The Fragile Armistice: The Legal, Economic, and Policy Implications of Trading in a Competitor's Stock

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The Fragile Armistice: The Legal, Economic, and Policy Implications of Trading in a Competitor’s Stock

Karl T. Muth*

The opportunity to make a profit... motivate[s] speculators to engage in the practice of buying and selling [contracts]. A speculator who owned no present interest... but anticipated a price decline might agree to a future sale at the current market price, intending to purchase... at a reduced price.... A “short” sale of that kind would result in a loss if the price went up instead of down. On the other hand, a price increase would produce a gain for a “long” speculator who had acquired [the asset]... but merely for the purpose of reselling... at an enhanced price.¹

I. INTRODUCTION

The question of whether a company’s treasury should speculate in the buying, short-selling, or trading in options on its competitors is one contemporaneous with the dawn of the modern market instruments.² Much thought but little legal scholarship has been dedicated to the question. This Article aims, through the use of examples and analogy, to demystify the practice of trading in a competitor’s stock; analyze the practice’s advantages and disadvantages, and attempt to explain its

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² In the late seventeenth century, it became clear, first in the commodities markets and more than a century later in the equities markets, that call and put options would be central to both market efficiency and the timely setting of accurate prices. An efficient options market leads, in most cases, to smaller bid-ask spreads in the underlying commodity or stock and serves as a secondary predictor of future demand. The ability to borrow stock, and hence the ability to sell short, allows the market to correct for unwarranted enthusiasm or stem upward momentum. As more complex instruments evolved and traded hands in the marketplace, whether a company with cash on-hand should hazard treasury funds directly or indirectly on the price of its competitor’s stock quickly became a question of some debate.

apparent relative rarity. First, the Article seeks to examine the legal barriers confronting the practice. Then, the Article addresses the question of whether this practice harms the market directly, or the business "community" more generally. Lastly, the Article explores the question of social norms that define the business community and the equity markets, and whether prevailing contemporary public policy can be reconciled with the decision to trade in a competitor's stock.

II. LEGALITY

Despite a cornucopia of provided causes of action under section 12(2) of the 1933 Securities Act, there is no public or private cause of action that suggests the short-selling or buying of puts of a competitor's stock is either unlawful or actionable by that competitor. If one examines what many agree is the most general portion of the 1933 Act, section 17(a) and its codified progeny—a provision intended to cover any fraudulent scheme in a transaction involving

3. See infra Part II (discussing statutes that address this practice).
4. See infra Parts III, IV (discussing the view that the issue affects the efficiency of the markets).
5. See infra Parts V, VI (discussing social norms of the business community and public policy).
6. Causes of action under Section 12(2) allow nearly every imaginable securities derivation of common law fraud principles, from simple material misrepresentations made to an individual plaintiff-investor to full-blown fraud-on-the-market scenarios.
7. Codified at 15 U.S.C. § 77j(b). For an informative look at Section 12(2), its scope, the remedies it provides, and the application of this section pre- and post-Gustafson, see Stephen M. Bainbridge, Securities Act Section 12(2) After the Gustafson Debacle, 50 BUS. LAW. 1231, 1251 (1995); Ted J. Fiflis, Gustafson vs. Alloyd Co., Inc.: Judicial vs. Legislative Power, 23 SEC. REG. L.J. 423 (1996); Peter V. Letsou, The Scope of Section 12(2) of the Securities Act of 1933: A Legal and Economic Analysis, 45 EMORY L.J. 95, 96 (1996). A comprehensive understanding of Section 12(2) is not, however, required for the discussion herein.
8. A short sale is the sale of a borrowed security in which the borrower holds a possessory interest but no ownership interest. See STEPHEN A. ROSS, RANDOLPH W. WESTERFIELD & JEFFREY JAFFE, CORPORATE FINANCE 866 (5th ed. 1999). Put another way, a short sale is "[a] sale of a security that the seller does not own or has not contracted for at the time of the sale, and that the seller must borrow to make delivery." BLACK'S LAW DICTIONARY 1366 (8th ed. 2004).
9. Just as a "call" option allows a participant in the market who holds the option to buy at a specified "striking" or "exercise" price, a "put" option allows its holder to sell at a given price. "American" put options allow the holder of the option to exercise it on or before the date on the put, while "European" put options allow the holder to exercise the option only on one particular day. For the sake of simplicity, put options described here are presumed to be "European" put options. There are many further distinctions between "species" of call and put option contracts, but an elementary understanding of the basic "phylla" is sufficient for this discussion. See DAVID S. KIDWELL ET AL., FINANCIAL INSTITUTIONS, MARKETS, AND MONEY 478–83 (1981).
12. In re NYSE Specialists Sec. Litig., 503 F.3d 89, 102 (2d Cir. 2007) (stating that fraud-on-
securities—even this broadest portion of the Act does not prevent trading in a competitor’s stock.\textsuperscript{13} Similarly, related federal statutes do not prevent this activity, whether in the form of a purchase of equity, the purchase of an option (with leverage or with cash), or a short sale.\textsuperscript{14}

The securities laws of Japan, for example, appear to have no prohibition against the practice.\textsuperscript{15} British securities law, which is primarily principles-based\textsuperscript{16} (as opposed to American securities law, which is rules-based), makes trades by competitors worthy of no higher level of scrutiny than trades by others. Nor is the tax treatment of trades involving a competitor’s stock in the United States\textsuperscript{17} or the European Union\textsuperscript{18} any more lenient or punitive than any other investment activity undertaken by a corporate treasury.


\textsuperscript{14}See supra note 2 and accompanying text (explaining the importance of these purchases to market efficiency).

\textsuperscript{15}In Japan, Articles 164–65, which cover the issues implicated by a short sale scheme, do not speak to any restriction on short-sales of a competitor’s stock. Article 190, now at Article 165, read before its amendment in 1988: “A listed company’s officers and major shareholders shall not sell their company’s stock if they do not own the stock.” See Tomoko Akashi, Note, Regulation of Insider Trading in Japan, 89 COLUM. L. REV. 1296, 1296–1319 (1989). There was, and is, no explicit prohibition, however, regarding short sales of a competitor’s stock in Japan today.

\textsuperscript{16}“Principles based” here refers to the British bias that the “spirit of the law” governs in cases where the securities laws are insufficient or uncertain. In other words, where there was intent to defraud, it is likely the resulting act will have succeeded in a fraud, even if the exact type of fraud perpetrated was not afforded space in any statute. Meanwhile, the American system is strictly rules-based—if a strategy does not violate any explicitly-stated rule, then it is fair game. See Michael R. Bloomberg & Charles E. Schumer, Sustaining New York’s and the US’ Global Financial Services Leadership 82 (2007), http://crapo.senate.gov/documents/mckinsey_report.pdf.

\textsuperscript{17}“For the purpose of this title . . . gains or losses from short sales of property shall be considered as gains or losses from sales or exchanges of capital assets . . . .” 26 U.S.C.A. 1233(a) (West 2002).

So long as there is no fraud,\textsuperscript{19} manipulation,\textsuperscript{20} or intent to deceive\textsuperscript{21} the market,\textsuperscript{22} and so long as proper disclosures are made, there is no law barring the purchase or trading of a competitor's stock in the United States. There are no laws prohibiting the purchase of options—including put options—on a competitor's stock. Nor are there any laws, NYSE regulations, SEC,\textsuperscript{23} or NASD prohibitions against short sales of a company's stock by one of its competitors in the marketplace. In fact, there are only a few extremely narrow scenarios\textsuperscript{24} in which short-selling of a competitor's stock is prohibited in the United States. One such scenario is where the short-sale is meant to drive down the price of a target company in a tender offer situation,\textsuperscript{25} which would offend SEC Rule 14e-4 (formerly 10b-4).\textsuperscript{26} The discussion that follows primarily addresses legal actions that could be taken by a publicly-traded corporation with regard to a publicly-traded competitor's stock.

