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Irredeemably Inefficient Acts: A Threat to Markets, Firms, and the Fisc

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This Article defines and explores irredeemably inefficient acts—a conceptually distinct and empirically important category of socially undesirable conduct. Though inefficient behavior is, no doubt, pervasive, the standard view holds that inefficient conduct may be converted into efficient behavior by forcing actors to internalize the external harms of their decisions. For some acts, however, such conversion is impossible. These acts are not just inefficient forms of otherwise socially beneficial activities—they are not just contingently inefficient. Rather, they are inefficient at their core; they reduce social welfare no matter what the regulator does. These irredeemably inefficient (or just irredeemable) acts are private, intentional, nonconsensual transfers of money. While this definition clearly describes theft, it also covers churning and price fixing, market manipulation and option backdating, insider trading and tax shelters, to name just a few examples. All these acts are socially undesirable in any form and at any level because though the money transfer is generally welfare neutral, transferors and transferees waste real resources to make sure that this transfer does, or does not, occur. Yet irredeemable acts may be overdeterred if enforcement is imperfect. Overdeterrence is possible for two reasons. First, enforcement increases the costs of irredeemable acts that remain undeterred. Second, enforcement burdens efficient conduct that yields outcomes indistinguishable from those produced by irredeemable acts. These considerations (along with the irrelevance of a standard cost–benefit comparison) underlie the unique optimal deterrence analysis of irredeemable acts. Antitrust law, corporate law, and criminal law largely reflect the divide between contingently and irredeemably inefficient acts, as well as some of the more specific prescriptions following from this Article's inquiry. Securities and commodities regulation fails to recognize the same distinction despite a wide variety of irredeemable acts in securities and commodities law violations. Although the tax policy implications of the proposed framework are limited, this framework helps to resolve a long-standing debate about tax shelter regulation. Overall, the proposed analysis enriches our understanding of socially undesirable con-

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duct, supports numerous rules and sanctions across divergent areas of economic regulation, and animates a call for legal reforms.

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INTRODUCTION

Law and economics excels when it helps policymakers turn a pumpkin into a golden carriage.[1] The need to do so arises because people engage in all kinds of socially harmful acts. Drivers speed, manufacturers pollute, and corporate executives issue misleading forecasts. Although all these examples reflect inefficient, externality-producing behaviors, the appropriate response is surely not to eliminate all driving, all manufacturing, and all corporate disclosure. All three examples reveal actions that are inefficient in some form or at some level, but are socially desirable in a different form or at a different level. Driving, manufacturing, and corporate disclosure are productive activities that give rise to benefits as well as costs. They may be inefficient, even highly inefficient, but they are only *contingently* inefficient. Their optimal regulation depends on finding the efficiency-maximizing tradeoff between costs and benefits. In many cases, efficiency is maximized if private actors are forced to take account of the external harms (and benefits) of their acts. If they do, a pumpkin indeed turns into a golden carriage.

This standard analysis does not apply to money theft as well as a wide variety of theft-like activities such as price fixing, market manipulation, securities churning, option backdating, tax shelters, and many others. Equating churning with theft is not a moral judgment.[2] Rather, the two are subject to the same economic analysis leading to the same ultimate conclusion: considered by themselves, both are inefficient in any form, at any level, and in all circumstances. I refer to theft, churning, and other private, intentional, nonconsensual transfers of money as *irredeemably* inefficient (or just *irredeemable*) acts. The previously unrecognized distinction between irredeemably and contingently inefficient acts is at the core of this Article's analysis.

Money theft is irredeemably inefficient because it produces no net social benefit, while giving rise to a variety of social costs. The social benefit is nonexistent because the only private benefit of theft is the thief's gain from the stolen money. But that gain is inevitably and fully offset by the victim's loss.[3] In the economist's lingo, the movement of cash from the victim's purse into the thief's pocket is a "mere" transfer.[4] It is welfare neutral in and of itself. In stark contrast, a speeding driver rushing a sick child to a hospital obtains a private benefit that may well exceed all costs the driver imposes on others, perhaps by a

1. *See* CHARLES PERRAULT, *Cendrillon, ou La Petite Pantoufle de Verre*, *in* HISTOIRES OU CONTES DU TEMPS PASSÉ 64, 69 (Amsterdam, Chez Jacques Desbordes 1742) (1697) (the story of Cinderella); *see also Cinderella*, WIKIPEDIA, http://en.wikipedia.org/wiki/Cinderella (last visited Nov. 11, 2013).

2. Churning occurs "[w]hen a securities broker engages in excessive trading in disregard of his customer's investment objectives for the purpose of generating commission business." Mihara v. Dean Witter & Co., 619 F.2d 814, 820 (9th Cir. 1980).

3. Variations in the marginal utility of money are discussed in section IV.A.

4. *See, e.g.*, Herbert Hovenkamp, *Antitrust's Protected Classes*, 88 MICH. L. REV. 1, 14 (1989); Steven Shavell, *Individual Precautions to Prevent Theft: Private Versus Socially Optimal Behavior*, 11 INT'L REV. L. & ECON. 123, 125 (1991).

wide margin. This is just another way of saying that driving is socially beneficial in some form, or that speeding is only contingently inefficient.

The costs of irredeemable acts arise for obvious reasons. People do not like when others steal their money. That is, people resist when others intentionally take what does not belong to them without obtaining the owner's consent. Both the intentional and the nonconsensual character of theft are essential to its irredeemable inefficiency for two related reasons. First, both are needed to ensure the victim's resistance. It makes no sense to resist a consensual transfer. It also makes little sense to invest significant resources in precluding other people's occasional mistakes. But when others deliberately steal one's money, resistance is ensured. Second, being aware of this resistance, thieves will try to overcome it by concealing their actions. (In contrast, those taking someone else's money with consent or by mistake will engage in no similar efforts.) Neither the thief's efforts nor the victim's exertions are a productive use of their time. Nothing of value is created or improved when people reinforce their doors, barricade their windows, and padlock their briefcases, while others try to overcome these defensive measures. Rather, all these efforts give rise to social (as well as private) costs. I call these the *transfer costs* because they inevitably accompany "mere" transfers. Given the absence of any net social benefit, the transfer costs make theft irredeemably inefficient. The same is true of all other private, intentional, nonconsensual transfers of money, that is, of all other irredeemably inefficient acts.

Because irredeemable acts have no redeeming features, it may appear that one of the main concerns underlying the optimal regulation of contingently inefficient acts is absent when we deal with irredeemable ones. Society would be worse off if there were too little driving, but we should hardly worry that there could be too little theft. Contingently inefficient speeding may be overdeterred, but what about irredeemably inefficient theft?

Overdeterrence, it turns out, is a problem for theft as well. The first concern is that courts may mislabel good acts as bad acts and punish what should not be punished. Taking $30 from a friend's pocket may be an unorthodox way of making him repay his long-overdue debt, but it is not theft. Theft's unique inefficiency depends critically on the intent to steal. Yet this intent is difficult to determine. Stronger deterrence efforts will necessarily burden legitimate loan repayments and other socially beneficial "look-alike" activities that may be confused with irredeemable acts of stealing, lowering social welfare. Though this problem may not seem particularly grave when it comes to theft, it will appear much more daunting when the discussion turns to churning, price fixing, tax avoidance, and other irredeemable acts. I refer to the cost of punishing the benign look-alike activities due to their mistaken labeling as irredeemable acts as the *mislabeling cost*. Second, though making theft illegal will deter some putative thieves, it will make others try harder. These additional efforts of resisting antitheft rules give rise to another social cost of greater deterrence. I call it the *resistance cost*.

The mislabeling and resistance costs present policymakers with a tradeoff. Broader antitheft rules and higher sanctions deter more theft, reducing its transfer costs. But these efforts also lead to higher mislabeling costs. Resistance costs increase with stronger enforcement on a per-act basis, but may increase or decline overall. Fewer offenders are resisting, but each resists more. The optimal deterrence of theft minimizes the sum of transfer costs, mislabeling costs, and resistance costs, as well as administrative costs.[5]

These considerations make the economic analysis of irredeemable acts different from the standard analysis of contingently inefficient acts in four important respects. First, the tradeoff between the marginal costs and benefits central to the optimal deterrence of contingently inefficient acts is nowhere in the picture. Second, the actor's intent is central to the analysis, though it is rarely relevant for contingently inefficient acts. Third, the actor's intent is the *only* factor that distinguishes socially desirable and undesirable conduct. The same is not true even when the economic analysis of contingently inefficient acts does incorporate a mental-state inquiry. Finally, the critical distinction between an inefficient irredeemable act and its benign look-alike counterpart is a binary choice (the intent to steal is either present or absent, for instance). In contrast, the optimal deterrence of contingently inefficient acts typically searches for the most efficient point on a continuum (be it a vehicle's speed, a driver's blood alcohol level, the accuracy of a corporate disclosure, or even the mental state of a corporate executive making the disclosure). Given these differences, it is no surprise that the optimal regulation of irredeemable acts differs from the familiar optimal deterrence theory designed for contingently inefficient acts.

The proposed framework intersects with several major areas of economics as well as law and economics. Scholars studying rent seeking will recognize irredeemable acts as a subset of rent seeking and directly unproductive profit-seeking activities.[6] The relative narrowness of the irredeemable-acts category yields a more definitive conclusion regarding their intrinsic inefficiency and

5. Administrative costs are "the costs borne by the state in applying a legal rule and the legal and related costs borne by the affected parties." Steven Shavell, *Liability for Accidents*, *in* 1 HANDBOOK OF LAW AND ECONOMICS 139, 177 (A. Mitchell Polinsky & Steven Shavell eds., 2007). These costs must be taken into account in the analysis of contingently and irredeemably inefficient acts alike. This Article's analysis generally ignores these costs for three reasons. First, though the optimal deterrence theory has identified many effects of these costs on the optimal content of legal rules and sanctions, these effects are adjustments to otherwise optimal provisions designed to accomplish the cost internalization objective. *See generally* A. Mitchell Polinsky & Steven Shavell, *The Theory of Public Enforcement of Law*, *in* 1 HANDBOOK OF LAW AND ECONOMICS 403 (A. Mitchell Polinsky & Steven Shavell eds., 2007). Second, it is not clear without further investigation whether administrative costs vary systematically between contingently and irredeemably inefficient acts. Finally, to the extent administrative costs reflect (or are affected by) such factors as the difference between mislabeling and chilling discussed below, these effects are taken into account in the analysis.

6. The foundational work on rent seeking is Gordon Tullock, *The Welfare Costs of Tariffs, Monopolies, and Theft*, 5 W. ECON. J. 224 (1967). Directly unproductive profit-seeking activities are defined in Jagdish N. Bhagwati, *Directly Unproductive, Profit-Seeking (DUP) Activities*, 90 J. POL. ECON. 988, 989–90 (1982). For a review of rent seeking and DUP literature, see, for example, Michael A. Brooks & Ben J. Heijdra, *An Exploration of Rent Seeking*, 65 ECON. REC. 32 (1989).

more specific policy payoffs. Public finance economists will view the irredeemable-acts analysis as an extension of the fundamental insights underlying the economic analysis of taxation. The link between the actor's motivation (intent) for taking an action and its social cost, as well as the binary nature of the intent inquiry, have direct analogues in the standard economic analysis of distorted, tax-motivated decisions. Antitrust scholars may view the contingent–irredeemable divide as akin to the rule of reason–per se distinction in competition law.[7] The two dichotomies are, indeed, closely related. The property rights scholars will see the connection between irredeemable acts and the "[t]aking of [t]hings"[8] generally regulated via property (rather than liability) rules. Although the overlap does exist, irredeemable acts are both narrower (they include only transfers of money) and broader (they extend beyond possessory interests) than the "takings" category. More importantly, the irredeemable-acts analysis abandons the assumption that property-rule protection ensures full deterrence,[9] picking up where the property-versus-liability-rules literature stops. In sum, the irredeemable-acts analysis builds on a distinguished intellectual foundation to advance our understanding of a particular, newly specified type of human conduct.

Moving from theory to practice, it is hardly surprising that the conceptual differences between contingently and irredeemably inefficient acts have a number of doctrinal implications. When the law relies on proxies—such as the "excessive" speed standard in traffic safety regulation or the "excessive" trading test in securities law—the meaning of the same term varies dramatically depending on the nature of the activity in question. The excessive speed standard reflects the tradeoff between the expected marginal costs and benefits of driving. This is the familiar tradeoff underlying the optimal regulation of contingently inefficient acts. In contrast, the excessive trading test is a proxy for determining the intent of the trading broker. If the broker trades to benefit the customer, there is no reason for legal intervention; if the broker's intent is to benefit himself, the result is clear inefficiency. Needless to say, decision makers concerned with social welfare would be well-advised to keep these divergent meanings in mind while regulating accidents and securities trading. The same is true of many other settings where contingently and irredeemably inefficient acts are regulated by identical proxies.

Another implication of the contingent–irredeemable divide is that the definitional structure that makes sense for the former is ill-suited for the latter. It may be sensible to define contingently inefficient acts by referring both to the actor's state of mind and to the outcome produced by the act. Using the same approach for irredeemable acts is certain to underdeter inefficient behavior. Thus, though

7. For a discussion of this distinction, see, for example, HERBERT HOVENKAMP, FEDERAL ANTITRUST POLICY: THE LAW OF COMPETITION AND ITS PRACTICE, § 5.6, at 253–59 (3d ed. 2005).

8. Louis Kaplow & Steven Shavell, *Property Rules Versus Liability Rules: An Economic Analysis*, 109 HARV. L. REV. 713, 757 (1996).

