the longest chapter in the book and considers, in somewhat haphazard order, "personal residence abroad," the foreign tax credit, licensing agreements, Western Hemisphere Trade Corporations, controlled foreign corporations, and something called "Straws in the Wind." I say the organization is haphazard because: (1) "personal residence abroad" seems to me to relate as much to jurisdictional bases as to "competing methods of

²⁵ *Korfund Co. v. Commissioner*, 1 T.C. 1180 (1943) [BITTKER & EBB 161].

²⁶ *British Timken Ltd. v. Commissioner*, 12 T.C. 880 (1949) [BITTKER & EBB 165].

²⁷ *Wodehouse v. Commissioner*, 178 F.2d 987 (4th Cir. 1949) [BITTKER & EBB 172] (copyrights); Rev. Rul. 55-17, 1955-1 CUM. BULL. 388 [BITTKER & EBB 177] (know-how).

²⁸ BITTKER & EBB 193-380.

engaging in business,"²⁹ (2) the foreign tax credit is discussed separately in two different places—first as it applies to foreign branches and then, after an intervening forty-three pages dealing with non-credit problems of foreign branches, as it applies to foreign subsidiaries; and (3) controlled foreign corporations are considered first in a general way, and then are considered specifically under various statutes, after a discussion of the indirect tax credit of section 902.

I would have found chapter III more satisfactory if the editors had first dealt with all aspects of the foreign tax credit, then discussed controlled foreign corporations under one main heading, and finally considered other problems arising in doing business abroad, for example, license agreements and Western Hemisphere Trading Corporations.

Foreign Tax Credit

Discussing the foreign tax credit only in the context of United States corporations that conduct foreign business through branches or subsidiaries does not reveal the true significance of the credit. As far as United States nationals are concerned, the foreign tax credit is the most important aspect of transnational taxation. If one had to explain the dominant feature of United States taxation of the foreign income of its nationals, one would say that all income, whether from domestic or foreign sources, is included in the tax base, but a credit against United States income taxes is allowed for foreign income taxes paid or accrued, in an amount not exceeding that proportion of United States income tax which foreign income bears to world-wide income. The significance of the credit is not limited to corporations having foreign branches or subsidiaries. It applies also to persons who work abroad, who own foreign stocks or bonds, or who license intellectual property to foreign licensees. Moreover, the foreign tax credit has a direct bearing on other provisions of Subchapter N and on bilateral tax treaties. For example, the foreign tax credit could make a provision of a bilateral tax treaty exempting certain foreign income of a United States national (or a provision providing lower rates of tax on foreign income) irrelevant to the taxpayer in some cases.³⁰ The

²⁹ The exemption from United States tax of certain earned income from sources outside the United States, as provided in Code § 911, is a statutory exception to the basic rule expressed in *Cook v. Tait*, 265 U.S. 47 (1924), that all income of United States nationals, from whatever source, is subject to United States tax. If the editors had chosen to include jurisdictional rules relating to United States nationals as an introduction to the foreign tax credit, a discussion of § 911 at this point in the book might have been appropriate.

³⁰ For example, a taxpayer whose effective United States tax rate is 40% and who has an item of foreign income subject to a foreign tax of 40% may not be burdened by the foreign tax if it may all be credited. Thus, a treaty reducing the foreign tax rate on his foreign income to 10% or 20% is of little interest to him. On the other hand, if the income subject to foreign tax is not considered to be from foreign sources under United States source-of-income rules, the treaty will have great significance. The same would be true if the taxpayer had other income subject to a foreign tax of

organization of the material tends to conceal the pervasive significance of the foreign tax credit.

I also differ with the editors' choice of emphasis. While almost forty pages are devoted to the question what is a creditable tax,³¹ only five pages are devoted to the limitations of section 904.³² Perhaps only a lack of sophistication prevents me from seeing the logic of this emphasis. The editors could say, for example, that as a result of (1) reduced taxes on certain foreign income covered by treaties, (2) the credit carryover provisions of section 904(d), and (3) the alternative "per-country" and "overall" limitations of section 904(a), there are, for all practical purposes, no limitations on the credit as far as corporate taxpayers with far-flung international operations are concerned. Such taxpayers can arrange to have enough low-taxed foreign income (royalties, interest, etc.) to combine with high-taxed foreign income and make all foreign taxes creditable. For these taxpayers, the truly significant question may be whether the foreign tax is an income tax that they have paid. But if this is the reasoning underlying the editors' selection of material, I would have liked to see some evidence of it.