III. A POTENTIAL THREAT TO EFFICIENT MARKETS?

"[T]he welfare of investors and financial intermediaries are inextricably linked[,] frauds perpetrated upon either business[es] or investors can redound to the detriment of the other and to the economy as a whole."\textsuperscript{27}

\begin{itemize}
  \item \textsuperscript{19} Fraudulent short-selling is a criminal offense and not a matter this Article is meant to address. Of course, not all short-selling is fraudulent. See United States v. Naftalin, 441 U.S. 768, 776 n.7 (1979) (drawing this distinction as to respondent's conviction). This Article deals solely with activities not barred by applicable law.
  \item \textsuperscript{20} Fraud and manipulation here refers to the general set of practices, and those stemming from them, described in McKinney's General Business Law Ch. 20, Art. 23 § 352-C.
  \item \textsuperscript{22} Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 476 (1977).
  \item \textsuperscript{23} It is important to note that the SEC has no jurisdiction or capacity to pursue criminal matters. Criminal complaints regarding securities law violations, when they occur, are pursued by the Department of Justice and the U.S. Attorney General. Rather, the SEC can bring enforcement actions as a plaintiff in federal district court or can bring an administrative action before an SEC administrative law judge (ALJ). See SEC, The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation, http://www.sec.gov/about/whatwedo.shtml (last visited Aug. 2, 2008).
  \item \textsuperscript{24} Other short-selling scenarios prohibited in the United States are even more specific, such as short sales by underwriters or dealers from the offering that occur during the pre-offering filing period, which would offend Rule 105, Regulation M.
  \item \textsuperscript{25} Cf. Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Bobker, 808 F.2d 930, 934 (2d Cir. 1986) (discussing the SEC's reasons for adopting Rule 10b-5, one of which was to discourage "short tenders" and "hedged tenders").
  \item \textsuperscript{26} SEC Rule 14e-4, known colloquially as the "short tender rule," generally prohibits an actor from tendering more shares than he or she owns. The short tender rule now appears at 17 CFR 240.14e-4.
  \item \textsuperscript{27} United States v. Naftalin, 441 U.S. 768, 776 (1979).
\end{itemize}
Some may fear that trading on a given company's doubts about a competitor's stock could lead to fraud and insider trading. This would be exceedingly rare, as 1) rival corporations are very rarely privy to the opinions of insiders at the target corporation; and 2) corporations are unlikely to collude where the collusion would lead to the devaluing of one corporation's stock. The only situation where this occurs with any appreciable frequency seems to be where the corporation participating in short-selling of the publicly-traded rival is not a true rival or peer. Often the "rival" corporations participating in short-selling in these (rare) cases are probably closely-held or might even take the form of a single-member limited liability company. These may be corporations controlled by insiders or those with inside information and are not true "competitors" to the company affected by the short-selling, even if they reside in the same market. For instance, a privately-held manufacturer of DVD players with a few dozen employees and five million dollars in sales might nominally exist in the same market as Sony, but is not a "competitor" in any economically-relevant sense of the word. Because two companies can interact as peers in the marketplace even when they are not peers in their industry, the market may be seen as the battleground of choice for cash-flush new entrants or cash-reserves-heavy incumbents.

A relevant example is the case of Enron, where the short positions held, in aggregate, were quite significant as a portion of Enron's total outstanding shares. Some short positions seem to have been held by partnerships and shell companies that co-existed in the energy market but were not peers of—or wholly independent of—Enron. Many of these companies, the government alleged, were created to facilitate insider trading or created as "favors" by banks friendly to Enron's

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28. Many scholars believed this in the 1980s and 1990s. However, this theory that short sale transactions are often (or even predominantly, as some contended) based on private or near-private information has been largely discredited in recent years. See, e.g., Holger Daske, Scott A. Richardson & A. Irem Tuna, Do Short Sale Transactions Precede Bad News Events? (May 13, 2005) (unpublished manuscript), available at http://ssrn.com/abstract=722242 (examining data covering 4,193 NYSE-listed securities and finding no substantial correlation between short sale transactions and significant negative news events, inconsistent with earlier work suggesting private information's being among primary drivers of short sale behavior).

29. An oft-cited example of this is AOL's use of its large cash position to acquire Time-Warner, an enterprise many times its size only a few years earlier.

30. An incumbent with substantial market share in a mature market may have steady cash flows and be more willing to make aggressive investments.


schemes. This raises the question of whether a large enough short position, as a percentage of shares outstanding alone, might create the fraud-on-the-market presumption in rule 10(b), in the absence of further findings of fact or expert testimony to that effect. The United States Court of Appeals has never definitively decided this issue. While the Cammer/Unger/Bell factors can be used to analyze whether an efficient market exists, these factors do not establish whether the efficient market under examination is vulnerable to tampering through short-selling by competitors and insiders.

For example, even though the annualized turnover ratio was 151.9% in Enron’s stock (seemingly suggestive of an efficient market and greater than the average for all stocks listed on the NYSE at the time), we now know there was substantial impact from inappropriate trading by insiders, if not competitors. The short interest in Enron stock represented only about 1% of outstanding shares until October 1, 2001. Short interest represented 2.4% of shares outstanding on


37. These factors help courts analyze whether a stock is trading in an efficient market and whether a fraud-on-the-market theory or presumption is an appropriate framework for continuing an analysis. The satisfaction of any or all of the factors does not, however, confer or remove any liability by itself. The factors are: (1) the average weekly trading volume compared to the total outstanding shares; (2) the availability of industry professionals following and reporting on the stock; (3) the extent to which market makers and arbitrageurs trade in or interfere with the market for the stock; (4) the company's eligibility to file SEC Form S-3; (5) the existence of facts "showing a cause and effect relationship between unexpected corporate events or financial releases and an immediate response in the stock price"; (6) the company's total market capitalization; (7) the range and volatility of bid-ask spreads in the stock; and (8) the stock's total market trading volume once insider trading has been subtracted. See Unger, 401 F.3d at 323 (citing Cammer, 711 F. Supp. at 1286-87). Consider also the latter factors added here in view of Krogman v. Sterritt, 202 F.R.D. 467, 477-78 (N.D. Tex. 2001).


40. This appears to have been a relatively consistent figure month-to-month prior to Q401. See In re Enron Corp. Sec., 529 F. Supp. 2d at 753.

41. Id.
October 15, 2001; 4.1% of shares outstanding on November 15, 2001; and 11.8% of shares outstanding on December 15, 2001. Despite voluminous discovery in the many securities cases that followed the Enron collapse, the staggering portion—over 10%—of Enron’s shares outstanding mirrored by short interest in December 2001 remains a mystery. Only a small portion of the questionable equities and option activity has ever been reliably attributed to trades made by Enron’s insiders. This leaves open the question of how much of the activity can be properly attributed to the corporate treasuries of partners and competitors.

However, this scenario of substantial short positions being held in the market generally is different and distinguishable from a scenario where a substantial short position is held by a competitor. In fact, the frequency of legitimate, lawful short sales so overwhelmingly outpaces the frequency of questionable short sales that short-selling in a given stock will not start the statute of limitations for a potential 10b-5 securities fraud plaintiff because short-selling alone—no matter who is doing the short-selling or how publicized it becomes—is not enough to provide notice that a fraud might be afoot. Further, insofar as the plaintiff was on notice of the occurrence of short-selling, the plaintiff is unlikely to be found to have been deceived by the party engaging in the short-selling. The environment for plaintiffs in this area is a harsh one.

As corporations generally want to execute on their core business strategies, rather than become long-term holders of shares or options in

42. Id.
46. A plaintiff must plead and prove loss causation in securities fraud cases and that the corporate actor acted with scienter, though most agree that a plaintiff need not prove that any particular individual acted or undertook to act with scienter. What this means, when combined with the Supreme Court’s interpretation of the PLSRA, is that a plaintiff must show each misleading statement that led to the fraud and show that the misrepresentations were the proximate cause of the particular loss the plaintiff seeks to recover. See Dura Pharm., Inc. v. Broudo, 544 U.S. 336, 345–46 (2005) (referencing 15 U.S.C. § 78u-4(b)(1), 4(b)(4) (2000)); Jennifer O’Hare, Retail Investor Remedies Under Rule 10b-5, 76 U. CIN. L. REV. 521, 548 n.142 (2008) (noting Congress appreciates but has chosen not to substantially lower plaintiff pleading hurdles); Tad E. Thompson, Messin’ with Texas: How the Fifth Circuit’s Decision in Oscar Private Equity Misinterprets the Fraud-On-The-Market Theory, 86 N.C. L. REV. 1086, 1100 (2008) (noting difficulty for plaintiffs under modern fraud interpretation).
their competitors, it seems likely a corporation will only buy, short, or buy options on direct competitors where there is substantial certainty that a change in the industry or sector will occur within a certain time. The two obvious times in which this would be true would be when a company makes unexpected earnings announcements or major product launches. The following hypothetical explores the product launch as an underlying trigger for this type of trading behavior and the associated problems that might quickly present themselves.