9. *See id.* at 724 n.33, 769.

it may make sense to define a certain form of speeding as *intentional*, *excessively fast* driving, it makes no sense to define securities churning as *excessively frequent* trading by a broker *for the purpose* of self-enrichment. If the intent to steal the client's money is established, it makes no difference how many trades the broker made (other than to establish damages, of course). On the other hand, it may be justified to give the government a choice of attacking irredeemable acts by focusing either on the state of mind or on the outcome. This is precisely what Congress recently did for tax-avoidance strategies violating the economic-substance doctrine. It would behoove Congress to adopt the same approach in amending the key parts of securities and commodities regulation, including some of the recent Dodd–Frank Act provisions.[10]

The proposed framework has significant implications for sanctions design as well. Sanctions for many contingently inefficient acts are grounded in the cost-internalization objective. Therefore, they depend on our guess regarding the variation of external harms of a given behavior once it crosses the legality threshold. This variation is highly context-specific. There is no reason to assume that the external harm of speeding varies with speed in the same manner that the external harm of drunk driving varies with the blood alcohol level. So it is possible that the optimal structure of speeding fines (higher fines for greater speeds over the limit) may differ from the optimal structure of drunk-driving penalties (a fixed sanction for any blood content over the limit).[11] In contrast, all irredeemably inefficient acts present policymakers with the same uncertainty, albeit in many different settings. The question is always whether a given set of observed facts reflects an irredeemable act or its benign look-alike counterpart. This evidentiary inquiry has little in common with empirical guesses about the variation of external harms of contingently inefficient acts. The distinct nature of this inquiry suggests that sanctions for irredeemable acts should be fixed (like drunk-driving fines) whether the act in question is a violation of tax law, corporate law, antitrust law, or securities regulation. This conclusion supports the otherwise puzzling refusal to vary sanctions for a range of antitrust, securities, and criminal law violations. The same conclusion raises doubts regarding the detailed variable-sanctioning scheme adopted in tax law.

Finally, this Article's most general policy recommendation is that contingently and irredeemably inefficient acts should be regulated separately. The distinction between rule-of-reason offenses and per se violations of antitrust law, the Model Penal Code's rearrangement of various forms of larceny, embezzlement, and false pretenses, and the Delaware courts' characterization of various options-related shenanigans as duty of loyalty rather than duty of care

10. Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified as amended in scattered sections of the U.S. Code). These points are discussed in detail in section III.B.

11. *Compare* MASS. GEN. LAWS ANN. ch. 90, § 20 (West 2013) (imposing increasing fines for greater speeds in excess of the speed limit), *with id.* § 24(1)(A)(1) (imposing sanctions if blood alcohol level exceeds 0.08%, but not varying the sanctions depending on the extent of the excess).

violations even in the absence of conflicts of interests, are all examples of such separate regulation. In contrast, treating both contingently and irredeemably inefficient acts as securities (and, more recently, commodities) fraud necessarily leads to conceptual confusion and misguided doctrine.

This Article concludes by examining the boundaries of the irredeemable-acts category and the assumptions on which it rests. These acts are indeed different from contingently inefficient acts that are clearly inefficient, from such acts that are also intentional, and even from such intentional acts whose efficiency depends only on the actor's intent. At the same time, the usefulness of the proposed contingent–irredeemable framework depends on the plausibility of empirical generalizations about the lack of efficiency benefits of private, intentional, nonconsensual money transfers. Because these generalizations are highly plausible and widely accepted in a number of settings discussed here, the ultimate question is about the breadth—rather than the existence—of irredeemable acts as a distinct category of human conduct. If similar generalizations are accepted in other settings, ranging from property theft to numerous forms of fraud and discrimination, this Article's analysis will find an even broader application.

Part I defines irredeemably inefficient acts and explains their incurable inefficiency. Part II considers the implications of the contingent–irredeemable distinction for the design of optimal legal rules and sanctions. Part III compares these implications to the actual rules and sanctions found in a number of regulatory regimes. Part IV further examines the irredeemable-acts category and addresses its limitations.

I. UNDERSTANDING IRREDEEMABLY INEFFICIENT ACTS

This Part argues that the list of conventional economic justifications for government regulation is incomplete. This conclusion follows directly from Gordon Tullock's well-known analysis published over four decades ago.[12] Yet, surprisingly, some significant implications of Tullock's insight for the design of legal rules and sanctions have gone unrecognized. The following discussion remedies this omission. It presents the core argument while ignoring most caveats, subtleties, and complications (which are addressed in Part IV). Section A briefly summarizes the basic analysis of contingently inefficient acts and the familiar tradeoff underlying their optimal regulation. Section B introduces irredeemably inefficient acts and explains why they also present policymakers with a tradeoff, albeit a different one. After highlighting the distinctive conceptual features of the irredeemable-acts analysis in section C, section D presents a range of potential irredeemable acts drawn from a variety of legal

12. *See generally* Tullock, *supra* note 6. This analysis is widely viewed as one of Tullock's main intellectual achievements. *See Gordon Tullock: Distinguished Fellow*, 88 AM. ECON. REV. 663, 663 (1998), *reprinted in* 1 VIRGINIA POLITICAL ECONOMY: THE SELECTED WORKS OF GORDON TULLOCK xxvii (Charles K. Rowley ed., 2004) (singling out Tullock's 1967 paper as one of his main contributions to economic thought).

regimes. Finally, section E traces the intellectual lineage of the newly proposed irredeemable-acts category, placing it in a broader theoretical perspective.

A. THE WELL-KNOWN ANALYSIS OF CONTINGENTLY INEFFICIENT ACTS

Although the list of socially wasteful human actions is, no doubt, long, the fundamental causes of inefficiency are quite limited. The main problems for parties engaged in direct interpersonal negotiations are asymmetric information and strategic behavior.[13] Actions undertaken in impersonal markets produce inefficient outcomes when markets fail. Perhaps the most important causes of such failures are externalities—"effect[s] of one person's decision on someone who is not a party to that decision."[14] Private actors do not take externalities into account because these actors do not bear the costs of negative externalities and cannot capture the benefits of the positive ones.

The solution to the externality problem is well-known. A legal regime that fully internalizes all external costs and benefits restores the operation of Adam Smith's "invisible hand."[15] Selfish individuals optimizing their own well-being unwittingly and inescapably maximize social welfare. Sometimes they abandon the externality-producing activity altogether. Frequently, however, they adjust the form or the level of the activity while continuing to engage in it. Because many inefficient private actions may be made efficient through this internalization process, I refer to them as *contingently* inefficient acts.

There are many ways of forcing private actors to take full account of negative externalities they produce. Strict liability harm-based regimes make actors legally liable for all external harms resulting from their actions. Strict liability act-based regimes force individuals to bear the cost of their risky behavior before any actual harm arises.[16] Products liability in torts is an example of the former regime.[17] Alcohol taxes supported by a rationale that drunks endanger the public and burden the socially subsidized healthcare system are an example of the latter.[18]

An alternative approach is to impose liability only on actions that cross a certain threshold beyond which marginal external harms produced by the acts exceed their marginal private benefits, at least on average.[19] As is true in the

13. "'[S]trategic behavior' is concerned with influencing another's choice by working on his expectation of how one's own behavior is related to his." THOMAS C. SCHELLING, THE STRATEGY OF CONFLICT 15 (1980).

14. R. H. COASE, THE FIRM, THE MARKET AND THE LAW 24 (1988).

15. ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS 423 (Edwin Cannan ed., Modern Library 1937) (1776).

16. The terms "strict liability," "harm-based," and "act-based" are standard in the economic analysis of law. *See, e.g.*, STEVEN SHAVELL, FOUNDATIONS OF ECONOMIC ANALYSIS OF LAW 474 (2004).

17. *See* W. PAGE KEETON ET AL., PROSSER AND KEETON ON THE LAW OF TORTS 536–38, 690–702 (5th ed. 1984).

18. *See* 1 ALFRED C. PIGOU, THE ECONOMICS OF WELFARE 192 (Cosimo Classics 2005) (1920).

19. Whenever I refer to private benefits, I mean *net* private benefits—that is, private benefits net of private costs.

case of strict liability, a threshold regime may be harm- or act-based.[20] The traditional law of torts is an example of the former. Numerous regulatory regimes ranging from traffic safety regulation to pollution regulation are instances of the latter.

A strict liability regime forces private actors to bear the external harm of their actions and relies on these actors to optimize their behavior. A threshold regime requires the government to determine the line beyond which private actions become inefficient. In a harm-based regime, liability is equal to the external harm, with a few well-known adjustments.[21] In an act-based regime, sanctions are equal to the expected external harm, appropriately adjusted as well.[22]

What if policymakers botch the line-drawing exercise in a threshold regime? What if they miscalculate the external harm or risk of harm in a strict liability or a threshold regime? If the line is drawn too favorably for the offenders (or if harm or risk of harm is underestimated), the result is underdeterrence. Some socially undesirable acts occur, producing greater social harms than benefits. For instance, people drive too fast and cause numerous serious accidents. If the line is drawn too favorably for the victims (or if harm or risk of harm is overestimated), the result is also inefficient. This time the problem is overdeterrence—some efficient acts are precluded by a threat of liability. For example, people drive so slowly that economic activity is greatly impeded and significant leisure time is consumed by commuting. Overdeterrence can be as socially costly as underdeterrence.

Needless to say, this discussion is not even a bare-bones summary of the economic analysis of contingently inefficient acts. It suffices, however, to emphasize the key points. Devising rules and sanctions that deter these acts optimally is a challenge. In harm-based regimes, over- and underdeterrence result if the legal system miscalculates the external harm (appropriately adjusted). In act-based regimes, the same problems occur if regulators err in estimating the expected external harm or in setting the threshold separating legal and illegal conduct. Thus, the optimal regulation of contingently ineffi-

20. I use the term "threshold" regime rather than the standard term "fault-based" regime, *see, e.g.*, SHAVELL, *supra* note 16, at 474, because the standard term is uninformative (and perhaps somewhat misleading) when applied to many legal thresholds outside of such traditional subjects of law and economics analysis as accidents and pollution. For instance, it is difficult to imagine why a rule that imposes one tax regime if a foreign individual spends 183 days in the United States during a calendar year and a different tax regime if that individual spends 182 days in the United States has anything to do with fault. *See* I.R.C. § 7701(b)(3) (2006 & Supp. V 2011) (stating a more complicated version of the 183-day rule).

21. These include adjustments to account for uncertain detection and the cost of the legal system. For a detailed discussion of uncertain detection, see Richard Craswell, *Deterrence and Damages: The Multiplier Principle and Its Alternatives*, 97 MICH. L. REV. 2185, 2211–23 (1999). For a model incorporating the cost of the legal system, see A. Mitchell Polinsky & Steven Shavell, *Enforcement Costs and the Optimal Magnitude and Probability of Fines*, 35 J.L. & ECON. 133, 133 (1992) [hereinafter Polinsky & Shavell, *Enforcement Costs*]. For a general discussion, see Polinsky & Shavell, *supra* note 5.

22. *See* Polinsky & Shavell, *Enforcement Costs*, *supra* note 21, at 133–34.

cient acts is a balancing act, and the risk of impeding efficient forms or levels of these activities is a key consideration in the balancing process.

B. THE MISSING ANALYSIS OF IRREDEEMABLE ACTS

Alfred C. Pigou's analysis of externalities is widely viewed as providing the fundamental economic justification for government regulation in a wide variety of settings.[23] Yet Pigou recognized that externalities are not the only problem that may justify a regulatory intervention. Advertising, he suggested, may amount to an unproductive arms race to lure competitors' customers.[24] Despite subsequent scholars' attention to Pigou's work on externalities, his insight that efforts to capture a greater share of a fixed pie may lead to significant social waste has remained unexplored for decades.

That changed with Gordon Tullock's article, which is generally viewed as laying the foundation for a vast literature on rent seeking.[25] Tullock's argument rebutted the optimistic view (prevalent at the time) that the welfare costs of monopolies and tariffs were likely to be small. This view rested on the empirical conclusion that deadweight losses resulting from monopolies and tariffs were insignificant. Economists realized, of course, that price distortions giving rise to deadweight losses were not the only economic effects to be considered. Monopolizing an industry or convincing a regulator to impose an import tariff also transfers wealth from consumers to the monopolist or the domestic producers. But that transfer, economists emphasized, is not a social loss in and of itself because, though some members of the society lose from it, others gain exactly as much. Monopolists and domestic producers get richer, consumers get poorer. Although this rearrangement surely has distributive consequences, no inefficiency results from the mere movement of money within the society.

Tullock revealed the fundamental flaw of this analysis, using theft as an intuitive example.[26] Theft, he pointed out, is the simplest case of a pure transfer. It gives rise to no deadweight loss (at least in the first approximation). Traditional analysis strongly suggests that welfare-maximizing policymakers should care little about combating theft. Yet just about every society not only outlaws it, but subjects thieves to high sanctions. Is this a misguided waste of resources?

Surely not, Tullock explained. Although theft is indeed a welfare-neutral

23. *See* PIGOU, *supra* note 18, at 192–203.

24. *See id.* at 196–200 (discussing "competitive advertisement directed to the sole purpose of transferring the demand for a given commodity from one source of supply to another" and explaining why the "social net products" of such advertising "is likely to indicate negative values throughout"). Pigou recognized that advertising may also serve a socially useful purpose of informing consumers. *See id.* at 196.

25. *See* Tullock, *supra* note 6; William C. Mitchell & Michael C. Munger, *Economic Models of Interest Groups: An Introductory Survey*, 35 AM. J. POL. SCI. 512, 523 (1991) ("[T]he formal origin of the modern study of rent seeking dates back to Tullock's brief but now classic essay of 1967 . . . ."). The term rent seeking is widely used but not well-defined. For a discussion of several definitions, see *infra* text accompanying notes 70–73.

26. *See* Tullock, *supra* note 6, at 228–31.

transfer in and of itself, it involves very real private gains and losses to thieves and their victims. A thief's expenditures may take the form of purchasing lock-breaking equipment and learning how to break locks, find valuables, conceal stolen goods, and so on. A victim's efforts may include purchasing locks and safes, and hiring private security guards. Less obvious social costs arise as well. Thieves forgo other, productive activities. Putative victims have weaker incentives to earn and save because their savings may be stolen. Deadweight losses result from these decisions by thieves and victims alike. Broadening the lens further reveals other possible costs. If unchecked, theft will distort asset prices. The value of readily movable assets (such as jewelry) would be depressed by the threat of theft. Thus, theft may give rise to negative externalities after all. These externalities, along with the direct expenditures and deadweight losses just described, are pure social waste. Although this analysis is known in the literature, no term has emerged to refer to all the costs just described.[27] Because all these costs are incurred to effect or resist "mere" transfers, I call them the *transfer costs*. Clearly, these costs may be very substantial. No wonder most societies outlaw theft.