Controlled Foreign Corporations

With the exception of a discussion of the indirect credit of section 902³³ and a brief consideration of the accumulated earnings tax as applied to foreign corporations,³⁴ all material under the heading "The Foreign Corporation" deals with foreign corporations that are controlled in fact. This portion of chapter III commences with a fable ridiculing present tax treatment of controlled foreign corporations and suggesting that the separate existence of foreign corporations owned and managed in the United States should be ignored.³⁵ The fable is followed by cases dealing with international corporate reorganizations,³⁶ an unsuccessful attempt at profit reallocation under section 269,³⁷ and a successful attempt at profit reallocation under section 482.³⁸ Next

60%. A treaty reducing the tax rate on some of the income to 20% might enable the taxpayer to credit all foreign taxes paid by utilizing the "overall" limitation of CODE § 904(a) (2).

³¹ BITTKER & EBB 210-49. An additional 20 pages deal with taxes "in lieu of" income, "etc." taxes, and "who paid" the foreign tax. *Id.* at 249-69.

³² *Id.* at 269-74.

³³ *Id.* at 319-27.

³⁴ *Id.* at 327-28.

³⁵ Roberts, *From the Thoughtful Tax Man*, 40 *Taxes* 355 (1962), cited as *The Talisman* in BITTKER & EBB 279-81.

³⁶ *Hay v. Commissioner*, 145 F.2d 1001 (4th Cir.), *cert. denied*, 324 U.S. 863 (1944) [BITTKER & EBB 281].

³⁷ *Siegel v. Commissioner*, 45 T.C. 566 (1966) [BITTKER & EBB 292].

³⁸ *Asiatic Petroleum Co. v. Commissioner*, 79 F.2d 234 (2d Cir.), *cert. denied*, 296 U.S. 645 (1935) [BITTKER & EBB 298]. This case arose under the predecessor of CODE § 482, § 45 of the Revenue Act of 1928, 45 Stat. 806.

come a case illustrating a typical tax haven operation,³⁹ an obscure case that presumably illustrates the operation of the foreign personal holding company tax,⁴⁰ and, finally, a ten-page discussion of Subpart F.⁴¹

Again, I have difficulty understanding the editors' emphasis. For example, seven pages are devoted to an obscure point under the foreign personal holding company provisions, while only ten pages are devoted to all of Subpart F and related provisions. More important, I am not sure the chapter deals with the problem of controlled foreign corporations in a cohesive manner. The syllogism is easily stated: United States nationals are taxed on income from sources without the United States but foreign nationals are not; corporations incorporated abroad (foreign corporations) are foreign nationals; therefore, foreign corporations are not taxed on income from sources outside the United States. Although the syllogism expresses existing law,⁴² its minor premise can be unrealistic in certain cases. To permit United States nationals who own foreign businesses to avoid or at least postpone United States tax on the profits of those businesses by the simple expedient of incorporating abroad puts a premium on form at the expense of revenue. Yet to attempt to tax the foreign corporation directly would in some cases be impossible⁴³ and would be unfair if a minority of the foreign corporation's shareholders were themselves foreign nationals.

There are only two ways to deal with controlled foreign corporations: (1) examine scrupulously the dealings of the foreign corporation with its United States parent to ensure that disproportionate profits are not attributed to the foreign corporation, and (2) tax the United States shareholders directly on their shares of the foreign corporation's profits. The Internal Revenue Service does examine intercorporate dealings where foreign corporations are involved and applies section 482 to reallocate profits in cases of abuse. But it has been reluctant to tax United States shareholders on their respective shares of foreign corporate profits. Application of such a tax across

³⁹ *Johnson Bronze Co. v. Commissioner*, 34 P-H Tax Ct. Mem. ¶65,281 (1965) [BITTKER & EBB 301].

⁴⁰ *Alvord v. Commissioner*, 277 F.2d 713 (4th Cir. 1960) [BITTKER & EBB 329]. After 4 pages of extremely complicated facts we learn that a shareholder of a foreign personal holding company will not be taxed on current profits when the Internal Revenue Service blocks the payment of dividends.

⁴¹ BITTKER & EBB 338-48. The description is a brilliant and concise summary taken from B. BITTKER & J. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* 258-71 (2d ed. 1966). Those who already have an appreciation of tax-haven corporations and Subpart F may understand it.

⁴² With the modification that foreign source income that is "effectively connected" with the conduct of a United States trade or business may be included in the United States tax base if the nonnational has a permanent establishment in the United States. CODE § 864(c)(4)(B) & (C).