Example I. The Product Launch Scenario.

As business schools have yet to produce any full-fledged case studies on point, a simple piece of historical fiction may be the next best way to explore the practical effects of this strategy.

To indulge in a simplified hypothetical, assume there are three actors, Apple Computer (AAPL), Research In Motion, Ltd. (RIMM), and AT&T (T), with the following rules:

- AAPL manufactures a cellular telephone called the iPhone;\(^47\)
- RIMM competes with AAPL with a product called the BlackBerry;\(^48\) and
- T provides service for all AAPL cellular telephones and some RIMM cellular telephones.

Further:

- The exclusive provider of iPhone service in the United States market is T;
- The universe for this hypothetical is limited to the United States market;
- By AAPL’s June 28, 2007 projections, at least 75% of iPhone sales will come at the expense of RIMM sales;
- By RIMM’s June 28, 2007 projections, its business will be largely unaffected by the iPhone because the BlackBerry is aimed at a business market, while the iPhone will primarily appeal to a youth consumer market; and
- Every iPhone sold results in the origination or renewal of a T service contract.

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On June 1, 2007, AAPL executives are 75% sure\(^49\) that the iPhone, when made available to consumers on June 29, 2007, will be a success, benefiting T and AAPL to RIMM's detriment. On June 15, 2007, AAPL executives are 80% sure this will be the case. AAPL's board of directors authorizes the corporate treasury to purchase puts on RIMM stock and to purchase T stock in the week before the iPhone's debut based on estimates and models that RIMM will decline 20% during the ninety days after the iPhone's release, while T will gain 5% during that period. It is worth noting that, by the benchmarks used by most legal scholars, while AAPL's board is very well-informed, it is not acting as a manipulator.\(^50\) The board's goal is not to influence pricing, but to profit from anticipated, independent market phenomena.\(^51\)

In fact,\(^52\) the iPhone's launch seemed to have a negligible impact on RIMM's stock price, and the ninety days following the iPhone's release were kind to RIMM. RIMM's stock climbed\(^53\) from $65.29 (the opening price the Friday the iPhone launched) to a closing price of $72.66 the following Friday, eventually reaching $100.00 per share in mid-day trading on September 26, 2007, and opening at $100.89 the following morning after a ninety-day steady climb.\(^54\)

Meanwhile, T traded essentially flat\(^55\) during that ninety-day period, despite strong iPhone sales. T traded between $22 and $25 per share.
every day, opening the day of the iPhone launch at $24.75 and closing on Friday, September 28, 2007 at $23.82.

At the end of the period, though the iPhone has been a wildly successful product and AAPL is often selling every unit it can build, AAPL's puts are out of the money and its T stock has failed to perform. If AAPL had simply purchased its own stock, which opened at $121.97 per share on iPhone launch day, and held it for the same ninety-day period, it could have sold on Friday, September, 28 for between $152.75 and $154.60 per share on that day.56

Now, the market is not a vacuum,57 but assuming the amounts of stock involved in AAPL's strategy would not have been great enough to substantially affect market activity during the period, it is safe to say that AAPL would have been better off buying back its own stock than buying puts on RIMM and buying shares in its partner, T. However, the situation for AAPL would have been much worse if it had elected instead to engage in short sales of RIMM, as AAPL would later have had to buy RIMM stock at close to $100 per share in order to cover its short-selling. "[W]hen a hedger takes a long or a short position that is greater than its interest . . . it is to that extent no longer a hedger, but a speculator."58 It would be almost impossible for RIMM to prove that AAPL harmed RIMM post hoc. After the short-selling scheme failed, even if RIMM uncovered all facts given here, a suit by RIMM against AAPL would have been unlikely to survive summary judgment under any cause of action.

28&f=2007&g=d (last visited Jan. 20, 2009). This website gives the open, high, low, close, volume, and adjusted close prices for T for June 29, 2007, through September 28, 2007. Id. Note that these numbers will not exactly match those in the discussion supra, as they have been adjusted for splits and dividend decisions.

56. Id.

57. "The suspect will often contribute in some way to the price change. Sometimes, while he is not completely responsible for the price change, the suspected trader might have: (1) reinforced, (2) stabilized, or (3) created a price change. The trader reinforces a price change when he brings about a price change that is larger than it would be without X', stabilizes a price change when the price change is weaker than it would be without X', and creates a price change when he is fully responsible for the complete price change. For that reason, when a regulator suspects X of manipulating the price, because, for example, the regulator observes no price change or a large price change when he expects otherwise, he cannot decide the direction or the extent of X' just by looking at the stock price behavior." Maithijs Nelemans, Redefining Trade-Based Market Manipulation, 42 VAL. U. L. REV. 1169, 1180 (2008). C.f. United States v. Phillipsburg Nat'l Bank & Trust Co., 399 U.S. 350, 380 (1970) (acknowledging, in the dissenting opinion of Justice Harlan, that even minor actions and competitive practices by third parties can affect other actors' market power).

IV. SOCIAL NORMS IN THE BUSINESS COMMUNITY

Some believe the practice of buying put options on a rival company’s stock to be unfair or morally objectionable. The same people, when asked about short sales of a competitor’s stock, are likely to find such actions incrementally “worse” than buying puts. These reactions have little to do with law and much more to do with business culture and social norms in the business community.

A norm can be understood as a rule that distinguishes desirable and undesirable behavior and gives a third party the authority to punish a person who engages in the undesirable behavior. . . . [A] norm is like a law, except that a private person sanctions the violator of a norm, whereas a state actor sanctions the violator of a law.

This may, at least in part, explain the rarity of the practice. If a company was fantastically successful with a short-selling strategy and, in a given year, a substantial measure of its profits came from shorting its nearest competitor, this might be seen as inequitable or “foul play” by the company’s peers and the public, even if the actions taken were neither criminal nor tortious.

One of the first things Jeff Skilling did after leaving Enron was to engage in a short sale on August 24, 2001, of AES, an Enron competitor. Due to the subsequent fall in AES’s stock, the value of the sale was likely between fifteen and thirty million dollars. The Wall Street Journal promptly published an article documenting Mr.

59. See F. & M. Schaefer Corp. v. C. Schmidt & Sons, Inc., 597 F.2d 814, 818 (2d Cir. 1979) (stating that it is unfair practice to trade in competitor’s debt and equity to the extent that power over competitor is gained); Briggs Mfg. Co. v. Crane Co., 185 F. Supp. 177, 179–83 (E.D. Mich. 1960) (stating that it is an unfair practice to impact competitors’ shareholders equity in any way that could influence competitiveness).


64. Id.
Skilling's successful trade. That the Wall Street Journal found the trade newsworthy is, in itself, telling as to the business community's attitude toward this behavior. In the aftermath of Enron, though supporting reforms, Alan Greenspan admitted that Congress was unable to "effectively legislate morality or character."  

This surprisingly uniform concept that certain practices by corporate treasuries, though legal, may be unfair, demonstrates the distinction between the "letter" and the "spirit" of American securities law. Specifically, the intent—rather than the wording—of the 1934 Act seems to have been broadly adopted by those in the market as the "rules of the game." As the Supreme Court noted, the 1934 Act and its companion legislative enactments embrace a "fundamental purpose . . . to substitute a philosophy of full disclosure for the philosophy of caveat emptor and thus to achieve a high standard of business ethics in the securities industry." The collateral nature of contributing to or profiting from a rival's failure through the securities markets rather than through the marketplace is morally unappealing to many who believe the company with the best product should prevail, rather than the company that dabbled in (or tampered with) its opponent's stock most successfully. This might be especially true in cases where a competitor engages in trades in order to take advantage of a specific event or temporary misfortune of the target competitor.

Example II. The Specific Event Hypothetical: A "9/11" trade.