Tullock's point was that the same analysis applies to transfers resulting from monopolies and tariffs. This led him to conclude that the social costs of these activities are much greater than what one would think by focusing on dead-weight losses alone. Tullock did *not* argue that theft and monopolies are fundamentally different phenomena, and he did *not* suggest that many other activities are very close to theft (at least money theft) in their irredeemable inefficiency.

This Article makes both arguments. Theft and monopolies are indeed fundamentally different because having a monopoly is a contingently inefficient act, and money theft is not. Although monopolies certainly give rise to social-welfare losses, they may also lead to welfare gains. (The same is true of advertising, as Pigou emphasized long ago.)[28] A monopoly may reflect a socially beneficial tradeoff between productive and allocable efficiency, give rise to substantial economies of scale, facilitate innovation, and yield other social benefits.[29] This is not to say that having a monopoly is always socially desirable, only to emphasize that the opposite is not always true. As long as this

27. For example, these costs (or their components) have been called "Tullockian rent seeking costs," Philip Jones & John Cullis, *Legitimate and Illegitimate Transfers: Dealing with "Political" Cost-Benefit Analysis*, 16 INT'L REV. L. & ECON. 247, 251 (1996), "secondary costs," Keith N. Hylton, *The Theory of Penalties and the Economics of Criminal Law*, 1 REV. L. & ECON. 175, 180 (2005), "the losses due to the antisocial pursuit of self-interest," Victor Goldberg, *Reflections on the Welfare Loss Rectangle*, 4 INDUS. ORG. REV. 151, 152 (1976), the costs of "rent avoidance" and "rent protection," Brooks & Heijdra, *supra* note 6, at 37, the costs of "defensive measures," Richard L. Hasen, *Lobbying, Rent-Seeking, and the Constitution*, 64 STAN. L. REV. 191, 230 (2012), and the costs arising from the "[e]fforts to protect and to take property," Kaplow & Shavell, *supra* note 8, at 769.

28. *See* PIGOU, *supra* note 18, at 196–200.

29. *See* HOVENKAMP, *supra* note 7, at 61–64; *see also* Verizon Commc'ns Inc. v. Law Offices of Curtis V. Trinko, LLP, 540 U.S. 398, 407–08 (2004) ("The opportunity to charge monopoly prices—at

is so, regulation of monopolies will involve a tradeoff between deterring socially wasteful monopolies and not deterring socially useful ones. This tradeoff—which exists even if enforcement is costless—is the quintessential challenge of regulating contingently inefficient acts.

Money theft is different. Because money has no intrinsic value, the offender's utility gain is always equal to the victim's utility loss.[30] Necessarily, the net social gain from the transfer viewed in isolation is zero. But the transfer inevitably gives rise to the social costs already discussed. These costs make money theft necessarily inefficient. If it could be deterred without cost, its optimal level would be zero. In a legal system that forces thieves to take account of all external harms produced by their actions, theft would not exist. In contrast with contingently inefficient acts that may be converted from their inefficient form into their efficient form through the harm-internalization process, theft cannot be adjusted in a way that would make it efficient. A theft made efficient is no theft at all. That is why I call theft and other acts that have the same fundamental features *irredeemably* inefficient (or *irredeemable*) acts.

Irredeemable acts are private, intentional, nonconsensual transfers of money or money equivalents. These transfers may take many forms, and it is worth examining at least one of them at this point in order to see how the economic analysis of theft applies to other activities. Consider churning—a discretionary securities trading by a broker in order to generate fees for himself rather than to benefit the customer.[31] A churning broker intentionally transfers money from the customer to himself, and the customer would surely object to that transfer if she knew about it. As with theft, both the intentional and the nonconsensual aspects of churning are essential for its irredeemable character because both are needed to ensure the existence of the transfer costs. If the trading is consensual, the customer has nothing to worry about (so no costs are incurred to prevent such trading). If the broker unintentionally executes more trades than the customer might have wanted, the customer may be dissatisfied and may even decide to switch to a different, more attentive broker. But an entirely different level of unhappiness is ensured if the customer suspects that the broker deliberately executes trades not to further the customer's interest, but to enrich himself. The desire to prevent this from happening is the source of the transfer cost on the customer side.[32] The critical role of intent is even clearer on the broker side. Neither a broker executing trades with the customer's consent, nor a broker mistakenly engaging in excessively frequent trading (from the customer's perspective) has anything to hide. Neither broker has a reason to conceal the

least for a short period—is what attracts 'business acumen' in the first place; it induces risk taking that produces innovation and economic growth.").

30. The discussion of variations in the marginal utility of money between the thief and the victim is deferred until Part IV.

31. *See* LOUIS LOSS & JOEL SELIGMAN, FUNDAMENTALS OF SECURITIES REGULATION 1097 (4th ed. 2004).

32. These costs include the customer's time and effort to monitor her broker as well as the reduction in, or even withdrawal from, securities trading by the customer for fear of churning.

trading, to mislead the customer, to fabricate the records, and so on. Hence, neither broker will incur any of the costs accompanying these activities. In contrast, a churning broker will engage in some or all of these evasive tactics, ensuring the existence of the transfer cost on his side of the irredeemably inefficient act of securities churning.

Money theft and churning have more in common than their unambiguous inefficiency—both are illegal. The same is true of almost all other irredeemable acts. Whether societies care about social welfare a lot, a little, or not at all, laws reflect a uniform disdain for these offenses. Yet no society is free of theft, churning, and many other irredeemably inefficient acts. Fully deterring these activities is difficult—why so?

The difficulty arises because every irredeemable act involves concealment.[33] Those engaged in these acts avoid exposure by hiding either their connection to the act or the nature of the act itself. A burglar's decision to wear a face mask and a pickpocket's effort to remain unnoticed while removing a wallet from a purse exemplify the former approach. The latter, more sophisticated strategy is possible because many irredeemable acts produce outcomes that may also result from activities that are both entirely legal and consistent with a perfectly efficient regime used by economists as a baseline to evaluate the costs of possible deviations.[34]

Theft itself presents this problem. If we observe one individual removing $20 from another person's pocket and conclude that an act of theft just occurred, we would surely rush to judgment. Perhaps we have observed a mere repayment of an outstanding debt—that is, an exercise of the transferor's property rights that constitute a welfare-maximizing baseline regime.[35]

Similarly (and more realistically), churning results in a certain number of trades executed over a fixed period of time. The same trades may also result, however, from the decisions of a faithful broker acting in the best interest of his client. Yet when a court observes the trades, it cannot be certain whether they reveal socially detrimental churning or socially desirable exercise of the broker's best judgment. Everything turns on the broker's intent, and that intent is difficult to ascertain.

This uncertainty is critical in understanding why overdeterrence is a serious concern in regulating irredeemable acts. Even though these acts give rise to no

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33. I do not address nonconsensual transfers of money carried out by force because such transfers present issues beyond the scope of this Article's analysis. *See infra* text accompanying notes 236–40. I also do not address blackmail—an irredeemable act where coercion replaces concealment—in order to focus on the core and basic case. Finally, because irredeemable acts are limited to private acts, they do not cover efforts to effectuate transfers through government coercion (such as lobbying).

34. *See, e.g.*, Brooks & Heijdra, *supra* note 6, at 44 (discussing the property rights baseline); Goldberg, *supra* note 27, at 151 (discussing the perfect competition baseline); Keith N. Hylton, *Intent in Tort Law*, 44 VAL. U. L. REV. 1217, 1237 (2010) (discussing the ideal market baseline).

35. *See* Dean Lueck & Thomas J. Miceli, *Property Law*, *in* 1 HANDBOOK OF LAW AND ECONOMICS 183, 186 (A. Mitchell Polinsky & Steven Shavell eds., 2007) ("[W]e argue that property rights and property law can be best understood as a system of societal rules designed to maximize social wealth.").

social benefits and are always inefficient, imperfect enforcement means that legal rules and sanctions aimed at deterring irredeemable acts necessarily penalize some benign look-alike activities. These activities belong to the relevant ideal baseline regime used by analysts as a benchmark. In the securities regulation context, this baseline is the efficient capital market, in which accurate, publicly available information about companies flows to investors who make their trading decisions aided by informed advisors and execute these decisions with the assistance of trustworthy agents such as stockbrokers. Given that baseline, mistakenly labeling faithful trading by brokers as churning and subjecting it to sanctions is socially costly. It leads to a less liquid, less efficient capital market, and more poorly diversified investors. I refer to the social cost of such mislabeling as the *mislabeling cost*. The broader the rules (that is, the more possible irredeemable acts they are likely to cover), the higher the sanctions, the greater the mislabeling cost.

The mislabeling cost is not the only cost of deterring irredeemable acts. Given that perfect enforcement is impossible (or, in any case, implausible), some such acts remain undeterred. The stronger the deterrence, the higher the transfer costs incurred by those engaged in undeterred irredeemable acts. It is easy to churn if brokers can avoid liability as long as they do not engage in rapid electronic trading. It is much costlier to churn if the only way to avoid liability is to have an explanation for every trade above a certain low number.[36] Granted, fewer brokers will churn in the latter case because some putative churners will give up and comply with the law. Others will resist, however, and incur very high transfer costs trying to circumvent the broader rules. This "bad things getting worse" effect of stronger deterrence is pervasive—it presents a challenge of regulating contingently and irredeemably inefficient acts alike. Yet this effect is often ignored in the literature.[37] There is not even a term to

36. In churning litigation, this number is called the "turnover rate." *See* LOSS & SELIGMAN, *supra* note 31, at 1100. For a more detailed example making the same point in the price-fixing context, see Louis Kaplow, *An Economic Approach to Price Fixing*, 77 ANTITRUST L.J. 343, 361 (2011).

37. It is instructive that, with one exception, the chapter on the public enforcement of law in the *Handbook of Law and Economics* (written by the leading scholars on the subject) makes no mention of the bad-things-getting-worse phenomenon despite discussing a range of social costs of greater enforcement. *See* Polinsky & Shavell, *supra* note 5, at 403. The exception focuses on secondary considerations—extortion under a threat of framing (which is itself a nonconsensual money transfer). *See id.* at 440–42. Kaplow does allude to some instances of the bad-things-getting-worse phenomenon in his recent work. *See* Kaplow, *supra* note 36, at 361 ("[S]uccessful interdependent oligopoly pricing can be worse than old-fashioned explicit cartels because the latter might be able to rationalize production and thus achieve some efficiencies that will not result from mere coordinated price elevation."). However, he neither generalizes his examples nor incorporates them in the basic tradeoff underlying his analysis of price fixing. *See id.* at 346 ("An economic approach to regulating oligopolistic price elevation . . . seeks to determine liability and apply sanctions based primarily on the deterrence benefits that result as well as any chilling of desirable behavior that may arise, in addition to the costs of operating the regime."). It does not appear that Kaplow includes the costs of undeterred price-fixing conspiracies in the "costs of operating the regime." Tax literature appears to be the only place where the bad-things-getting-worse phenomenon is widely recognized. Even in that literature, the social cost of this phenomenon has no established name or clear definition. *See* Alex Raskolnikov, *Accepting the*

describe the cost of this phenomenon. I will refer to it as the *resistance cost*, alluding to the offenders who resist regulatory efforts to eliminate irredeemable acts.

The existence of the mislabeling and resistance costs means that irredeemably inefficient acts present policymakers with a tradeoff. On the one hand, greater deterrence of irredeemable acts reduces their total transfer cost because some such acts no longer occur. On the other hand, the marginal mislabeling cost increases with greater deterrence. Stronger enforcement also increases the marginal resistance cost on the per-act basis, but the overall resistance cost may increase or decline overall. Fewer offenders are resisting, but each resists more. The overall effect depends on whether the higher per-act resistance costs offset the reduction in the number of irredeemable acts persisting despite stronger deterrence. Given this tradeoff, full deterrence of irredeemably inefficient acts is not a welfare-maximizing social objective. In fact, it is quite possible to overdeter irredeemable acts even though social welfare would certainly increase if these acts magically disappeared altogether. Therefore, our legal system's restraint in regulation of theft and churning is well justified.

This is not to say that the specific rules regulating theft, churning, and other irredeemable acts are socially optimal. Before evaluating these rules in detail, it is useful to put the proposed contingent–irredeemable distinction into sharper focus and to demonstrate its practical relevance.

C. WHAT IS DIFFERENT AND UNIQUE ABOUT IRREDEEMABLE ACTS?

Having identified the social costs of irredeemable acts and the challenges of deterring them, we are now in a position to compare these challenges with the familiar difficulties of regulating contingently inefficient acts. The comparison reveals a number of distinctions related to the role of private benefits, the importance of intent, and the binary versus continuous choice underlying the optimization process. All these distinctions have implications for the design of optimal legal rules and sanctions, which are discussed in the next Part.

First, although both contingently and irredeemably inefficient acts present policymakers with tradeoffs, the two tradeoffs are different. Regulating contingently inefficient acts requires an inquiry into the activity's marginal costs and benefits. In contrast, regulating irredeemable acts requires the balancing of costs.[38] The optimal regulation of contingently inefficient acts strives to maxi-

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Limits of Tax Law and Economics, 98 CORNELL L. REV. 523, 539 (2013). For a related discussion of increased risk-bearing by undeterred offenders, see generally A. Mitchell Polinsky & Steven Shavell, *The Optimal Tradeoff Between the Probability and Magnitude of Fines*, 69 AM. ECON. REV. 880 (1979).

38. Note that the negligence standard associated with the Learned Hand formula is not contrary to the statement in the text. This standard states that conduct is negligent if the cost of a possible precaution is lower than the expected cost of accidents, appearing to compare one kind of cost to another. *See* United States v. Carroll Towing Co., 159 F.2d 169, 173 (2d Cir. 1947). This balancing of costs, however, makes sense only if the conduct is assumed to be socially desirable (meaning that its

mize the good. The optimal regulation of irredeemable acts aims to minimize the bad.