⁴³ As, for example, where the foreign corporation has no assets within the United States. Foreign courts will not enforce tax claims of the United States even if those claims are reduced to a judgment. *United States v. Harden*, 41 D.L.R.2d 721 (Sup. Ct. Can. 1963).

the board would deny the tax benefits of incorporation to United States shareholders, for they would be taxed as partners of any business incorporated abroad. Applying such a tax even in limited circumstances creates a host of technical difficulties, and the United States has by no means applied it extensively. United States shareholders have been taxed on foreign corporate profits only where it has appeared that the prime purpose of foreign incorporation has been tax avoidance. But, as noted above, the law in this area is probably in a state of flux. The Code does not reflect a clear and consistent approach to the problem of controlled foreign corporations, and one can say that the book under review reflects existing law once one concedes that the present approach of the Code to controlled foreign corporations is scattershot and confused.⁴⁴

IV. TAX TREATIES

Chapter IV deals with bilateral income tax conventions between the United States and other countries. It includes the text of the Income Tax Treaty Between Germany and the United States, cases interpreting various clauses contained in tax treaties, and the text of the OECD Draft Taxation Convention. As an exposition in isolation of income tax treaties and their provisions, the chapter is excellent. It does not, however, reflect the close interrelationship between income tax treaties and Internal Revenue Code provisions. Some of these interrelationships have already been mentioned.⁴⁵

For example, treaties obviously modify those Code provisions taxing the United States income of foreign nationals. The Code may impose a tax of 30 per cent on United States royalty income paid to nonnationals, but a treaty may reduce that tax to 10 per cent,⁴⁶ or

⁴⁴ Other aspects of this chapter deal with Western Hemisphere Trade Corporations, BITTKER & EBB 348-73, licensing arrangements, *id.* 276-78, and "Straws in the Wind," *id.* 375-80. "Straws in the Wind" concerns the "Boggs Bill," which is probably a dead letter.

⁴⁵ See note 30 *supra* and accompanying text. The interrelationship of treaties and the foreign tax credit may be illustrated by the following example. Taxpayer is a United States national who has a permanent establishment in Germany. In 1966, taxpayer's effective United States tax rate was 30%. The German source profits of taxpayer amounted to \$10,000 and were subjected to German income taxes of \$5,000. Taxpayer had no other income from sources outside the United States. Only \$3,000 of the German tax could be credited because of the limitations of CODE § 904(a).

In 1967, taxpayer obtained a German patent and licensed it to a German licensee, obtaining \$10,000 in royalties in 1967. Taxpayer also earned \$10,000 from the operation of his German establishment. The royalty income was not effectively connected with the profits attributable to the permanent establishment. Under the German-American Tax Treaty, article VIII, *supra* note 16, at § 3011, Germany would not tax the royalty income. But taxpayer might nevertheless claim that his total income from German sources was \$20,000, reducing his effective German tax rate to 25%, and making all German taxes creditable. The taxpayer would probably be successful. See Rev. Rul. 54-15, 1954 CUM. BULL. 129. On the other hand, if the treaty incorporated a "force of attraction" theory, as treaties with some other countries do, the existence of a German establishment would taint the unconnected royalty income, leading to a German tax of \$10,000 (assuming constant rates), of which only \$6,000 could be credited.

⁴⁶ See Japanese-American Income Tax Treaty, art. VII, *supra* note 6, at § 4410.

eliminate it completely, as does the treaty between the United States and Germany.⁴⁷ It is perhaps less obvious that United States tax treaties reflect internal law as much as they modify it. Most United States tax treaties were drawn, for example, when the "force of attraction" principle prevailed under internal law. Tax treaties adopted the same principle: the existence of a permanent establishment within the United States made all other United States income of a foreign national ineligible for the special exemptions or low rates provided by the treaty, even if the other income was not connected with the permanent establishment.⁴⁸ Now that the "force of attraction" principle has been at least partly abandoned under internal law,⁴⁹ it is logical to expect that tax treaties will be revised to enable a foreign national to claim exemptions and special rates even if he has a permanent establishment in the United States.⁵⁰

Tax treaties are not self-contained. Neither are the foreign tax credit provisions, the provisions relating to "source" rules, or the provisions relating to the taxation of nonnationals. All are interrelated, and at some point the interrelationships should have been exhibited in the book. The editors could have shown them in the material on tax treaties, but did not do so.