If a rival air carrier, Unfriendly Skies, had somehow bought 120-day puts on United Airlines (UAL) at the start of the September 11-14, 2001 NYSE markets-closed period, and the action had been substantial and came to light, would the buyer of the puts be expected to show remorse for helping plunge its competitor, UAL, into bankruptcy? Would the gains (substantial, as UAL fell from a price around $30 per share to

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67. Steve Thel, The Genius of Section 16: Regulating the Management of Publicly Held Companies, 42 HASTINGS L.J. 391, 427 (1991) ("While popular criticism of short-selling often reflects little more than a distaste for those who would profit from the misfortunes of others, short selling by corporate managers poses more concrete problems.") (emphasis added).
68. Ian Ayres & Joe Bankman, Substitutes for Insider Trading, 54 STAN. L. REV. 235, 281 (2001) ("The possibility of gains from substitute stock trading has the potential to distort business decisionmaking.").
69. "Short of a patent fraud or obvious wrongful application of its constitution or regulations, the courts should leave such associations (stock exchanges) to apply their own regulations," Aronson v. McCormick, 178 N.Y.S.2d 957, 959 (Sup. Ct. 1958) (quoting Cohen v. Thomas, 209 N.Y. 407, 411 (1913)).
roughly half that at the end of the period, if one examines UAL NYSE closing prices across this date range) outweigh criticism from investors, the public, and the press during United Airlines’ bankruptcy?

The legal concepts of disclosure in bankruptcy are important when a corporation considers whether to short its competitor. This is because courts that apply a broad ownership disclosure rule\(^7\) to a Chapter 11 bankruptcy might require the disclosure of short sales, derivatives, and interests in a competitor (including short interests and obligations stemming from put options).\(^1\) This type of disclosure in the context of bankruptcy is the likely situation in which a competitor’s short strategy would come to light. Because bankruptcy courts must respect the laws of the states in which they sit,\(^2\) there is little in the way of settled law regarding the breadth of ownership disclosure. The bankruptcy court for the Southern District of New York, for instance, applies the beneficial ownership disclosure rule it infers from rule 13d-3(a)-(b) in tandem with the Adoption of Beneficial Ownership Disclosure Requirements,\(^3\) leading to uncertain results for those seeking full disclosure. The New York state rules would be narrow enough,\(^4\) as generally applied, in terms of requisite disclosure requirements to potentially conceal the existence of short sales by competitors while the company in question was en route to bankruptcy. As the focus of disclosure in bankruptcy is to discover all assets and debts, rather than

\(^{70}\) The breadth of the requisite disclosure is increasingly often a point of contention, as the creditors’ committee in a Chapter 11 bankruptcy has a fiduciary duty to the creditors it represents, but not to the debtor. ALAN N. RESNICK & HENRY J. SOMMER, COLLIER ON BANKRUPTCY § 1103.05(g)(ii)(2)(a) (15th ed., rev. 2007). Therefore, releasing information that may be in the interest of a creditor, yet embarrassing to the same creditor, poses a difficult quandary for both the court and the committee. The committee has a responsibility to keep private all sensitive information, but trades made by competitors in open markets may not be classified as such because they are matters of record.


\(^{72}\) See Butner v. United States, 440 U.S. 48, 54 (1979) (“Congress has generally left the determination of property rights in the assets of a bankrupt’s estate to state law.”); In re Payless Cashways, 203 F.3d 1081, 1084 (8th Cir. 2000) (bankruptcy court must apply choice of law rules of state where it sits); In re Jason Realty, L.P., 59 F.3d 423, 427 (3d Cir. 1995) (bankruptcy court cannot “upend the property law of the state” in which it sits); Matter of Wheaton Oaks Office Partners, Ltd. P’ship, 27 F.3d 1234, 1241 (7th Cir. 1994) (same).


\(^{74}\) 22 N.Y.C.R.R. § 130 (availability of sanctions); 22 N.Y.C.R.R. §§ 670.2(g) (disclosures required of counsel); CPLR §§ 3101 (scope of requisite disclosure); 3102 (methods of obtaining discovery and requests for admission); 3103 (special and protective orders); 3104 (discovery oversight and supervision); 3105-3123 (depositions, discovery, supervision, and objections); 3124 (failure to disclose, procedure to compel); 3126 (penalties for failure to comply with required disclosure; read in concert with 3101).
all interim interests, a bankruptcy court has little reason to delve into
every passing interest. However, if a competitor was to borrow a large
amount of stock and that stock had "gone missing," this might require
additional diligence from the bankruptcy court. In such a scenario, it
seems incrementally more likely the competitor-borrower would be
discovered.

The concerns regarding public relations if a short-selling strategy
were uncovered are obvious: to the public, short-selling of a struggling
competitor might seem like piling-on or immoral, calculated behavior.
Often, the public expects regret for harm, whether it is criminally or
legally effectuated—particularly when the harm caused is the result of a
calculated plan. "A person who kills while angry is usually guilty of a
less serious crime than a person who kills in a calm, unmotional state
..."

The emotional reaction to a given course of action by another is
usually based upon complex beliefs. However, the fact that some may
find aggressive trading in a competitor’s stock morally objectionable
should not animate the legislature to make the practice illegal. "A core
presumption underlying modern legality is that ... the sphere of law
admits only of reason; and vigilant policing is required to keep emotion
from creeping in where it does not belong." Not all things that might
be perceived as unfair or wrongful are unlawful or tortious.

There are also suspicions in the business community that the SEC
will discover (or manufacture) reasons to pursue corporations that
engage in activity poisonous to the value of its competitors. This likely
overestimates the risk involved and disregards the overarching rule of
criminal prosecutions that "ambiguity concerning the ambit of criminal
statutes should be resolved in favor of leniency." This means that a
criminal defendant should not "be subjected to a penalty unless the

75. An entity that borrows stock of Company A, sells it short, and still has not bought
replacement "make good" shares of Company A at the time Company A becomes insolvent may
take its gains "free and clear" without buying "make good" Company A shares.
77. See Martha C. Nussbaum, Emotion in the Language of Judging, 70 ST. JOHN'S L. REV. 23,
25 n.6 (1996).
78. Terry A. Maroney, Law and Emotion: A Proposed Taxonomy of an Emerging Field, 30 L.
practice [can be] 'unfair' or 'deceptive' [but] not 'unlawful' and vice versa.") (quoting Motors,
Inc. v. Times Mirror Co., 162 Cal. Rptr. 543, 546 n.2 (1980)).
80. Janmark, Inc. v. Reidy, 132 F.3d 1200, 1202 (7th Cir. 1997) ("A wrong does not become a
tort' until an injury has occurred (speeding is wrongful, but not tortious, if no one is injured.").
U.S. 808, 812 (1971)).
words of [a] statute plainly impose it."\(^8\) While the possibility exists that a maverick prosecutor, given the right fact pattern, would misconstrue a statute to allow the prosecution of a corporation trading in the stock of its competitor, this possibility seems remote. Even if one takes into account the fears of negative publicity and civil remedies, these fears alone do not explain the apparent scarcity of this activity in the marketplace.

On Tuesday, July 15, 2008,\(^8\) the SEC issued an emergency order\(^8\) putting a halt to short-selling in Fannie Mae, Freddie Mac, and seventeen financial firms\(^8\) including Goldman Sachs Group, Inc.,

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\(^8\) The seventeen financial firms named in the order were BNP Paribas Securities Corp. (BNPQF or BNPQY), Bank of America Corporation (BAC), Barclays PLC (BCS), Citigroup Inc. (C), Credit Suisse Group (CS), Daiwa Securities Group Inc. (DSECY), Deutsche Bank Group AG (DB), Allianz SE (AZ), Goldman Sachs Group Inc. (GS), Royal Bank ADS (RBS), HSBC
Lehman Brothers Holdings, Inc., and Merrill Lynch & Co. It is unclear whether, or to what extent, Fannie Mae, Freddie Mac, and the seventeen parent companies of primary dealers mentioned in the order were shorted by their competitors prior to the July 15, 2008 order. What is clear, however, is that Lehman Brothers suspected certain hedge funds of shorting its stock and called for an SEC investigation. The full list of names Lehman Brothers gave to the SEC is not, as of this writing, publicly available. However, the likelihood that none of these hedge funds have any ties to Lehman’s rivals is very tiny indeed, as the autonomy that hedge funds enjoy relative to the world of major banking enterprises is often slight at its maximum. The crisis in this part of the financial markets continued that month, causing the SEC to issue an order on July 29, 2008 extending the original emergency order through Tuesday, August 12, 2008. Further extensions followed amid significant debate as to whether, and to what extent, short-selling might be reined-in through legislation or exchange rulemaking.