Second, the main concern with overdeterring contingently inefficient acts is typically expressed as the concern with the "chilling of socially valuable . . . activity."[39] Although the term "chilling" is occasionally used in discussing what this Article calls irredeemable acts,[40] I use a new term, "mislabeling cost," for this purpose to highlight the different nature of the overdeterrence concern. Chilling is a problem when the acts *themselves* produce private (as well as social) benefits. In contrast, mislabeling is a concern with burdening beneficial acts *different from* the irredeemable ones. The chilling concern calls for a *substantive* analysis of costs and benefits of a given act. The mislabeling concern leads to an *evidentiary* question about what kind of act took place.

Third, the economic analysis of contingently inefficient acts has not developed a generally accepted explanation for the role of intent (or any other mental state) in their regulation.[41] After all, $100 worth of external harm is worth $100 whether the harm is intentional, reckless, negligent, or nonnegligent. This conception of harm is often difficult to square with legal doctrine. A few scholars who do offer economic interpretations of intent treat it as an indicator of some objective state of events such as the magnitude of harm, various probabilities,[42] or the cost of acquiring certain information.[43]

In contrast, intent to carry out a nonconsensual transfer is at the center of the economic analysis of irredeemable acts. Moreover, this intent is a real mental-

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private benefits exceed its external harm, that is, the optimal level of the conduct is greater than zero). *See* Polinsky & Shavell, *supra* note 5, at 424–27.

39. Louis Kaplow & Carl Shapiro, *Antitrust*, *in* 2 HANDBOOK OF LAW AND ECONOMICS 1073, 1194 (A. Mitchell Polinsky & Steven Shavell eds., 2007) (referring to chilling as the "most important" concern in regulation of monopolies); *see also* SHAVELL, *supra* note 16, at 475 (explaining in the general discussion of public enforcement of law that "if the sanction is greater than harm, there will sometimes be a chilling effect on desirable acts; parties may be discouraged from acts that create greater benefits than harm").

40. *See* Kaplow, *supra* note 36, at 366.

41. "Economic analysis of law has expressed puzzlement at the intent rules in the law . . . . Under the standard economic approach, which focuses on internalization of external costs, the actor's intent would appear to be irrelevant." Hylton, *supra* note 34, at 1242.

42. *See* Richard A. Posner, *An Economic Theory of the Criminal Law*, 85 COLUM. L. REV. 1193, 1221 (1985) (arguing that the intent requirement in the criminal law relates, *inter alia*, to probability of apprehension and conviction); Steven Shavell, *Criminal Law and the Optimal Use of Nonmonetary Sanctions as a Deterrent*, 85 COLUM. L. REV. 1232, 1248 (1985) (suggesting that the intent requirement in the criminal law relates to probabilities of harm and escaping from sanctions, as well as to the magnitude of harm). Although both of these articles are almost thirty years old, a recent book by Steven Shavell essentially restates his brief 1985 analysis of intent without further elaboration or empirical support. *See* SHAVELL, *supra* note 16, at 553–54.

43. *See* Jeffrey S. Parker, *The Economics of Mens Rea*, 79 VA. L. REV. 741, 745–46 (1993). The exception to the economic interpretation of intent as an indicator for some objective value (be it harm, probability, or cost) is Judge Posner's suggestion that the intent requirement "is just a locution that laymen use to describe a pure coercive transfer." Posner, *supra* note 42, at 1221. Posner's example is theft, so his argument supports my assertion about the distinctive character of theft (and other theft-like acts).

state criterion and not an indicator of something else.[44] Therefore, it is easy to explain why legal regulation of many such acts often hinges on the intent determination.

Fourth, not only is intent important in the economic analysis of irredeemable acts, it is determinative. The only difference between inefficient churning and efficient good faith brokerage is the broker's state of mind. The same is true of the distinction between inefficient theft and efficient exercise of one's property rights, as Judge Richard Posner recognized decades ago.[45] Because intent is both critically important and difficult to establish, irredeemable acts present courts with challenges that most contingently inefficient acts do not raise.[46]

Finally, contingently inefficient acts typically represent points on a continuum that seamlessly connects clearly inefficient and clearly efficient forms or levels of a given activity. There is no sharp line dividing outrageous speeding and extremely safe driving, full sobriety and total drunkenness, a perfect truth and a complete lie in corporate disclosure. In contrast, churning and faithful brokerage are not two points on a continuum. Rather, they are completely distinct acts separated by an unbridgeable void. The difference between these acts turns on the broker's intent, which is either to benefit the broker or to benefit the customer. The question "would you have executed the exact same trade without taking your commission into account" has a yes or no answer.[47] The choice between churning and good faith brokerage (as well as between any other irredeemable act and its benign look-alike counterpart) is a binary choice.

All these distinctions matter in the real world. To recognize the importance of drawing them, one needs to appreciate the scope of the irredeemable-acts category. The next section addresses this question.

D. IRREDEEMABLE ACTS: FURTHER EXAMPLES

Theft and churning are hardly the only irredeemable acts. Several other examples come from the very area Tullock studied in his seminal article—regulation of competition. Specifically, all forms of the so-called naked collusion—agreements among competitors that are "unrelated to any organization of production or distribution"[48]—are irredeemable acts. They include naked price fixing

44. In contrast, in his economic analysis of intent in tort law, Keith Hylton explains that "intent standards are objective, in the sense that they do not depend on what was actually in the mind of the defendant when he acted." Hylton, *supra* note 34, at 1220.

45. "[T]he external acts involved in [stealing someone's umbrella and in taking the umbrella by mistake] are the same; *only the state of mind with which they are done provides a clue to the difference in their economic character*." Posner, *supra* note 42, at 1221 (emphasis added). Posner generalized from property theft to the entire criminal law. My extension of the economic analysis of theft is much more limited.

46. After all, intent is irrelevant in the economic analysis of many contingently inefficient acts and is usually only one of several relevant factors when it does play a role.

47. A "maybe" in this context is equivalent to a "no"; that is, only a "yes" is an acceptable answer for a customer suspicious of churning.

48. *See* HOVENKAMP, *supra* note 7, at 195.

and bid rigging, as well as some other forms of market division. In each case, the colluding firms in essence transfer money from consumers to themselves. This is done intentionally (that is, with an intent to benefit from collusively set prices). And consumers surely do not consent to being fleeced. Because the only result of these activities is a money transfer, they lead to no efficiency gains. At the same time, numerous social costs arise. Thus, all forms of naked collusion are irredeemable acts.

Given the key role that theft played in developing the irredeemable-acts concept, it is hardly surprising that criminal law offers plenty of examples. They range from the traditional common law offenses of larceny and embezzlement to some of the numerous statutory crimes such as mail and wire fraud. Where such offenses involve money (rather than property), the irredeemable-acts definition fits well. All these offenses involve intentional, nonconsensual transfers.[49] The same is true of the tort of conversion.[50] In every case, the offender interferes with the victim's basic exercise of property rights (the ideal efficient baseline), giving rise to the transfer costs. And in most cases, the offender's hope is that the victim will not realize what happened.

Securities and commodities markets provide especially fertile grounds for irredeemable acts. Market intermediaries have invented seemingly limitless ways to enrich themselves by, in essence, stealing other people's money.

Insider trading (when limited to actual insiders rather than tippees[51]) is the most notorious one. Insiders enrich themselves financially, that is, they transfer money to themselves. They do so intentionally in that they intend to profit from inside information. The entities to which the inside information belongs do not consent to its use in this way and neither do other market participants.[52] Market manipulation is another example. Again, the manipulators enrich themselves intentionally at the expense of market buyers and sellers who would have objected to buying and selling at artificially inflated or deflated prices if they could.[53] Front-running—a broker's trading ahead of a large customer order to profit from the price move resulting from that order—is a species of insider

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49. *See* WAYNE R. LAFAVE, CRIMINAL LAW § 19.5, at 987, § 19.7, at 1005–06 (5th ed. 2010).

50. *See* KEETON ET AL., *supra* note 17, § 15, at 88–90.

51. Insider trading by tippees is not an irredeemable act because tippees may be fully aware that they trade on inside information (intent to effectuate a nonconsensual money transfer is present), completely unaware of this (intent is absent), or anything in between.

52. For a discussion, see LOSS & SELIGMAN, *supra* note 31, at 919–22.

53. For a discussion of securities market manipulation, see *id.* at 1119–37. For a discussion of commodities market manipulation, see Prohibition on the Employment, or Attempted Employment, of Manipulative and Deceptive Devices and Prohibition on Price Manipulation, 76 Fed. Reg. 41,398, 41,406–08 (July 14, 2011) (codified at 17 C.F.R. pt. 180); Antidisruptive Practices Authority, 76 Fed. Reg. 14,943, 14,945–47 (proposed Mar. 18, 2011). For the argument that manipulation turns entirely on intent, see Daniel R. Fischel & David J. Ross, *Should the Law Prohibit "Manipulation" in Financial Markets?*, 105 HARV. L. REV. 503, 510 (1991) (arguing that the only definition of manipulation "that makes any sense is subjective—it focuses entirely on the intent of the trader").

trading.[54] Not surprisingly, customers resent it.[55] Scalping is a version of front-running carried out on the basis of self-produced information.[56] Here, clients receiving investment advice are the victims who would object to the advisor's profiteering while he undertook to deliver the benefits of his research to them. Cherry-picking—a broker's trading alongside her customers while taking advantage of the cheapest execution prices and burdening the customers with the least favorable ones—comes close to outright theft.[57] The same is true of churning. This is hardly a complete list.[58]

Corporate governance is yet another area where irredeemable acts appear to be proliferating. Some are blatant; others are more subtle. In each case, corporate officers and directors act in a manner that is inconsistent with the ideal corporate-governance baseline featuring loyal fiduciaries faithfully exercising their informed business judgment for the benefit of the shareholders.[59]

Option backdating is an example of the blatant variety.[60] Corporate boards that approved issuances of backdated stock options simply lied to the shareholders. They represented that these options were issued at the money on a certain date, though in fact they were issued on a later date when the stock price was higher. What looked like an at-the-money option to shareholders was in fact a more valuable in-the-money option.[61] Despite the large sums and the financial sophistication of the parties involved, the offenders' plan is the same as that of a pickpocket—hope that the victims do not realize that they are being ripped off. Note that the beneficiaries of option backdating were often the executives who

54. The inside information in this case comes from the customer who reveals to the broker a plan to place a large buy or sell order. Front-running has been described as the practice that "takes money from investor's pockets and puts it in brokers' pockets." David M. Bovi, *Rule 10b-5 Liability for Front-Running: Adding a New Dimension to the "Money Game,"* 7 ST. THOMAS L. REV. 103, 105 (1994) (quoting Linda Sandler, *Brokers' Practice of Trading for Own Accounts Before Filling Customer Orders Irks Investors*, WALL ST. J., Feb. 17, 1988, at 57) (internal quotation marks omitted).

55. *See id.* at 109–10.

56. *See, e.g.*, SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 196–97 (1963).

57. *See, e.g.*, SEC v. K. W. Brown & Co., 555 F. Supp. 2d 1275, 1289–90 (S.D. Fla. 2007).

58. *See* LOSS & SELIGMAN, *supra* note 31, at 1061, 1066 (describing brokers misappropriating client's funds in a variety of ways). The point that securities fraud in secondary markets has many similarities to theft is not new to the literature. *See, e.g.*, Janet Cooper Alexander, *Rethinking Damages in Securities Class Actions*, 48 STAN. L. REV. 1487, 1496 (1996) ("[W]hen securities violations occur, wealth is redistributed among investors but the net effect is a transfer from one group of investors to another. The net social cost, as measured solely by trading gains and losses, arguably is zero." (emphasis omitted)); Paul G. Mahoney, *Precaution Costs and the Law of Fraud in Impersonal Markets*, 78 VA. L. REV. 623, 630 (1992) ("In this respect, securities fraud is no different from theft."). However, these analogies fail to distinguish irredeemable variants of securities fraud from contingently inefficient ones. For an analysis of broker misconduct along the lines suggested by Tullock, see Frank H. Easterbrook & Daniel R. Fischel, *Optimal Damages in Securities Cases*, 52 U. CHI. L. REV. 611, 648–49 (1985).

59. *See, e.g.*, Leo E. Strine, Jr. et al., *Loyalty's Core Demand: The Defining Role of Good Faith in Corporation Law*, 98 GEO. L.J. 629, 635–40 (2010) (describing the fiduciary duties).

60. *See* Ryan v. Gifford, 918 A.2d 341, 357–58 (Del. Ch. 2007). *See generally* David I. Walker, *Unpacking Backdating: Economic Analysis and Observations on the Stock Option Scandal*, 87 B.U. L. REV. 561 (2007).

61. An at-the-money call option allows its owner to purchase securities for their current market price; an in-the-money call option allows its owner to purchase securities for a below-market price.

received the options rather than the directors who approved option issuances. This complication does not change the analysis. The key features of an irredeemable act are an intentional action, a transfer of money, and a transfer that is nonconsensual and concealed. All are present in the backdating case.

Option spring loading and bullet dodging are less blatant examples of irredeemable acts, but they are examples nonetheless. In each case, a board of directors issues an at-the-money option that is very likely to become in the money in a matter of days in light of the board's inside information.[62] It is fairly easy to see that issuing such options is problematic (that is, the transfer is nonconsensual) when the shareholder-approved compensation plan allows for issuances of only at-the-money options.[63] But what if the compensation plan allows for issuance of in-the-money options as well? Even in this case, the issuance is an irredeemable act. As two Delaware Court of Chancery judges recently recognized, even in this case, the Board conceals the transfer from the shareholders.[64] Concealment demonstrates the intentional and nonconsensual nature of the transfer and gives rise to the transfer cost.

The last examples of irredeemable acts come from the tax area. The analysis here is more complicated, but the suggested framework is informative nonetheless. The complexity arises because, in contrast with other legal regimes considered above, it is unclear what is the ideal baseline in the tax setting. In general, public economics views any tax-motivated decision as inefficient.[65] Taxpayers who try to reduce their tax burdens attempt to enrich themselves (transfer money from the public fisc to their own pockets), they conceal their efforts from the government, and the efficiency-maximizing tax collector would surely not consent to this transfer. Thus, in the first approximation, any tax-motivated decision is an irredeemable act.