V. FOREIGN CURRENCY

Chapter V deals with problems arising from the use of foreign currency in business and investment transactions. This is a troublesome area, and the chapter well illustrates the confusion and inconsistency that often result when tax law develops with few or no statutory guidelines. Certain rules can be deduced from statutes of general applicability. Dealers in foreign exchange realize ordinary gain or loss on exchange transactions, and may inventory foreign exchange at the lower of cost or market.⁵¹ Casual speculators and investors may treat foreign exchange as capital assets, the gain or loss on which is recognized only when the exchange is converted into another currency.⁵² But vexing problems arise when persons who are neither dealers nor speculators use foreign exchange in their business or investment activities. These taxpayers must decide whether

⁴⁷ German-American Tax Treaty, art. VIII, *supra* note 16, at ¶ 3011.

⁴⁸ See, e.g., Japanese-American Income Tax Treaty, art. VII, *supra* note 6, at ¶ 4410.

⁴⁹ See text accompanying note 17 *supra*.

⁵⁰ The "force of attraction" principle was abandoned in a 1965 amendment to the treaty between the United States and Germany. It has also been abandoned in the new Convention with the French Republic with Respect to Taxes on Income and Property, CCH Tax Treaties ¶¶ 2839-46L.

⁵¹ BITTKER & EBB 488.

⁵² Mere appreciation in value is not taxed, and depreciation in value is not deductible, until the gain or loss is "realized" by a "sale or other disposition" of property. CODE §§ 1001-02.

exchange transactions are to be separated from underlying business or investment transactions, and if so, how, and whether the separate exchange profit or loss is capital or ordinary. These questions are raised in this book, and although the materials give the student no more than an introduction into the area, I believe they are adequate for a general course in transnational income taxation.⁵³

VI. CONCLUSION

This book is a typical casebook, containing a collection of cases and articles supplemented by the editors' notes. To the extent that statutes are dealt with directly, they are summarized rather than analyzed. The editors include long and detailed cases on obscure points of law, but neglect or give superficial attention to matters I consider to be of major importance. The treatment of the foreign tax credit is shallow; there is no comprehensive discussion of the Foreign Investors' Tax Act of 1966; international corporate reorganizations are virtually ignored; section 482 is given only passing attention; licensing agreements are discussed in two pages;⁵⁴ and the treatment of controlled foreign corporations under Subpart F merits only a ten-page discussion borrowed from a corporate tax handbook. At the same time, eight pages are devoted to an obscure case under the foreign personal holding company tax⁵⁵ and eleven to a case involving the attempted collection of tax from a Uruguayan taxpayer.⁵⁶ I do not mean to minimize the importance of cases, but additional editing might have provided space to explore other matters more intensively.

Another weakness of the book is its failure to pull together concepts that cannot be considered in isolation. One cannot plan a transnational joint venture, for example, without examining sections 351 and 367, foreign tax credit provisions, source rules, and tax treaties, not only separately but as they affect each other.⁵⁷ The interplay of

⁵³ The last chapter covers such problems as withholding, returns and information, collection, sailing permits, and foreign enforcement or non-enforcement of United States tax claims.

⁵⁴ BITTKER & EBB 276-78.

⁵⁵ *Alvord v. Commissioner*, 277 F.2d 713 (4th Cir. 1960) [BITTKER & EBB 329-35].

⁵⁶ *United States v. First Nat'l City Bank*, 379 U.S. 378 (1965) [BITTKER & EBB 549-59].

⁵⁷ Assume, for example that a United States taxpayer wishes to transfer low basis technology to a foreign corporation in return for stock. The taxpayer's first concern is whether the gain on the transfer will be recognized. Nonrecognition requires not only qualification under CODE § 351, but prior clearance under CODE § 367. If the gain is recognized under United States law, the taxpayer may find that the gain is taxed as ordinary income under CODE § 1249. If the gain is not recognized under United States law, but is taxed abroad, the taxpayer may find that as a result of the interplay of the foreign tax credit limitations of § 904 or the source rules of §§ 861-64, none of the foreign tax on the gain may be credited. On the other hand, if the taxpayer has income from other countries taxed at very low foreign rates because of treaty limitations, he may be able to credit the foreign tax imposed on the incorporation of the technology by resorting to the "overall" limitation of CODE § 904(a)(2).

statutes and their relation to tax treaties affects all but the simplest of transnational transactions. The organization and content of the book do not reflect the extreme degree of interdependence among the sources of law in this area. However, this weakness can be overcome by using transnational problems that require the student to pull together the applicable statutes, treaties, and cases.

The present book is a substantial improvement over the first edition. It is not my idea of perfection, but I know of no better single source of materials for use in teaching a course on transnational taxation. Professors may wish to supplement it with additional materials in specific areas, and with problems or other materials designed to aid students in the study of statutes. But with such supplements, teachers should have ample material for a stimulating course in what I consider to be a fascinating area of law.