The idea that short-selling is abused and should be subject to restriction is not a new one:

Mr. Untermeyer correctly states that the Stock Exchange itself “has it within its power to prevent or restrict short selling.” Yet even so hostile a critic as he has heretofore been of Stock Exchange machinery is careful to add that whether such action would be advisable “is quite another thing.” The stock Exchange authorities have given public warning that the speculative seller of stocks whose purposes were shown by deliberate circulation of disturbing rumors would be severely disciplined. But they too have declared through their president that since “normal short selling is an essential part of a free market for securities,” prohibition of such sales “might result in the destruction of the market,” and would therefore, in any case [be] “too


high a price to pay for the elimination of the few who abuse this legitimate practice."

This editorial commentary appeared in the New York Times not in October 2008, but rather on October 18, 1930. The government's decision to intervene in 2008, and only as to certain companies in the financial services industry, led to an order with far more complex considerations than the blanket restriction considered in 1930.

Hence, the details of this emergency order are worthy of examination. The order did not halt trading in any particular security. Rather, it required that no one affect a short sale in any of the named securities without 1) borrowing the securities prior to the short sale date, and 2) having the capacity to deliver the securities on the settlement date. These restrictions did not, however, apply to market makers, block positioners, or others who might need to sell short in order to participate in market-making, hedging, or authoring derivatives based on the named securities. In essence, it was a stricter requirement than that contained in rule 203(b)(1) of SEC Regulation SHO, and it affected most actors in the market. This may be the only example in U.S. history where an action by a government agency created a situation where essentially only actors related to a company's competitors (other major players in the financial services industry) could short-sell its stock.

The idea of a conspiracy to control market activity and drive the price of a stock downward is not a new one. In order to prevent an

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91. Id.
92. See, e.g., Guidance Concerning Order, supra note 84 (setting forth questions and answers concerning the Order).
93. Id.
94. Id.
97. See generally Bd. of Trade of Chicago v. Olsen, 262 U.S. 1 (1923) (holding that manipulation and cornering of the grain market was contrary to public policy and violated Grain Futures Act); Logan County Nat'l Bank v. Townsend, 139 U.S. 67 (1891) (finding that a bank improperly bought and sold debt instruments to carry out a scheme to manipulate market in
orchestrated run to sink a stock's price—with those holding short positions making money on the way down—short-selling of equities instruments in the American market was controlled from 1939 to June 2007 by the “tick test” rule. The rule required the current price of the stock to be higher than the last price and, via this requirement, prevented a trader from taking a short position in a stock already in continuous freefall. Enforced by the threat of imposing criminal liability on both principal and agents, the rule was meant as a prophylactic solution to stock price control or manipulation through short-selling (which, it was thought, would later be remedied by investigation and prosecution pursuant to section 9(a)(2) of the Securities Exchange Act of 1934). Specifically, it is illegal to participate in “a series of transactions in any security registered on a national securities exchange . . . creating actual or apparent active trading in such security, or raising or depressing the price of such security . . . by others.” Proving, to the degree required by U.S. securities law, that one was injured by a competitor’s short-selling might well prove impossible. And, even if an award of damages was

certain municipal bonds contrary to the bank’s charter and irreconcilable with public policy); In re E. U.tils. Investing Corp., 23 F. Supp. 719 (D. Del. 1938) (discussing bankruptcy court discovery that parent company illicitly manipulated its own stock price in attempt to defraud and hobble debtor subsidiary). See also SEC v. Wickham, 12 F. Supp 245 (D. Minn. 1935) (“[G]overnment regulation and supervision in the field of securities is the result of the unscrupulous manipulations and brazen fraud that has been practiced on the public during the boom days.”).


99. Id.

100. A customer who urges a broker to act contrary to the rule is subject to criminal liability in equal measure to the broker who executes the instructions given under the Securities and Exchange Act of 1934, § 10(a), 15 U.S.C.A. § 78j (2000).


104. Even testimony by Herbert Hoover, then Commerce Secretary, that short-selling in commodities markets in the harvest season of 1920 had been undertaken by market participants who “deliberately intended to depress the price” and that this was the proximate cause of harm to farmers, was met with substantial skepticism. Future Trading in Grain: Taxing Contracts for the
appropriate, it might be meaningless after the fact—no amount of money damages could un-sink Bear Stearns or revive its brand in the marketplace.

Even with complete knowledge of the series of transactions that adversely affected the plaintiff corporation—knowledge likely unavailable prior to comprehensive discovery—the affected company might still lack sufficient information to state a claim against an aggressive, opportunistic, short-selling competitor. This is due to the requirement that "[i]n alleging fraud or mistake, a party must state with particularity the circumstances constituting fraud or mistake. Malice, intent, knowledge, and other conditions of a person’s mind may be alleged generally."\(^{105}\) These rules of pleading are in place in order to serve the three policy-driven purposes underlying rule 9(b): 1) to provide defendants with fair notice of the claims promulgated by plaintiffs; 2) to protect defendants from unnecessary harm that could be caused by unfounded allegations of fraud; and 3) to reduce the number of suits that will not meet their burden at trial.\(^{106}\) The Private Securities Litigation Reform Act of 1995\(^{107}\) contains a further difficult pleading requirement: in any action "in which the plaintiff may recover money damages only on proof that the defendant acted with a particular state of mind," the complaint must "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind."\(^{108}\) Illustrating the requisite \textit{mens rea} when that intent must be shared by a corporation’s board, or unanimously adopted by those managing a corporate treasury, would be difficult even under the very best evidentiary circumstances.\(^{109}\)

Financial institutions are particularly fragile when struck by a wave of shorts by competitors, especially when this is accompanied by negative news\(^{110}\) about the company in question (even if the news

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\textit{Sale of Grain for Future Delivery, and Options for Such Contracts, and Profiding for the Regulation of Boards of Trade and for Other Purposes: Hearing on H.R. 5676 Before the Comm. On Agriculture and Forestry, 67th Cong. 174 (1921) (statement of Herbert Hoover, Commerce Secretary). Today's short-selling, as discussed here, happens in far more complex, far more efficient equities markets where the causal chain may be very difficult to untangle.}\(^{105}\)

\footnotesize{\textit{FED. R. CIV. P. 9(b).}}


\footnotesize{\textit{15 U.S.C. § 78u-4 (b)(2).}}

\footnotesize{\textit{Alan Schwartz, CEO of Bear Stearns, asserted on March 14, 2008: Bear Stearns has been subject to a significant amount of rumor and innuendo over the}}
involved is not particularly revelatory and indisputably true) since these companies depend upon the public’s confidence. The vulnerability of many publicly-traded enterprises and the lack of legal recourse after the fact may well be enough to create a “gentleman’s agreement”—a social contract of sorts—that permeates the business culture. Understanding the existence of a “thou shalt not bet against thy competitor” rule, even without understanding its underlying premise, may so saturate the business culture as to present social norms adopted by most businesspeople. However, even if the vast majority of actors cooperate with this rule, assenting to a Lockean social contract of sorts, are they acting rationally? This is, perhaps, best illustrated by considering a market segment like banking where organizations tend to be savvy as to the market generally but relatively opaque as to one another.

Example III. What Do Competitors Know and When Do They Know It?

It is rational for a bank that may or may not compete with Bear Stearns to buy puts on Bear Stearns as it withdraws its own business from Bear Stearns. It is also rational, though risky, for such a bank to take a short position in Bear Stearns in the same situation—especially if exposed to information on the street which seems to overwhelmingly suggest that others are also pulling business away from Bear Stearns. Unless there is fraud, collusion, or corporate espionage afoot, it is unlikely the bank pursuing this strategy has inside information relative past week. We attempted to try to provide some facts to the situation but in the market environment we’re in, the rumors intensified and given the nervousness in the market a lot of people it seemed wanted to act to protect themselves from the possibility of rumors being true and didn’t want to wait to see the facts.

David Gaffen, The Bear Stearns Conference Call, WALL ST. J., http://blogs.wsj.com/marketbeat/2008/03/14/the-bear-stearns-conference-call/ (Mar. 14, 2008, 12:39pm). The call failed to dispel negative rumors, and downward momentum continued, with the stock down 39%. Id. The same damage from rumors has threatened hedge funds and closely-held concerns. Tim Barakett, founder of Atticus Capital (a fund with nearly $15 billion under management as of September 1, 2008), found himself defending against rumors the fund would be liquidated and shuttered: “We’ve heard these rumors as well and they’re not true.... We’re certainly not liquidating. In fact we have a large net cash position and are looking for opportunities to invest capital.” Gregory Zuckerman, Big Hedge Fund Atticus Denies Rumors it is Liquidating, WALL ST. J., Sept. 4, 2008, http://online.wsj.com/article/SB122056054369301101.html?mod=2_1569_topbox. Barakett was quoted as saying this in The Wall Street Journal roughly seventy-two hours after rumors of Atticus’s liquidation hit the street. Id.