This conclusion suggests that the ideal tax baseline is a system where no tax-motivated decisions are made. Human nature being what it is, the only way to ensure this is to make tax-motivated decisions impossible. A so-called lump-sum tax leads to precisely that outcome because nothing a taxpayer does changes her lump-sum tax burden. Yet lump-sum taxes have no policy appeal. A nonuniform lump-sum tax based on any relevant, immutable taxpayer character-

62. *See* Weiss v. Swanson, 948 A.2d 433, 439–40 (Del. Ch. 2008) (discussing spring loading and bullet dodging); *In re* Tyson Foods, Inc., 919 A.2d 563, 591–93 (Del. Ch. 2007) (discussing spring loading).

63. *See In re Tyson Foods*, 919 A.2d at 592–93.

64. *See Weiss*, 948 A.2d at 442; *In re* Tyson Foods, Inc., No. Civ. A 1106-CC, 2007 WL 2351071, at *3–6 (Del. Ch. Aug. 15, 2007).

65. This statement does not apply to the decisions reflecting the fact that taxpayers have less money after tax than they would have had in the absence of a tax system (the so-called income effect). It also ignores the so-called Pigouvian taxes. For examples of such taxes, see Raskolnikov, *supra* note 37, at 536–37.

istic is impossible to implement, even approximately. A uniform lump-sum tax is unacceptable on distributional grounds.[66]

If the lump-sum tax is rejected as the ideal baseline, the most plausible alternative is the so-called optimal income tax. This is a progressive tax on labor income that combines a uniform cash payment to every taxpayer with a schedule of flat or declining marginal rates.[67] That system has more in common with the real world than any lump-sum tax does. Yet the optimal tax remains so far removed from the actual tax rules that it is impossible to evaluate most of these rules (and sanctions used to enforce them) by reference to this ideal baseline. Without this comparison, one cannot decide whether any particular taxpayer decision is an irredeemable act or its benign look-alike counterpart.

Two exceptions to this conclusion make the contingent–irredeemable framework useful in the tax setting. First, the actual income tax does tax labor income under a progressive rate schedule, just like how the optimal income tax suggests. Real-life taxpayers try to escape this tax by shifting income to related lower bracket taxpayers and by recasting their labor income as capital income.[68] These so-called *income shifting* and *character conversion* strategies may be analyzed as irredeemable acts. Yet only a small portion of our tax rules addresses income shifting and character conversion.

Another application of the proposed framework to taxation relies on a fundamental concession. Although economists view all tax-motivated decisions as inefficient, the Internal Revenue Code does not make working less, saving less, or gifting less in order to save taxes illegal (to take just a few examples). But for an important subset of cases, economists' focus on tax motivation is fully reflected in the law. This subset comprises taxpayer actions inconsistent with congressional intent. Needless to say, economic theory has little to contribute to determining that intent. But once a decision maker concludes that a particular tax-minimizing transaction violates the legislature's objective, taxpayer motivation becomes doctrinally important. Within this limited universe of cases, economic reasoning applies. A taxpayer who acts without taking tax consequences into account does nothing inefficient (or illegal) because, though that taxpayer saves taxes (intentionally transfers money to herself), this transfer is not nonconsensual in the relevant sense. In contrast, a tax-motivated taxpayer—that is, the one who intends to take advantage of a particular interpretation of the tax law that is inconsistent with congressional intent—engages in an inefficient (and illegal) irredeemable act.

All these examples suggest that one may find irredeemable acts in many different settings. This variety of possible applications of the proposed framework necessarily highlights the preliminary nature of this Article's discussion. A

66. *See, e.g.*, N. Gregory Mankiw et al., *Optimal Taxation in Theory and Practice*, 23 J. ECON. PERSP. 147, 149 (2009).

67. *See* Raskolnikov, *supra* note 37, at 564.

68. This recasting makes sense for taxpayers because capital income is taxed at a lower rate or is not taxed at all. *See id.*

deep expertise in each substantive area just mentioned is needed to evaluate the fit between the irredeemable-acts category and any particular offense. The purpose of suggesting the irredeemable-acts examples, then, is to facilitate such an inquiry, not to conclude it.[69]

E. IRREDEEMABLE ACTS IN PERSPECTIVE

Irredeemable acts are a new concept, but it has not emerged out of the ether. In fact, it is closely linked to a number of well-known ideas in economic and legal thought. Understanding the intellectual heritage of the irredeemable-acts category is useful in evaluating it.

The closest connection is to the rent-seeking literature. That literature's many intellectual contributions come with at least one significant problem: rent seeking has no clear definition. The narrowest version of the concept limits rent seeking to pure transfers (that is, transfers that are not embedded in potentially socially desirable activities) and only to transfers accomplished through government coercion.[70] Under this definition, lobbying to establish an import quota or a tariff is rent seeking, but theft, advertising, and establishing a monopoly (with or without government support) are not. The broadest definition eliminates both restrictions,[71] expanding the reach of the analysis but making it vulnerable to the charge that "[e]verybody [is] [r]ent-[s]eeking [b]ecause [e]verything's [c]alled [r]ent-[s]eeking."[72] In fact, Tullock himself acknowledges this problem, settling for a not entirely satisfactory conclusion that rent seeking is any activity that includes (though is not necessarily limited to) unproductive use of resources and that ends up being inefficient overall.[73] Although this definition ensures that all rent seeking is inefficient, it says little about the efficiency of any particular type of conduct. Is advertising, having a monopoly, or even lobbying to set a tariff inefficient? Is it rent seeking? It depends.

A related concept of directly unproductive, profit-seeking (DUP) activities[74] narrows the inquiry to pure transfers (thus, it includes theft but not advertising or having a monopoly). Although DUP acts cover both transfers accomplished

69. Therefore, examples used throughout this Article that refer to actual offenses as irredeemable acts should be viewed as shortcuts suggesting that such offenses appear to be plausible candidates for the irredeemable-act categorization.

70. For a discussion of several definitions, see Brooks & Heijdra, *supra* note 6, at 32–33.

71. RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 36 n.4 (7th ed. 2007) ("The tendency of an expected gain to be translated into costs through competitive efforts is called rent-seeking . . . ."); Brooks & Heijdra, *supra* note 6, at 32 ("Rent seeking is the expenditure of scarce resources to capture an artificially created transfer." (quoting Robert D. Tollison, *Rent Seeking: A Survey*, 35 KYKLOS 575, 578 (1982)) (internal quotation marks omitted)).

72. Mark Kelman, *On Democracy-Bashing: A Skeptical Look at the Theoretical and "Empirical" Practice of the Public Choice Movement*, 74 VA. L. REV. 199, 224 (1988).

73. GORDON TULLOCK, *Rent Seeking: The Problem of Definition*, *in* 5 THE RENT-SEEKING SOCIETY: THE SELECTED WORKS OF GORDON TULLOCK 3, 9 (Charles K. Rowley ed., 2005) ("My suggestion is that we use the term 'rent seeking' (and I always have) solely for cases in which whatever is proposed has a negative social impact.").

74. *See generally* Bhagwati, *supra* note 6.

through government coercion[75] and those that are "government free or exclusively private,"[76] the DUP literature has largely focused on the former.

Irredeemable acts are a subset of both rent seeking (broadly defined) and DUP activities. Specifically, irredeemable acts are limited to pure transfers that do not involve government coercion. The former limitation supports the conclusion regarding these acts' definite inefficiency. The latter enables the analysis of their optimal deterrence by welfare-maximizing lawmakers who are not co-opted into carrying out these activities themselves.

The second important intellectual lineage connects irredeemable acts to the economic analysis of taxation. For a number of reasons, a widely shared view among tax academics, practitioners, and policymakers is that decisions made with an intent to reduce one's taxes (usually called tax-motivated) are undesirable only in some circumstances.[77] People's motives are complex and multifaceted, this view holds. Tax-related reasons combine with nontax considerations in a variety of ways. Only when tax motives predominate should Congress consider denying the tax benefits.[78]

Economists and economically oriented tax academics view this position as misguided.[79] In the words of David Weisbach, "[a]nytime anyone alters his behavior because of taxes we have the same problem . . . . The starting point, therefore, should be that all tax planning, all altering of behavior in response to taxes, should be suspect."[80] This statement is a straightforward application of economic analysis. As long as the taxpayer's decision is altered *to any extent* by tax considerations, as long as the decision would not have been *exactly the same* in the baseline hypothetical world without taxes (or, more precisely, in a world with a lump-sum tax raising equivalent revenue), the decision is distorted and inefficient. This analysis views tax motivation (taxpayer intent, in this Article's terms) not only as important, but also as dispositive. Moreover, that motivation is binary. It is either present or it is not. At the same time, tax motivation is private information that is difficult for the government to obtain. That difficulty

75. Or, as Bhagwati himself puts it, "wholly related to governmental policies." *Id.* at 991.

76. *Id.* Bhagwati uses theft as an example of an exclusively private activity. *Id.*

77. These reasons include principles announced in important court decisions, *see* David A. Weisbach, *Ten Truths About Tax Shelters*, 55 TAX L. REV. 215, 220–22 (2002) (discussing cases establishing legitimacy of tax planning), Congress's use of the Internal Revenue Code to create all sorts of incentives, *see id.* 224–25, and the obvious fact that deterring all tax-motivated decisions is simply impossible, *see* Raskolnikov, *supra* note 37, at 540–44 (discussing the undeterrability problem).

78. *See, e.g.*, I.R.C. § 6662(d)(2)(C) (2006) (defining a tax shelter as an arrangement whose "significant purpose" is the avoidance or evasion of tax); *id.* § 7701(o)(1) (2006 & Supp. V 2012) (treating transactions as having "economic substance" only if "the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction"). If a taxpayer has a purpose of reducing her taxes that does not arise to the level of significant or substantial, the tax benefits will be allowed. *See id.*

79. Again, the discussion here does not address Pigouvian taxes. These taxes are a species of regulation of externality-producing activities rather than instruments to raise revenue in order to achieve redistributive goals and finance public goods.

80. Weisbach, *supra* note 77, at 224.

is the key consideration in the economic analysis of optimal taxation. The earlier discussion of intent to engage in any irredeemable act is just an extension of this analysis beyond the tax setting.

Two other precursors of the irredeemable-acts analysis are the property-versus-liability rules framework and the per se–rule of reason distinction in antitrust. The latter is discussed below. As for the former, irredeemable acts are indeed related to the "transfers of things" for which property-rule protection is likely to be more efficient.[81] The connection is both the obvious one (each category addresses transfers) and the less obvious one—social losses that this Article calls the transfer costs support the conclusion about a greater efficiency of property rules.[82] Yet the overlap is far from complete. Irredeemable acts are not limited to transfers of possessory interests, but the transfers of things are. More importantly, the property-versus-liability rules analysis assumes perfect compliance with property rules.[83] In contrast, the policy payoff of conceptualizing irredeemable acts is to devise the optimal regulation of these acts in light of the fact that they cannot be perfectly deterred.

Finally, three contributions appear similar to the proposed analysis but are not. Fred McChesney's theory of crime comes closest. However, McChesney's conclusion hinges on a much stronger assumption than those necessary to support this Article's argument.[84] Louis Kaplow's "[a]cts that [d]efinitely [a]re [u]ndesirable"[85] have only a superficial similarity to irredeemable acts. Definitely undesirable acts are those that produce harms in excess of private benefits. Defined as such, definitely undesirable acts include all irredeemable acts and all contingently inefficient acts that happen to be welfare reducing (without distinguishing between the two).[86] Robert Cooter uses his framework of "prices and sanctions"[87] to analyze both "continuous behavior whose optimal amount is positive for some people" and "discontinuous act[s] whose optimal frequency is zero."[88] Although this sounds very similar to the distinction between contingently and irredeemably inefficient acts, Cooter does not explain which acts are "discontinuous," other than to give an example of a terrible crime and to argue that there are clear community standards critical of many serious crimes.[89] This mode of reasoning is very different from the one offered

81. *See* Kaplow & Shavell, *supra* note 8, at 773.

82. *See id.* at 768–70.

83. *See id.* at 724 n.33, 769.

84. For a description of McChesney's argument and a critique of the strong assumptions underlying it, see *infra* note 240.

85. Louis Kaplow, *The Optimal Probability and Magnitude of Fines for Acts that Definitely Are Undesirable*, 12 INT'L REV. L. & ECON. 3, 3 (1992).

86. Moreover, Kaplow's justification for the assumption that harms exceed benefits for definitely undesirable acts is that the private benefits from these acts are not "legitimate." *Id.* For a criticism of this assumption, see *infra* text accompanying notes 236–39.

87. Robert Cooter, *Prices and Sanctions*, 84 COLUM. L. REV. 1523, 1523 (1984).

88. *Id.* at 1548.

89. *Id.* at 1548–49. Cooter does not explain why community standards are likely to be efficiency maximizing.

here. Despite the differences, all three contributions just mentioned—along with the literatures discussed earlier in this section—are part of the intellectual foundation for the irredeemable-acts analysis.

II. IMPLICATIONS FOR REGULATORY DESIGN

The traditional economic analysis of contingently inefficient acts is useful to legal scholars because it offers clear and intuitive practical guidance. This analysis gives content to abstract terms, informs the design of legal rules, and suggests the optimal structure of sanctions. This Part demonstrates that the proposed analysis of irredeemable acts yields these benefits as well.