111. For an excellent discussion of this issue and the possibility for collusion (or other anticompetitive behavior) that these tacit agreements among competitors may present, see David Gilo, The Anticompetitive Effect of Passive Investment, 99 MICH. L. REV. 1, 13–20 (2000) (addressing the issue of tacit collusion with passive investment).
to Bear Stearns. Some portion of the information upon which it relies may be rumor, even "gut instinct," but it is not improper for the bank, its officers, and its treasury to weigh the veracity and importance of the rumors on the street.

Could the behavior by the actor in the example be problematic, not legally, but as a matter of public policy (harmful to the public interest or public trust)? It is important to note that there is only liability if one supports the reading of section 10(b) of the Securities Exchange Act to its liberal maximum, and no court has done so. Section 10(b) makes it unlawful for any person—including a corporate person—

to use or employ, in connection with the purchase or sale of any security registered on a national securities exchange . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [SEC] may prescribe as necessary or appropriate in the public interest or for the protection of investors.

It is unclear whether this "as necessary or appropriate in the public interest or for the protection of investors" clause alone could confer liability upon an actor merely making rational decisions as in the example above, though this seems unlikely in the absence of the fraud rule 10b-5 was conceived to combat.

V. A COMBINATION OF SOCIAL NORMS AND CONCERN FOR THE MARKET

Concern for the market environment in the abstract may be a factor that only motivates action when combined with norms set by peer corporations.

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113. While corporations have no duty to correct rumors rampant in the market unless the rumors are attributable to the company in view of the Securities Exchange Act of 1934, § 10(b), 15 U.S.C. § 78j(b) (2006 & West Supp. 2008), a corporation's officers are protected by the business judgment rule's presumption when acting on the basis of rumors or to dispel rumors so long as they act reasonably. An informed basis for decision-making and an honest belief they acted in the best interest of the corporation is sufficient whether the informed basis is sympathetic to or contrary to the prevailing rumors in the marketplace. See Robinson v. Pittsburgh Oil Ref. Corp., 126 A. 46, 48 (Del. Ch. 1924) (discussing the presumption in favor of the directors who are considered to have a bona fide regard for the interests of the corporation).


115. "It shall be unlawful for any person . . . to engage in any . . . course of business which operates or would operate as a fraud or deceit upon any person, in the connection with the purchase or sale of any security." 17 C.F.R. § 240.10b-5(c) (2008).
In an experiment, researchers told a set of hotel guests that re-using towels would be good for the environment. Researchers informed a separate set of hotel guests that most other guests had participated in the towel re-use program. The message that described the norm yielded a nine percent better towel re-use rate than the purely ecological message.

Similarly, a message that "shorting one’s competitors may hurt the market environment generally" is likely not as effective as a message that "most of us don’t short our competitors." From where might this message originate?

It is quite unlikely that all business schools educating the corporate treasurer—or law schools educating the general counsel—agree upon a moral code regarding shorting one’s competitors. The only logical explanation is that goodwill is threatened unless all, in a move of trusting reciprocity (or knowing collusion), abstain from the behavior. "The instinct for retribution is part of the nature of man," and of corporations made of men, too. Once a cycle is begun by one corporation discovering the offending behavior of its rival, the tendency toward retribution in the markets, the media, or via a flight to third parties (conversations with partners, suppliers, and customers, for instance) will be present. Even if the motive is not retributive, the underlying philosophy of self-defense is pervasive and convincing, dating from the very beginnings of modern philosophical and theological understanding. Worse, the response may be foolhardy,


117. See generally Gilo, supra note 111.


119. Cf. Klaus Abbink, Bernd Irlenbusch & Elke Renner, The Moonlighting Game: An Experimental Study on Reciprocity and Retribution, 42 J. ECON. BEHAV. & ORG. 265 (2000) (discussing the potentially more compelling action of retribution). Abbink, et. al, propose a game where Player A chooses to pass money to Player B or to steal money from Player B. Id. at 267–69. Player B can then either return money or punish Player A. Id. Despite the ability to form non-binding contracts to attempt to “contract around” negative outcomes and encourage cooperation or positive reciprocity, retribution was found to be far more compelling than reciprocity. Id. at 270–74.

unrelated, and disproportionate, as it must be very fast in order to have any hope of effectiveness. This tendency toward an inappropriate response is exacerbated by the fact that judicial remedies are too slow and too poorly-suited to combat competitor short strategies, particularly when combined with false information in the market (which may or may not have originated from the competitor in question). Injunctions can halt disclosures from known parties, but they cannot effectively stop wholesale the spread of information or the proliferation of, potentially fatal, negative "word on the street."^121

From a social norms perspective, the analysis becomes more troubling. The short-selling corporation is only "successful" (from its perspective) if the short has the intended effect of weakening the target corporation. The target corporation’s self-defense is only effective if the short-selling corporation’s "bad act" is timely uncovered, exposed, and mitigated or retaliated against. All positive outcomes for the actors, though they may represent "success" against each other, represent failure to comply with prevailing social norms in the business world.

VI. PUBLIC POLICY CONCERNS

In 2000, Sappington and Sidak noted that "[i]t would be useful, for example, to develop a careful welfare analysis of the short selling of competitors' stock," yet little substantial work has occurred in this area.^122 Extant work in related areas^123 largely contains assertions alien to, rather than within the ambit of, a policy discussion.

Undoubtedly, there are parallels between the issue of short sales in a competitor's stock and the public policy issues central to antitrust. Conceivably, the short-selling of a competitor could have one or more of several motives: 1) to undermine market confidence in the competitor; 2) to ripen the competitor for acquisition; and/or 3) to drive the competitor from less profitable markets; or 4) to encourage the competitor to retreat to its core products and markets. All are, not entirely coincidentally, also goals historically associated with predatory pricing.^124 To the extent that shorting a competitor could facilitate or

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^124. See generally Frank H. Easterbrook, Predatory Strategies and Counterstrategies, 48 U.
enable consolidation that would not occur otherwise, the effects are
generally negative from a policy standpoint. A publicly traded
enterprise not vulnerable to predatory pricing or other methods of attack
may still be attacked through the markets, particularly if the short-
selling party’s goal is an acquisition or a modest decline in the
enterprise’s stock.\footnote{125}

Even in cases where the short-selling strategy fails, as in Example
I,\footnote{126} it is the short-selling itself that seems to offend public policy, even
if the intended harm to the shorted competitor never comes to fruition.
This is consistent with the general philosophy applied to contracts that
tend to contravene the goals of public policy:

The question [of] whether a contract is against public policy
depends upon its purpose and tendency, and not upon the fact
that no harm results from it. In other words, all agreements the
purpose of which is to create a situation which tends to operate
to the detriment of the public interest are against public policy
and void, whether in the particular case the purpose of the
agreement is or is not effectuated. For a particular undertaking
to be against public policy actual injury need not be shown; it is
enough if the potentialities for harm are present.\footnote{127}

There is also a policy question—separate from any economic
consideration that can be measured or analyzed quantitatively—of “how
short” the market should generally be. As corporate treasuries have vast
financial resources, an all-out “short war” in a major sector would have
substantial market effects. This decade has seen the market
tremendously “short” in historical terms. In 2001, nine out of twelve
months saw record highs in terms of the portion of the market that was
“short.”\footnote{128} For instance, there were approximately six billion shares
shorted in September of 2001.\footnote{129} This increase continued in the latter
half of the decade, where in the 1990s, it would have been unimaginable

\footnote{125} See generally L. G. Telser, \textit{Cutthroat Competition and the Long Purse}, 9 J. L. & ECON. 259 (1966) (discussing monopolization and market control are more readily available via mergers and acquisitions than via traditional predatory tactics).
\footnote{126} See supra Example I.
\footnote{129} \textit{Id.}
that shares short in Ford would represent 248.9 million of its 2.26 billion shares outstanding.\textsuperscript{130}

While there is likely no magic number that represents the percentage of a market or an issue that should be represented by short positions, large short positions taken by corporate treasuries in competitors may pose unique problems.\textsuperscript{131} Capital diverted from other projects to engage in this sort of speculation is not used for research and development of new products or to explore new markets. Another peculiarity of competitor short-selling is that companies may be willing to absorb higher costs\textsuperscript{132} for short-selling equities if the upside from the transaction itself is only part of the anticipated gain (harm to confidence in a competitor or reduction in the market capitalization of a takeover target in the same sector would be possible other "gains").