A. GIVING CONTENT TO ABSTRACT TERMS

Any first-year law student introduced to law and economics realizes that words do not always mean what they say. Whether one considers the "reasonable" person standard of tort law[90] or the "reasonable and prudent" requirement of traffic safety regulation,[91] a legal economist views the term "reasonable" as a proxy for comparing marginal costs and benefits of any given activity.[92] This cost–benefit tradeoff underlies all thresholds used in regulating contingently inefficient acts.[93]

Irredeemable acts are often regulated by proxies as well. For example, though all irredeemable acts are intentional, nonconsensual transfers, the common law does not define churning as trading by a broker with an intent of self-enrichment. Rather, the antichurning rule only penalizes such trading if it is "excessive."[94] Similarly, competition law does not penalize all price elevations that do not respond to the market forces of supply and demand.[95] Rather, it bans only price increases that result from certain interfirm communications—express (and possibly implicit) "agreements."[96] And tax law allows certain tax-

90. KEETON ET AL., *supra* note 17, § 32, at 173–74.

91. MINN. STAT. § 169.14(1) (2010); R.I. GEN. LAWS § 31-14-2(a) (2010). A similar proxy-based rule requires driving "in a careful and prudent manner and at a . . . rate of speed no greater than is reasonable and proper." MONT. CODE ANN. § 61-8-303(1) (1996). This is the famous "basic rule" that was the law in Montana for decades. For a discussion of this rule's history and application, see Allen M. Brabender, *The Misapplication of Minnesota's Speeding Statute and the Need to Raise the Posted Limit or Expand Use of the Dimler Amendment*, 27 HAMLINE L. REV. 1, 2 (2004).

92. *See* A. MITCHELL POLINSKY, AN INTRODUCTION TO LAW AND ECONOMICS 43–46 (3d ed. 2003).

93. *See* SHAVELL, *supra* note 16, at 476–79.

94. *See* Mihara v. Dean Witter & Co., 619 F.2d 814, 820 (9th Cir. 1980). For a discussion, see LOSS & SELIGMAN, *supra* note 31, at 1097–1101.

95. A price increase motivated by any other considerations necessarily reflects the intent to carry out a concealed, nonconsensual transfer of money—that is, it reflects an irredeemable act.

96. For the outer reach of the agreement requirement, see Am. Tobacco Co. v. United States, 328 U.S. 781, 809–10 (1946) ("No formal agreement is necessary to constitute an unlawful conspiracy. . . . Where the circumstances are such as to warrant a jury in finding that the conspirators had a unity of purpose or a common design and understanding, or a meeting of minds in an unlawful arrangement, the conclusion that a conspiracy is established is justified."). For a discussion, see HOVENKAMP, *supra* note 7, at 166–67, 178–80.

motivated character conversions as long as taxpayers provide themselves with "reasonable" compensation.[97]

The "excessive" trading, "reasonable" compensation, and "agreement" requirements are all proxies.[98] But their economic content is not the cost–benefit comparison familiar from tort law and speeding regulation. Rather, these vague terms substitute for direct inquiries into whether a given outcome reveals an irredeemable act or its benign look-alike counterpart—inquiries that turn on determinations of the actor's intent.

The use of proxies in regulation of contingently as well as irredeemably inefficient acts is not necessarily a reason for concern; the fact that law uses identical terms in both contexts is. Imagine, for example, a judge who has embraced the standard economic interpretation of such terms as "reasonable" or "excessive" in tort law or speeding regulation.[99] He understands that what is really at stake are the marginal costs and benefits of greater care or greater speed.

The judge now faces a churning case with its excessive trading inquiry or a tax dispute that involves the reasonable compensation test. If the judge approaches these cases by comparing the marginal costs and benefits of the activities in question, he would be utterly confused. This confusion would be entirely justified. Churning and tax structuring have no benefits, only costs. They are irredeemable acts that are never socially optimal by themselves. They should be regulated not by comparing costs and benefits, but by balancing the transfer costs with the mislabeling and resistance costs. Unless the judge understands the fundamental difference between contingently and irredeemably inefficient acts, economic reasoning would lead him astray. In contrast, recognizing the irredeemable nature of churning and tax-motivated compensation would enable the judge to proceed with an intelligent analysis in each case.

B. INFORMING THE DESIGN OF LEGAL RULES

Another benefit of appreciating the contingent–irredeemable divide is related to the optimal design of legal rules. Specifically, combining proxy-based and intent-based tests may be optimal for contingently inefficient acts, but is definitely non-optimal for irredeemable ones.

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97. *See* David E. Watson, P.C. v. United States, 668 F.3d 1008, 1016–18 (8th Cir. 2012). For a discussion, see generally Raskolnikov, *supra* note 37; Robert W. Wood & Christopher A. Karachale, Commentary, *Unreasonably Low S Corporation Pay*, 135 TAX NOTES 893 (2012).

98. This point is well understood in the competition literature, less so in the tax literature, and appears to be lost in the securities regulation debates. *See* Louis Kaplow, *Direct Versus Communications-Based Prohibitions on Price Fixing*, 3 J. LEGAL ANALYSIS 449, 478–79 (2011) (discussing the "agreement" requirement); Daniel N. Shaviro, *Economic Substance, Corporate Tax Shelters, and the* Compaq *Case*, 88 TAX NOTES 221, 223 (2000) (arguing that many anti-abuse tax rules have no connection to underlying goals of the income tax without suggesting that some of these rules are proxies for determinations of tax motivation).

99. Wintjen v. Kloeppel, 549 S.W.2d 564, 566 (Mo. Ct. App. 1977) (articulating the requirement to abstain from driving at a "high, dangerous, unreasonable or excessive speed").

Take churning, for example. This irredeemable act is defined as "*excessive* trading [by a securities broker] in disregard of his customer's investment objectives *for the purpose* of generating commission business."[100] This definitional structure parallels that of the general description of securities fraud—"a misstatement or omission of *material fact*, made with *scienter*."[101] Both definitions describe the threshold of liability—materiality in general securities fraud, excessiveness for churning. And both definitions incorporate a mental-state threshold—scienter in general fraud, purpose for churning.

However, what makes sense in general securities fraud (or, more precisely, for contingently inefficient securities law violations) does not make sense for churning (or any other irredeemable act). A policymaker designing the former rule may reasonably conclude that, for instance, accounting misstatements should not lead to liability if they are immaterial because the social cost of such misstatements does not exceed the social benefits of judgment-based accounting rules. Hence, the materiality threshold may be optimal for such misstatements. It is also plausible that the cost–benefit tradeoff calls for a threshold-based regime with recklessness (or some other mental state) serving as the divide between actionable and non-actionable conduct. For example, one may conclude that imposing liability for negligent misstatements (even if material) would severely chill disclosure of any information to the public, undermining the efficiency of capital markets. This analysis justifies a rule that imposes liability only if corporate misstatements meet both the materiality and the scienter thresholds.

But this analysis has no application to churning. The excessiveness requirement here is nothing but a proxy for determining the intent of the accused broker. One may certainly decide that using a proxy is better in this setting than relying on direct inquiries into the putative offender's state of mind.[102] But there is no justification for giving the defendant the benefit of *both* a proxy test and an intent inquiry at the same time.

Imagine that a judge or a jury is convinced that a broker accused of churning did in fact churn the account. Perhaps the customer discovers the broker's diary frankly stating as much. Is there any reason to allow the broker to escape liability because his trading was not excessive? Certainly not.

Although there is no reason to require the government (or a plaintiff) both to prove the defendant's intent and to satisfy the proxy requirement, the opposite approach is plausible. Suppose the regulator views a given irredeemable act as particularly harmful. Alternatively, the regulator believes that an intent determination is especially difficult and no good proxy is available. It is quite rational for this regulator to use a belt-and-suspenders strategy, so to speak. Having both

100. Mihara v. Dean Witter & Co., 619 F.2d 814, 820 (9th Cir. 1980) (emphasis added).

101. SEC v. Fehn, 97 F.3d 1276, 1289 (9th Cir. 1996) (emphasis added).

102. Better, that is, in a sense of allowing us to deter irredeemable acts while minimizing the mislabeling and resistance (as well as administrative) costs more cheaply than by using direct-intent determinations.

a proxy test and an intent inquiry at its disposal would give the government a stronger overall deterrent where deterrence would be too weak otherwise. As discussed in Part III, this approach is used in securities regulation and in tax enforcement.

C. RETHINKING THE SANCTIONS DESIGN

The contingent–irredeemable framework proposed here has substantial implications for the design of sanctions as well. The ultimate conclusion is that a certain form of graduated sanctions that may make sense for contingently inefficient acts is inappropriate for irredeemable ones. Thus, though optimal deterrence may support a schedule of higher statutory fines for more aggressive speeding, it does not support a schedule of greater statutory fines for more egregious price fixing. To understand the reason for this distinction, one needs to develop a theory of optimal penalties for irredeemable acts and to contrast it with the analysis of optimal sanctions for contingently inefficient acts. That analysis, however, is dramatically less developed than the reasoning underlying the optimal design of substantive legal rules for contingently inefficient acts. It is necessary, therefore, to begin with an inquiry into the optimal sanctions for these acts.

1. Optimal Deterrence of Contingently Inefficient Acts

The economic analyses of optimal sanctions and optimal legal rules are inextricably linked.[103] For contingently inefficient acts, that link is in large part due to the common goal of internalizing negative externalities that these acts produce. Given this goal, the basic prescription for the magnitude of sanctions in harm-based regimes is clear—sanctions should be equal to the external harm.[104] One advantage of this solution is that sanctions increase with the size of harm. If a tortfeasor causes $10,000 worth of damage to the neighbor's property, he will be forced to pay ten times more than if he causes only $1,000 worth of damage. Greater external harms are deterred to a greater extent without any need for case-by-case government intervention.

Act-based regimes do not have the same damage-adjustment mechanism because act-based sanctions do not reflect actual harms. If an act-based regime is of a strict liability type, the problem may be addressed if the external harm is proportionate to the activity level. For instance, if the external harm of alcohol consumption is roughly proportionate to the amount of alcohol consumed, a flat alcohol tax will do the job. Those consuming more alcohol will pay higher

103. In Judge Easterbrook's words, "[a]nything that could be accomplished by changing the rules of liability also could be done by changing the rules of damages." Frank H. Easterbrook, *Detrebling Antitrust Damages*, 28 J.L. & ECON. 445, 447 (1985).

104. As already mentioned, this basic prescription must be modified in several ways. *See supra* note 21.

taxes, internalizing the greater external harm of their behavior.[105]

If an act-based regime is threshold type, however, or if the future harm is not directly proportionate to the activity level, this solution is unavailable. In these cases, another familiar approach may be used to match sanctions to the variations in the expected external harm.

Take speeding fines as an example. They grow as the speed limit is exceeded by a greater and greater margin. I will call an increase in statutory (or *nominal*) fines *graduation*. Thus, sanctions are graduated if they increase as offenses increase along one of several possible axes. In the speeding case, this axis is the distance from the threshold separating lawful and unlawful conduct. I will use the term *aggressiveness* to refer to that distance. Thus, speeding fines exhibit aggressiveness-based graduation. Speeding regulation is not the only regime that provides for sanctions that have this structure.[106]

Note that aggressiveness is not the only possible axis of graduation. Others include the magnitude of the victim's loss (or the offender's gain),[107] the number of previous offenses,[108] the effort to comply with the law,[109] and various mental states.[110] In fact, aggressiveness is somewhat unique. All other axes denote both an objective fact and a legal criterion used for sanctions graduation. In contrast, aggressiveness is a purely legal concept on its face. As

105. The alcohol tax would be an imprecise solution to the problem of negative externalities from alcohol consumption because many people drink without imposing any such externality. This type of imprecision caused by heterogeneity among individuals subject to regulation is pervasive.

106. For example, the Resource Conservation and Recovery Act (RCRA) provides a complex and detailed regulatory scheme for managing hazardous waste. *See* 42 U.S.C. §§ 6901–6992k (2006). One provision of the regulations issued pursuant to this act requires owners of hazardous waste facilities to erect a physical barrier around the facilities. Sanctions for violating that requirement (as well as many others) exhibit aggressiveness-based graduation. RCRA Civil Penalty Policy Guidelines refer to this graduation as the "extent of deviation from a requirement." RES. CONSERVATION AND RECOVERY ACT ENFORCEMENT DIVISION, EPA, RCRA CIVIL PENALTY POLICY 18 (2003) [hereinafter RCRA Enforcement Division], *available at* http://www2.epa.gov/sites/production/files/documents/rcpp2003-fnl.pdf.

107. For example, sanctions for securities fraud double if the illegal act causes substantial losses. *See* 15 U.S.C. § 78u-2(b)(1)–(3) (2012).

108. *See, e.g.*, U.S. SENTENCING GUIDELINES MANUAL § 4A1.1 introductory cmt. (2012) ("A defendant with a record of prior criminal behavior is more culpable than a first offender and thus deserving of greater punishment.").

109. Certain tax sanctions depend on whether a taxpayer's actions reveal "negligence," which is defined to include "any failure to make a reasonable attempt to comply with the provisions of this title." *See* I.R.C. § 6662(b)–(c) (2006).

110. An imposition of criminal sanctions for violations meeting the mens rea requirement is an example of a mental state-based graduation. For a range of mental states, see Samuel W. Buell, *What Is Securities Fraud?*, 61 DUKE L.J. 511, 580 (2011). Though the mental state-based graduation is a form of aggressiveness-based graduation (with the threshold being a certain state of mind rather than a certain speed, emissions amount, or "reasonableness"), it is useful to treat the mental-state axis separately because sanctions often exhibit graduation based on both mental state and aggressiveness that reflects thresholds other than the state of mind. For instance, reckless speeding is punished more severely than negligent speeding (holding the speed in excess the limit constant). *See, e.g.*, CONN. GEN. STAT. § 14-222(a) (2013). At the same time, the fine increases with the amount over the speed limit (holding the mental state constant). *See* JUDICIAL BRANCH, STATE OF CONNECTICUT, MAIL-IN VIOLATIONS AND INFRACTIONS SCHEDULE app. A (2012), *available at* http://www.jud.ct.gov/Publications/Infractions/infractions.pdf.

will soon become clear, it usually corresponds to the expected external harm.[111]

Given the prominence of speeding fines in day-to-day life, one would expect that the efficiency-grounded explanation of their aggressiveness-based graduation is well developed and well accepted in the literature. Not so, it turns out. Thus, before asking whether a similar penalty structure makes sense for irredeemable acts, we need to answer that question for contingently inefficient ones.

Assume (temporarily) that once legal rules are in place, there is no uncertainty, enforcement is perfect (all offenses are detected and prosecuted without error), and all putative offenders know all legal rules. Recall that the reason to impose a speed limit in the first place is that, on average, the marginal benefits of driving up to that limit exceed the marginal-expected external harms. Above the limit, the harms exceed the benefits. This implies that as speed increases, the marginal-expected external harm increases as well. If so, speeding fines should rise with speed to provide greater deterrence for more harmful violations. An increase of expected external harm with the vehicle's speed seems like a very reasonable assumption, making the entire schedule intuitive for most drivers.

Another possible reason for graduated nominal fines is the uncertainty regarding the optimal location of the legal threshold. Imagine that policymakers are confident that the optimal speed limit is somewhere between 55 mph and 65 mph, but they are unsure about its exact location in that range. If policymakers are less concerned about slight overdeterrence than slight underdeterrence, they would set the speed limit at 55 mph, impose low fines between 55 mph and 65 mph, and set substantially higher sanctions above 65 mph. Note that they will do so even if they do not believe that the expected external harm increases with speed for speeds above 65 mph. In reality, both rationales are likely to apply.

Relaxing the unrealistic assumption about a perfect legal system complicates things considerably. Imagine that any of the following is true. Radar guns used by the police sometimes err. Car speedometers do not always show the speed precisely. Drivers do not read speedometers perfectly, and the same is true of police officers and their radar guns. Or imagine that 55 mph speed limit does not really mean 55 mph. This, it turns out, is true in thirteen states where some posted speed limits are merely presumptive.[112] All these uncertainties have a common effect: the further the conduct deviates from the legal threshold (the more aggressive it is), the more likely is the imposition of sanctions. A driver going 60 mph may plausibly argue that he thought the speedometer showed 55 mph; coming from a person driving 100 mph, the same argument sounds much less convincing. Similarly, the first driver may persuade a court in one of the thirteen presumptive states that his speed was reasonable; the second driver

111. Legal regimes in which rules have extremely weak connections to an optimal system, such as the tax law, also exhibit aggressiveness-based graduation. In these cases, aggressiveness is a purely legal concept with no economic substance. *See* Raskolnikov, *supra* note 37, at 577–78.

112. Exceeding these limits is not illegal per se; rather, it creates a presumption of illegal conduct that may be rebutted by the driver. *See* Brabender, *supra* note 91, at 2.

does not stand a chance.[113]

These variations in probability that a court will find an actor liable for violating a legal threshold (the *probability of conviction*) create a graduated scale of expected penalties even if there is only one statutory speeding fine.[114] A 100 mph driver will pay that fine for certain (perfect detection is still assumed), but a 60 mph driver will pay the same fine, let us posit, only with a 50% probability. If the nominal fine is $100, the expected fine is $100 for the 100 mph driver and $50 for the 60 mph driver. Outrageous speeding is deterred to a greater extent than slight speeding.[115] Why do we need graduated nominal fines as well?

Two answers appear plausible, though neither is addressed in the literature. First, we may need explicit graduation if the increase in probability of conviction does not escalate expected sanctions fast enough. This justification is based on an empirical assumption not only about the growing magnitude of the expected external harm, but about the difference in the rate with which this harm rises compared to the rate with which the probability of conviction increases. If increasing the vehicle speed from 70 mph to 80 mph doubles the probability of conviction but quadruples the expected external harm, higher nominal fines for faster driving are optimal.[116] Needless to say, this assumption may not have much empirical support, and its realism almost certainly varies from one setting to another.[117] Thus, one may suspect that the rate at which the expected external harm grows with a driver's speed is different from the rate at which it grows with the degree of a driver's intoxication. If so, the optimal level of graduation for speeding and drunk driving fines would differ.[118]

The second possible reason for graduated statutory speeding fines is that the increase in expected sanctions based on a change in probability of having to pay a single nominal fine is upward bound. Probability of conviction cannot exceed 100%, and the expected fine cannot exceed the nominal one. But the expected

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113. For empirical support, see Michael D. Makowsky & Thomas Stratmann, *Political Economy at Any Speed: What Determines Traffic Citations?*, 99 AM. ECON. REV. 509, 520, 523 (2009).

114. For the same use of the term "probability of conviction," see Craswell, *supra* note 21, at 2215.

115. "Indeed, a positive (or, at least, non-negative) correlation between the likelihood of liability and the social costs of a defendant's behavior could be the definition of a minimally rational legal system." John E. Calfee & Richard Craswell, *Some Effects of Uncertainty on Compliance with Legal Standards*, 70 VA. L. REV. 965, 970 (1984).

116. The obvious corollary is that if increasing the vehicle speed from 70 mph to 80 mph quadruples the probability of conviction but only doubles the expected external harm, optimal deterrence requires nominal fines that *decline* with speed. All of this is holding the probability of detection fixed—a questionable assumption. *See* Craswell, *supra* note 21, at 2211–12.

117. There has been surprisingly little empirical research investigating the variation of external harm of driving with speed. The most recent and comprehensive study is Arthur van Benthem, Do We Need Speed Limits on Freeways? (2012) (unpublished manuscript), *available at* https://bepp.wharton.upenn.edu/profile/21174/research.

118. There is at least some evidence that drunk-driving fines should not be graduated based on aggressiveness (that is, the extent to which blood alcohol level exceeds the limit). *See* Donald S. Kenkel, *Do Drunk Drivers Pay Their Way? A Note on Optimal Penalties for Drunk Driving*, 12 J. HEALTH ECON. 137, 145–47 (1993).

external harm from speeding may continue to grow well past the point where the conviction is certain.[119] If so, aggressiveness-based graduated nominal fines are justified, at least for some range of offenses.

Again, note that this explanation is highly offense specific. Other violations—including traffic violations—may exhibit an upward-bound expected external harm to match an upward-bound probability of conviction. Take a failure to turn on the headlights in the dark as an example. It is regulated by an uncertain standard,[120] and it is beyond doubt that as evening turns to night, darkness falls. At least in the continental United States, a rural highway is as dark at midnight as it is at one in the morning. The expected external harm from, in essence, driving blind does not vary between these two times, and neither does the probability of conviction.[121] Therefore, the fact that probability of conviction for failure to turn on the lights is 100% in either case is not a reason to graduate nominal fines based on aggressiveness.

Perhaps there are other reasons for the aggressiveness-based graduation of nominal sanctions in threshold-type, act-based regimes regulating contingently inefficient acts. If so, they remain to be uncovered.[122] Focusing on the rationales

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119. For instance, it is plausible to assume that driving 80 mph in a 55 mph zone will not be found reasonable by any court even in a presumptive jurisdiction, yet the expected harm of driving 120 mph may be substantially greater than that of driving 80 mph. Probability of conviction in both cases is 100%, so the only way to achieve graduated expected sanctions is to graduate nominal fines.

120. *See, e.g.*, ARIZ. REV. STAT. ANN. § 28-922 (2013) (providing that vehicles should have their lights on "[a]t any time from sunset to sunrise and at any other time when there is not sufficient light to render *clearly discernible* persons and vehicles on the highway") (emphasis added); CAL. VEH. CODE § 280 (West 2000) (defining "darkness" as "any time from one-half hour after sunset to one-half hour before sunrise and any other time when visibility is not sufficient to render *clearly discernible* any person or vehicle on the highway at a distance of 1,000 feet") (emphasis added).

121. In contrast, the expected external harm from driving 80 mph in a 55 mph zone does vary from the expected external harm from driving 120 mph in the same zone, though the probability of conviction is 100% in either case.

122. As Richard Craswell points out, variations in probability of detection suggest reverse graduation, that is, declining nominal penalties for more egregious violations because such violations are more likely to be detected and prosecuted compared to the marginal ones. *See* Craswell, *supra* note 21, at 2212–13. Richard Craswell and John Calfee investigate deterrence effects of uncertainty and demonstrate that it can produce either over- or underdeterrence, with overdeterrence being more likely if the uncertainty is not particularly great. *See* Calfee & Craswell, *supra* note 115, at 986–87; Richard Craswell & John E. Calfee, *Deterrence and Uncertain Legal Standards*, 2 J.L. ECON. & ORG. 279, 279–80 (1986). Craswell and Calfee focus on the deterrence variations from changing the level of uncertainty. Their analysis does not alter the conclusion that, given any particular level of uncertainty, greater sanctions lead to greater deterrence. Thus, their analysis is not directly relevant to an inquiry into graduated sanctions. Craswell and Calfee do point out that fines that neither increase marginally from zero once the legal standard is breached, nor are equal to the expected external harm, may provide for optimal deterrence, although they do not discuss the point further. *See* Calfee & Craswell, *supra* note 115, at 994. More importantly, their emphasis on simulations that result in overdeterrence based on some assumptions and underdeterrence based on others highlights the point emphasized in the text: assumptions, including those about the rates with which the expected external harm and the probability of conviction vary with aggressiveness, are critical in determining whether a graduated or a flat structure of nominal sanctions is more efficient, and in the former case, what is the optimal rate of graduation. Ian Ayres argues that treble damages should be made to vary with the degree of monopoly overcharge, though he admits that such variation would be very difficult to implement. Ian Ayres,

suggested here reveals the most important common feature of aggressiveness-based graduated fines—their context dependence. Each case turns on its own empirics. Is the external harm upward bound in the relevant range of probabilities of conviction? Does it rise faster (or slower) than that probability increases? These questions have no general answers. The justification for aggressiveness-based graduation of sanctions that works for speeding does not work for driving in the dark. Even if the same explanation works in different settings, the extent of graduation varies from one offense to another. Graduation of nominal sanctions for speeding and hazardous waste disposal may well have the same rationale. Yet penalties for hazardous waste violations vary by a factor of one hundred depending on aggressiveness,[123] something that is certainly not true of speeding fines. The unique variation of external harms of each contingently inefficient act determines the need for (and the extent of) optimal aggressiveness-based graduation of statutory sanctions.

2. Optimal Deterrence of Irredeemable Acts

For irredeemable acts, the analysis is very different. In contrast with contingently inefficient acts that present policymakers with endless variations of cost–benefit patterns, irredeemable acts raise a single ultimate question—what happened? Every judgment about the cause of an outcome potentially reflecting an irredeemable act is a binary guess: either the outcome is caused by an irredeemable act, or it is not. Where the law deals with irredeemable acts through direct inquiries into the actor's intent, the only reason for uncertainty in imposing liability is evidentiary. Everything turns on intent, and intent is difficult to establish. Where the law deploys proxies, uncertainty is due both to the evidentiary issues and the indeterminacy of language.

That language indeterminacy makes aggressiveness-based graduation possible for irredeemable acts. If liability for churning depends on the excessiveness of trading, a certain number of trades will be clearly excessive, while a smaller number only possibly so. If liability for price fixing depends on the existence of an agreement, some communications will establish an agreement more clearly than others. Given the tax law's reasonable compensation test, an owner–employee who pays himself no salary is taking an aggressive position, while another owner–employee who pays herself a low but nontrivial amount is being less aggressive. All these variations make aggressiveness-based graduation of nominal sanctions possible for proxy-regulated irredeemable acts. But can this graduation be optimal?

Assume that the nominal penalty for those liable for engaging in irredeem-

Pushing the Envelope: Antitrust Implications of the Envelope Theorem, 17 MISS. C. L. REV. 21, 24 (1996). Such variation, moreover, would be magnitude- rather than aggressiveness-based. Given that the statute prohibits monopolization as well as attempts and conspiracy to monopolize, 15 U.S.C. § 2 (2012), aggressiveness-based variation would tie damages to the flagrancy of such a monopolization, attempt, or conspiracy, rather than to the magnitude of the overcharge.

123. *See* RCRA Enforcement Division, *supra* note 106.

able acts is precisely equal to the act's external harm, appropriately adjusted.[124] Assume also that courts (or other decision makers) take all, and only, relevant factors into account in deciding whether the observed outcome reveals an irredeemable act. What kind of sanctions would ensure the optimal deterrence of putative irredeemable-acts offenders?

Imagine a group of CEOs who are thinking about fixing prices. They realize that the more communications they have, the more they discuss prices during their communications, the closer they come to suggesting a joint price increase, and so on, the more likely it is that—if prices do increase in tandem—a court would find the firms liable for entering into an illegal price-fixing agreement. The very same factors affect the likelihood that an oligopolistic (rather than market-driven) price increase will in fact take place, giving rise to an external harm. Moreover, the probability of conviction and the probability of harm depend on these factors in exactly the same way. Whatever makes the CEO interactions more aggressive makes the harm more likely, and also makes the conviction more certain. Therefore, under the strong assumptions made above, the expected external harm and the expected sanction are identical for any combination of factors. If so, the variation in probability of conviction is all that is necessary in order to produce the optimal graduation of expected sanctions. There is no reason to vary nominal penalties based on aggressiveness. In fact, such variation is decidedly ill-advised. The same logic applies to other irredeemable acts that depend on multiparty coordination and communication.

To be clear, this is not an argument against graduating nominal sanctions for price fixing along other axes, such as the volume of affected commerce, the length of the oligopolistic price increase, and so on. These axes are different from aggressiveness, which in this case means the likelihood that the firms have entered into an agreement to fix prices.

The analysis is somewhat different for churning, tax-motivated character conversion, and other irredeemable acts completely controlled by their perpetrators. These acts may be carried out without any communications possibly revealing the intent to steal. The overarching conclusion about the need for graduation, however, remains the same. A broker who decides to make a single additional trade to generate extra commissions engages in churning that is all but impossible to identify in the absence of a mind-reading machine. The same is true of a taxpayer who shifts a single dollar from (high-tax) salary to (low-tax) dividend income for tax reasons. Neither actor aggressively violates the relevant prohibition, and the external harm resulting from these acts is miniscule. The more self-enriching trades a broker makes, the more money a taxpayer shifts from salary to dividends, the more aggressive their positions are, and the greater is the external harm of their actions. If courts take these same considerations into account in deciding whether a given outcome reveals an

124. For instance, an adjustment may be necessary to take imperfect detection into account. *See* sources cited and discussion *supra* note 21.

irredeemable act, and if, upon concluding that it does, the court imposes a sanction equal to the external harm (properly adjusted),[125] an increase in the expected external harm would correspond directly to an increase in the expected sanction. Again, no additional graduation of nominal penalties is necessary. Granted, both the churning and the tax-avoidance examples oversimplify the relationship between the magnitude of external harm and the factors actually used by courts to determine whether an outcome corresponds to an irredeemable act.[126] But seeing a fuller picture does not detract from the conclusion that the need for graduation is unlikely.[127]

In fact, this conclusion is intuitive once one recalls that every litigation has only two possible outcomes—the defendant is either liable or not. This binary determination may be a poor match for a continuous variation of external harms from speeding, polluting, or other irredeemable acts of varying levels of aggressiveness. This mismatch may be addressed by a (roughly) continuous variation of statutory sanctions, that is, by penalties reflecting aggressiveness-based graduation. Irredeemable acts, in contrast, involve a binary determination of intent, with proxy tests being mere proxies (for lack of a better word) for this determination. A binary liable–non-liable decision is a much better fit for a binary good–bad intent action. In fact, under the assumptions made above, the fit is perfect.