Another policy concern is the preservation of transparency, both to the market and to peer stakeholders. Substantial meddling in a competitor's stock can occur with minimal disclosure, so long as the positions taken are not overwhelming in size and so long as the competitor does not enter bankruptcy. Percentage stake in one's competitor,\textsuperscript{133} relative scale of competitors' operations,\textsuperscript{134} and action versus indifference and inaction\textsuperscript{135} are basic screens used by courts to define the line between permissible behavior and bad acts.


\textsuperscript{131} See e.g., \textit{Hedge Funds in Corporate Governance and Corporate Control}, 15 U. PA. L. REV. 1021, 1073–74 (2007) (discussing the complexities of large short positions held by various competitors in the context of a pending merger).


\textsuperscript{134} See \textit{ROBERT BORK, THE ANTITRUST PARADOX} 18–24 (2d ed. 1993) (noting that social or judicial interest in intervention may be higher where competing actors are of disparate size or differing market power).

\textsuperscript{135} See John T. Parry, \textit{The Virtue of Necessity: Reshaping Culpability and the Rule of Law}, 36 HOUS. L. REV. 397, 400 (1999) (stating that "the questions raised by necessity cases can be restated as questions of culpability").
Example IV. Do Threshold Stakeholder Rules Make Sense?

Tango and Uniform are publicly-traded competitors in jurisdiction Zulu. In Zulu, there must be public filings and disclosures whenever a person, natural-born or a creature of the law, owns a stake representing five percent or more of the outstanding shares of a publicly traded entity. There are one hundred shares of Uniform outstanding. On January 1, Tango’s treasury short-sells four shares of Uniform, planning to cover its short on January 15. On January 8, Tango’s treasury short-sells another four shares, planning to cover on January 22. On January 15, Tango’s treasury short-sells four more shares, planning to cover on January 29. Because Tango only takes a possessory interest at the time it sells, and only holds an obligation to cover in the meantime, Tango never “owns” more than five percent of Uniform. Each time Tango covers its short in Uniform, it only buys four shares of Uniform and immediately uses them to cover its short. Using this method, Tango could potentially have a substantial effect on Uniform’s stock without any additional disclosure burden in Zulu.

Uniform could, of course, utilize its resources to “defend” against a general short-selling campaign or piling-on by investors other than Tango. For example, “[n]ot long before Tyco went bankrupt it was still buying full-page advertisements to campaign against short-selling.” 137 Firms may resort to legal threats and even maintain suit 138 in order to discourage short-selling. Having to “defend” in the first place, however, particularly against one’s competitors in the marketplace, creates dubious incentives largely contrary to good public policy.

At some level, the public (and the markets, if the two are not synonymous) accepts a certain behavior, perhaps begrudgingly, when necessary even though these behaviors would be found morally reprehensible in another context. Take the following two examples.

Example V(a). David and Goliath.

BigCo and LittleCo are companies in the same sector. BigCo manufactures the Obligatory Widget, something almost everyone buys at a reasonable price. LittleCo manufactures the Niche Widget, something some people buy at a higher price. BigCo has an upcoming

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136. The short-seller has a mere possessory interest in another’s shares and a contractual obligation to cover until he or she takes title to shares in order to cover the short at a subsequent date. TOM TAULLI, WHAT IS SHORT SELLING 3-4 (2004).

137. Don't Shoot the Messenger—Why Short-Selling Should Be Encouraged, ECONOMIST, Mar. 1, 2003, at 78, 78.

product, the Super Widget, that it is ninety-five percent sure will be the final, crushing blow to put LittleCo out of business. The Super Widget does everything the Niche Widget does at a fraction of the price. The day before launching the Super Widget, BigCo shorts LittleCo. BigCo makes a great deal of money selling Super Widgets, claims essentially one-hundred percent of LittleCo’s market share, and profits on its short-selling as LittleCo spirals into bankruptcy.

Example V(b). David and David.

IffyCo and MaybeCo are small companies in the same sector. IffyCo comes out with a new product, Super Widget, that it believes will be successful, perhaps at the expense of MaybeCo. IffyCo shorts MaybeCo and makes a modest profit on its short-sale play, but it is not substantial compared to its profit from the new product.

Many people would find BigCo’s conduct more objectionable than IffyCo’s conduct. This is because people have difficulty visualizing abstract relationships and, instead, superimpose the moral principles and social niceties they’ve learned elsewhere onto corporate entities. Add to Example V(a) that BigCo and LittleCo were not long ago (perhaps prior to a spin-off) the same company, or companies with generally aligned interests in the same industry. Now, the opportunistic short-selling of LittleCo by BigCo seems more outrageous, with a whiff of corporate filicide.

This concept of “betrayal” is what made Jeff Skilling’s shorting of AES so newsworthy to the Wall Street Journal. There was not then, and has not been since, any substantiated allegation that Skilling’s shorting of AES was based upon inside information, was improper or criminal. Rather, AES and Enron were competitors with generally aligned interests relatively peacefully coexisting in the market until news of Skilling’s trade. To the extent that large-scale short-selling fosters bitter relationships within a sector rather than gentlemanly competition, most will consider the practice counterproductive from a public policy standpoint. This bias evidences itself in both civil and criminal law. While “fair competition” may not be an easy standard

\[139. \text{CASS R. SUNSTEIN, FREE MARKETS AND SOCIAL JUSTICE 28–30 (1999).}
\[140. \text{Skilling was found guilty as to insider trading concerning the sale of 500,000 shares of Enron stock on September 17, 2001. See generally United States v. Skilling, No. H-04-025-02, 2006 WL 3030721 (S.D. Tex. Oct. 23, 2006) (detailing the allegations and the Supreme Court’s decision denying Skilling’s various motions relating to his guilty verdict). He was never charged regarding the AES short sale transaction.}
\[141. \text{Jonathan Baron & Ilana Ritov, Intuitions About Penalties and Compensation in the Context of Tort Law, 7 J. RISK \\& UNCERTAINTY 17, 17–18 (1993).}
\[142. \text{See, e.g., United States v. Gilman, 478 F.3d 440, 448–49 (1st Cir. 2007) (holding that in}

for courts to apply,\textsuperscript{143} it seems an easier standard for investors to internalize. If people are analogizing short-selling to something else that they intuitively believe is contrary to public policy, this could explain the moral dilemma at work when BigCo shorts LittleCo or when Unfriendly Skies shorts United immediately after September 11, 2001.\textsuperscript{144}

Of course, many companies will argue in retrospect that the competitor was in dire straits from the beginning. To ask the company to forego the potential gains available from short-selling its competitor's stock is unfair and distorts the market. But, "without the short-selling, and the accompanying rumors on Wall Street, the company could have been saved from bankruptcy," the shorted competitor will inevitably argue.\textsuperscript{145} Is it, then, incrementally nobler to let one's competitor die peacefully than to speed its decline with a series of well-timed short sales?

\textbf{Example VI. Inaction.}

Alpha and Bravo are close friends. Bravo has a painful, irreversible, terminal illness and has given Alpha medical power of attorney. Bravo has executed legal documents stating that she does not want extraordinary measures taken to prolong her life in this type of scenario. Alpha stands by while Bravo dies, though Alpha could act to prolong Bravo's life.

\textbf{Example VII. Action.}\textsuperscript{146}

Charlie and Delta are close friends and medical doctors. They have a mutual agreement that if either has a painful, irreversible, terminal illness, the other will painlessly terminate the afflicted individual's life. Delta contracts a painful, irreversible, terminal illness. Charlie injects Delta with poison, causing Delta's prompt and painless death.

While both Bravo and Delta die, most draw a moral distinction between the two deaths.\textsuperscript{147} Alpha's inaction is morally superior, many

\begin{footnotesize}

\textsuperscript{144} See supra Example II.

\textsuperscript{145} This is exactly the argument made by Bear Stearns executives in fall of 2008, first to the press, then to Congress, then to the Attorney General's office. Jenny Anderson, \textit{A New Wave of Villifying Short Sellers}, \textit{N.Y. Times}, April 30, 2008, at C1.


\textsuperscript{147} Cass R. Sunstein, \textit{Moral Heuristics} 9–10 (Univ. of Chic. Law Sch. John M. Olin Law &
would argue, to Charlie's action. Most will also draw a public policy distinction that the personal choice requiring no affirmative act in Example VI can be allowed, while allowing affirmative acts that cause the death of another in Example VII could make for bad policy. Business failures due to healthy competition can be analogized to "death by natural causes," or Bravo's death in Example VI. Meanwhile, BigCo's short-trading strategy against LittleCo better matches the affirmative step taken by Charlie to kill Delta in Example VII.

Examples VIII and IX illustrate the philosophical quandary as to whether advancing one's own interests is morally superior to interfering with the interests of a nearby competitor, even if they produce largely indistinguishable gains.

Example VIII. Conferred Advantage.

Druggist knows with absolute certainty that if he gives a certain injection, GoFast, to his racehorse, the horse will run two percent faster, enough to ensure that it wins the race. GoFast has no negative health effects and Druggist knows (to the degree of absolute certainty) that the horse will not be harmed in the long-run if he administers GoFast. There is a risk, however, that the horse will slightly disappoint relative to future, higher expectations. He administers GoFast and his horse wins while the rival horse loses.

Example IX. Conferred Disadvantage.

Druggist knows with absolute certainty that if he gives a certain injection, GoSlow, to a rival racehorse, that the horse will run two percent more slowly, enough to ensure that it will not win the race. GoSlow has no negative health effects, and Druggist knows (to the degree of absolute certainty) that the horse will not be harmed in the long-run by GoSlow. There is a risk, however, that the horse will be seen as an underperformer and will be euthanized or retired due to the poor performance. If the horse is euthanized or retired, there is a very small chance that Druggist's participation in the scheme will be uncovered. He administers GoSlow, and the rival horse loses while Druggist's horse wins.

Presuming that in Examples VIII and IX Druggist has access to both horses without committing a tort or crime and that his only motive is to manipulate the outcome of wagers placed on the horse race for profit,

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most will contend that, while both are objectionable, administering GoFast to his own horse is less objectionable than administering GoSlow to the rival horse for the same reasons investors and actors in the marketplace would rather see companies triumph through competition than manipulate each others’ prices through a short-selling trading strategy. The euthanasia or retirement possibility in Example IX represents the bankruptcy of the target corporation. The small chance of Druggist’s involvement being discovered represents the small chance a broad ownership disclosure will be required in bankruptcy that will trigger revelations regarding the short-selling strategy a competitor undertook.

This series of examples illustrates the basis for a general public policy preference for corporations to fail in the midst of competition rather than due to the affirmative acts of competitors. This preference is likely derived from the broader preference for incrementally “less affirmative” acts where the underlying acts might be considered bad acts. It also reflects the preference for actors who pursue their own success rather than focusing their efforts on facilitating a rival’s failure. Lastly, it reflects the preference for harms that are less personal—Skilling’s short-selling of his company’s competitor is morally “worse” than the same action taken by someone who knows little about the industry.

However, Examples VI through IX, while interesting philosophically, are insufficient practically. They inaccurately portray the relationships between competitors in the marketplace and poorly mirror the effects of a short-selling strategy executed by one competitor against another. They do serve to illustrate, however, that “harmful acts are generally worse than harmful omissions, in terms of both the state of mind of the wrongdoer and the likely consequences of the wrong.”

149. For a famous mid-century fantastic dilemma on the topic see Judith Jarvis Thomson, The Trolley Problem, in RIGHTS, RESTITUTION, AND RISK: ESSAYS IN MORAL THEORY, supra note 146, at 94–116 (describing the actor with the choice of diverting a trolley that will surely hit five men onto a track where one man will be killed). More applicable to the question at hand is the variation (based on the work of modern Aristotelian ethicist Philippa Foot and developed further by Judith Jarvis Thomson at M.I.T.) of the problem where subjects must choose between having the actor throw a switch to put the trolley on course to kill one person (to avoid the death of five) or to throw a man off the bridge nearby (which will surely kill the man but equally surely stop the trolley). In one recent study, eighty-nine percent of participants thought throwing the switch to divert the trolley was a moral choice, but only eleven percent considered throwing the man from the bridge moral, despite either’s resulting in the loss of an innocent life. See Marc Hauser, Liane Young & Fiery Cushman, Reviving Rawls’ Linguistic Analogy, in MORAL PSYCHOLOGY AND BIOLOGY (W. Sinnott-Armstrong ed., forthcoming) (manuscript at 15–22, on file with author).

150. Sunstein, supra note 147, at 9.
The question from a public policy standpoint, then, is whether a short sale by a competitor is a harmful act. If the short-selling is a harmful act, and actionable, then our system provides the legal framework with which to examine the proximity of causation and apportion responsibility for the resulting harm.\textsuperscript{151} If this short-selling by a competitor is suspect,\textsuperscript{152} but not actionable, then it may be difficult to discourage with current securities market regulatory tools. If this type of short-selling is not a harmful act, then it poses no public policy concern, regardless of the practice’s prevalence.

This public policy concern stems not solely from peculiarly philosophical quarters, but also from economic concerns. Recent research\textsuperscript{153} increasingly shows that actors in the marketplace are not predictable, self-interested entities; rather, they are interested in fairness and reciprocity. This concern in the marketplace, combined with concern for any activity perceived to jeopardize the credibility and stability of markets, leads many—including this author—to believe that rampant short-selling between competitors is a matter of public concern, whether or not it is a “harmful act” in a tort sense, or the proximate cause of any harm. Instead, it is the breach of a social contract between actors that is, itself, the impropriety—and damage to reputation, if discovered, is the primary deterrence.

VII. CONCLUSION

While the buying of options on one’s competitor and the short-selling of a competitor’s stock is legally permissible, this remains a relatively rare practice. When substantial trades in a competitor’s stock occur, they are likely to be subject to deliberation and scrutiny at the highest levels. Any corporation considering the practice must weigh the risks of discovery, negative media attention, and offending prevailing business etiquette.

\begin{footnotesize}
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\item \textsuperscript{151} See Price Waterhouse v. Hopkins, 490 U.S. 228, 241 (1989) (Brennan, J.) (describing the various factors taken into consideration regarding apportionment of blame for an employer’s decision); W. PAGE KEETON ET AL., PROSSER AND KEETON ON THE LAW OF TORTS § 41 at 266–67 (5th ed. 1984) (discussing various factors involved in determining causation).
\item \textsuperscript{152} Many actions taken by management may be suspect, but not actionable. See, e.g., Lewis v. Chrysler Corp., 949 F.2d 644, 652 (3d Cir. 1991) (holding that suspect, but not unlawful, failure to disclose management’s self-serving motive in defending against takeover is not actionable under the securities acts).
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Regulation barring such trades, even if desirable in theory, will generally be more difficult and more expensive to maintain than already-extant social norms.\footnote{See ROBERT C. ELLICKSON, ORDER WITHOUT LAW 282–83 (1991) (summarizing the effects of a “social-control” system).} Much as workers’ expectations of their peers may be more effective in enforcing a workplace dress code than a rule alone,\footnote{Dianne Avery & Marion Crain, Branded: Corporate Image, Sexual Stereotyping, and the New Face of Capitalism, 14 DUKE J. GENDER L. & POL’Y 13, 122 (2007).} a similar fear of disapproval, criticism, and loss of social currency prevents most corporations from actively trading in or engaging in short-sales of competitors’ stock.

Further, as most corporations do not have substantially better information about their competitors than is prevalent in the market generally, short sales or the buying of puts against a competitor’s stock rarely present a value proposition superior to other uses for funds in the treasury. This lack of any information advantage, combined with a threat of being discovered or “shamed” by peers,\footnote{See Abigail Barr, Social Dilemmas and Shame-Based Sanctions: Experimental Results from Rural Zimbabwe 3–5 (Univ. of Oxford Ctr. for the Study of African Economies, Working Paper Series No. 2001.11, 2001), available at http://www.csae.ox.ac.uk/workingpapers/pdfs/2001-11text.pdf (analyzing shaming as an effective deterrent measure).} is sufficient to dissuade the majority of potential actors. In the end, concern for the corporation’s reputation, for the market, and for the integrity of prevailing norms and public policy will discourage most corporations from making substantial treasury investments in their competitors, be they long or short.