Needless to say, the two assumptions made earlier are heroic. Sanctions for irredeemable acts are virtually certain to differ from the acts' expected external

125. *See* sources cited and discussion *supra* note 21.

126. Thus, the "excessiveness" of trading depends not only on the number of trades, but also on the client's investment objectives, the type of financial instrument being traded, the extent of discretion given to the broker, and so on. *See* LOSS & SELIGMAN, *supra* note 31, at 1099–1101. Similarly, the "reasonableness" of compensation depends on a variety of factors, including the nature of the business, the taxpayer's experience, and so on. *See* Watson v. United States, 757 F. Supp. 2d 877, 889–90 (S.D. Iowa 2010) (listing nine factors).

127. Unlikely, but not impossible. One can imagine a scenario where the external harm from churning increases with aggressiveness, rather than with the absolute amount of money lost by a client, which may be low for a very aggressive churning (numerous self-enriching broker trades) of a small account and high for mildly aggressive churning (just a few unnecessary trades) of a large account. For instance, if clients are undisturbed by their broker's extra trade here and there but stop all trading if they discover egregious churning, sanctions featuring aggressiveness-based graduation may be justified. One can imagine other scenarios, however, that would point in the opposite direction. For example, clients may be deeply disturbed to discover any churning because it reveals a breach of trust. Contingent on this finding, a more aggressive churning is merely a greater monetary loss for a given client than a less aggressive one, and a greater loss is compensated by a greater damages award that is based on the amount of money misappropriated by the broker regardless of the extent to which the trading was "excessive." In this latter case, optimal nominal fines may *decline* with aggressiveness.

It is also important to keep in mind that churning is a particular type of irredeemable act. For churning, aggressiveness relates both to the likelihood that an irredeemable act took place and the magnitude of the act's external harm. This relation complicates the analysis. No such relationship exists in the collusion example, however, as well as for many other irredeemable acts. Whether the putative cartel members have entered into an "agreement" has no connection to the external harm from their anticompetitive activities. In this and similar cases, it is difficult to find any justification for varying nominal fines based on aggressiveness, at least within the confines of the rational-choice framework.

harms, perhaps significantly. Courts are unlikely to take every relevant factor into account in determining liability, while dismissing every irrelevant consideration. Neither admission changes the conclusion, however. If sanctions diverge from the expected external harm, the appropriate response is to reduce the divergence, not to come up with a schedule of graduated penalties. If courts ignore important evidentiary considerations or give weight to irrelevant ones, the way to improve deterrence is to educate the courts. In the end, the optimal deterrence theory suggests that, though the aggressiveness-based graduation of sanctions may be efficient for contingently inefficient acts, it is inefficient for irredeemable ones.

D. THE NEED FOR SEPARATE REGULATION

The final suggestion that follows from recognizing the fundamental difference between contingently and irredeemably inefficient acts is the broadest one: It makes sense to regulate them separately. A failure to do so exacerbates every problem discussed thus far and creates others.

The case of terminological confusion is the clearest one. It is all but impossible for a court to interpret the same word (such as reasonable or excessive) to mean different things if a single code section or common law rule using this word applies to both types of acts. When the same word appears in different places—even if in a single statute—divergent interpretations are easier to establish.[128]

Separate regulation is also necessary to avoid using the same definitional structure for both types of acts. For instance, assume that a contingently inefficient offense is appropriately defined by combining a proxy test and an intent inquiry. How can the same provision govern an irredeemable act without inappropriately giving the offender two bites at the apple?

Furthermore, confusion is certain to arise when liability for contingently inefficient acts is conditioned on the offender's mental state, and that state falls short of intent. Imagine a single rule regulating both types of acts. Assume that the rule correctly ties liability for contingently inefficient acts to reckless behavior. This setup is an invitation to a debate about the optimal deterrence of reckless irredeemable acts—an invitation that has been taken up in the literature.[129] But there is no such thing as a reckless irredeemable act.[130] A defen-

128. *See, e.g.*, Comm'r v. Beck's Estate, 129 F.2d 243, 246 (2d Cir. 1942) (suggesting that Congress change the word "gift" to "geft" and "gaft" to avoid confusion over different meanings of the same term for income, gift, and estate tax purposes).

129. *See infra* note 192.

130. A possible exception is a decision to impose liability for engaging in irredeemable acts upon proof of recklessness in light of the difficulty of proving intent. *See* Buell, *supra* note 110, at 558; Prohibition on the Employment, or Attempted Employment, of Manipulative and Deceptive Devices and Prohibition on Price Manipulation, 76 Fed. Reg. 41,398, 41,404 (July 14, 2011) (codified at 17 C.F.R. pt. 180) (discussing a commenter's suggestion that "recklessness contemplated [in the new antifraud rule should] not [be] recklessness in a tort sense, but rather a business activity that diverges so greatly from rational market behavior as to indicate a fraudulent intent"). This is an evidentiary solution

dant's degree of culpability cannot vary for these offenses—it is intent in each case. At the same time, no matter how many cases interpreting the rule in question hold irredeemable-acts offenders liable while finding that they engaged in intentional conduct, nothing should change regarding the desirability of recklessness as the mental-state threshold for contingently inefficient acts. It is much easier to avoid this confusion when separate rules govern the two types of offenses.

Finally, the optimal structure of sanctions may well be different for contingently and irredeemably inefficient acts. Aggressiveness-based graduation may be appropriate for the former, but is inappropriate for the latter. If such graduation is desirable for contingently inefficient acts, optimal deterrence cannot be achieved if both types of acts are governed by a single sanctioning regime.

III. FROM THEORY TO DOCTRINE

The practical appeal of the traditional economic analysis of contingently inefficient acts is well-known: many prescriptions following from this analysis are reflected in the existing legal rules. This close connection between theory and reality gives weight to economically grounded proposals for further reform. The usefulness of the irredeemable-acts category must be tested against the same benchmark. Therefore, this Part compares the doctrinal implications just discussed to several actual legal regimes. To spoil the suspense, irredeemable acts survive this comparison reasonably well.

A. RECOGNIZING THE ROLE OF INTENT

Doctrinal treatment of many irredeemable acts reflects the law's recognition of their intentional nature. The common law definition of larceny includes the intent to steal.[131] Embezzlement typically requires intent to defraud.[132] The Model Penal Code definition of theft incorporates the "purpose to deprive."[133] Market manipulation is defined by reference to a prohibited purpose as well.[134] The same is true of securities churning.[135] And tax shelters must have the

akin to reducing the burden of proof. It has no effect on the conceptual point that irredeemable acts are always intentional.

131. *See* LAFAVE, *supra* note 49, at 987 ("For larceny there must be an intent to steal . . . .").

132. *See id.* at 1005 ("Embezzlement requires a specific intent to defraud."). Many state embezzlement statutes and numerous federal theft-related provisions define the requisite intent either by using various versions of the word "fraud" or simply by referring to "embezzlement" (which is typically interpreted to mean fraudulent conversion). *See id.* at 1003 (regarding state embezzlement statutes); 18 U.S.C. § 641 (2012) (referring to embezzlement or knowing conversion); 18 U.S.C. § 656 (referring to embezzlement); 18 U.S.C. § 666 (referring to anyone who "embezzles, steals, obtains by fraud"); 18 U.S.C. § 1341 (referring to "scheme or artifice to defraud").

133. *See* MODEL PENAL CODE § 223.2 (2012).

134. Thus, certain acts carried out "[f]or the purpose of creating a false or misleading appearance of active trading," 15 U.S.C. § 78i(a)(1) (2012), "for the purpose of inducing the purchase or sale of [a] security" by others, *id.* § 78i(a)(2), (4), "for the purpose of raising or depressing the price of [a] security," *id.* § 78i(a)(3), (5), and "for the purpose of pegging, fixing, or stabilizing the price of [a] security in contravention of [the SEC] rules and regulations," *id.* § 78i(a)(6), are all unlawful.

135. *See* Mihara v. Dean Witter & Co., 619 F.2d 814, 820 (9th Cir. 1980).

"purpose of . . . the avoidance or evasion of Federal income tax."[136] Whether the rule uses the term "intent," "purpose," or "motive," the underlying inquiry is always the same—whether an act was carried out with an intent to effectuate a concealed, nonconsensual transfer. This is entirely consistent with the proposed definition of irredeemable acts.

Note that this meaning of intent is different from an intent to harm a transferee. Though a thief and the churning broker know that their intent to enrich themselves amounts to an intent to impoverish their victims, market manipulators and insider traders may not intend to harm any particular market participant. The intent to harm is irrelevant, however. The inefficiency of irredeemable acts comes from the transfer costs, so any intentional conduct that gives rise to these costs is problematic. Notably, the Supreme Court's holding that an intent to harm competition is necessary to impose liability for price fixing has been steadily eroded by the appellate courts' decisions finding that an intent to fix prices is all that is required.[137] This is precisely what this Article's analysis suggests.

Sometimes the intent requirement is not clear from the face of the rule aimed at deterring irredeemable acts. This does not mean that the requirement is absent. Consider insider trading, for example. It has no statutory definition.[138] The Supreme Court has held that liability for insider trading under Section 10(b) of the Securities Exchange Act (the Exchange Act) and Rule 10b5 may attach if certain persons in possession of material nonpublic information trade "on the basis of" that information.[139] Rule 10b5-1(b) reveals that, at least in the view of the Securities and Exchange Commission, the term "on the basis of" comes very close to meaning something like "with an intent to take advantage of."[140] In other words, insider-trading prosecutions under Section 10(b) require

136. I.R.C. § 6662(d)(2)(C) (2006).

137. According to the Supreme Court, imposition of criminal punishment under the Sherman Act requires a finding of intent, meaning either the purpose of causing anticompetitive effects or their actual existence combined with the defendant's knowledge that such effects are likely to arise from his conduct. United States v. U.S. Gypsum Co., 438 U.S. 422, 440–46 (1978). The appellate courts have repeatedly declined to demand proof of intent to harm competition. *See, e.g.*, United States v. Cargo Serv. Stations, Inc., 657 F.2d 676, 683 (5th Cir. Unit B Sept. 1981) ("[I]f price fixing is inevitably an unreasonable restraint of trade, the intent to fix prices is equivalent to the intent to unreasonably restrain trade."). For a discussion, see HOVENKAMP, *supra* note 7, at 593–94.

138. *See* LOSS & SELIGMAN, *supra* note 31, at 996–97 (suggesting that United States v. O'Hagan, 521 U.S. 642 (1997), "should end congressional efforts to 'define' insider trading").

139. *See* United States v. O'Hagan, 521 U.S. 642, 651–52 (1997).

140. Although the general rule of Rule 10b5-1(b) defines "on the basis of" to mean awareness of material inside information, the exceptions make clear that mere awareness is not sufficient. *See* 17 C.F.R. § 240.10b5-1 (2013). For instance, if the trader entered into a binding contract to sell a security before becoming aware of inside information related to it, the sale would not be "on the basis" of that information. The seller would be aware of inside information at the time of sale, yet liability would not attach. This is consistent with the irredeemable-acts analysis. Sales pursuant to pre-existing binding contracts do not lead to the transfer costs because no one is being taken advantage of at the time of the sale. Whether Rule 10b5-1(b) successfully prevents corporate insiders from trading while taking advantage of inside information (rather than being merely aware of it) is doubtful. *See* M. Todd

intentional acts.[141] Again, this is consistent with this Article's analysis.

Finally, note that a clear intent to conceal usually signals a lack of consensual transfer. Option spring loading and bullet dodging illustrate the point. Corporate directors engaged in these practices undertake actions that, on a certain view, they are explicitly authorized to perform. Recall that spring-loaded and bullet-dodged options are at the money in form but in the money in substance. If the board is authorized to issue both types of options, how can it possibly go wrong? After all, the money transfer to the executives in this case is consensual in a certain sense. The answer is that people generally object to being deceived. The directors' effort to conceal the nature of their actions is especially clear here because they were authorized to issue in-the-money options. Yet they chose to accomplish the same result while making it look like they were doing something else. This effort to dupe the shareholders is certain to raise suspicions and give rise to shareholder objections, resulting in the transfer costs. As long as this is the case, the transfer is intentional and nonconsensual. This means that bullet dodging and spring loading are irredeemable acts, and that the Delaware Chancery Court was well-advised to disapprove them.[142]

B. ADOPTING APPROPRIATE DEFINITIONS

The earlier discussion used the common law treatment of securities churning as an example of a misguided combination of a proxy-based and intent-based regulation. Fortunately, the regulatory (as opposed to common law) definition of churning drops the purpose requirement altogether, choosing a proxy over a direct-intent inquiry (as this Article's analysis would suggest).[143] Yet the persistent judicial adhesion to the misguided common law rule serves as a cautionary tale of confusion that could be easily avoided if courts recognized the difference between contingently and irredeemably inefficient acts.[144]

The earlier discussion also explained why it may be wise to give the gov-

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Henderson et al., *Hiding in Plain Sight: Can Disclosure Enhance Insiders' Trade Returns?* (U. of Chi. L. & Econ. Working Paper No. 411, 2012), *available at* http://ssrn.com/abstract=1137928.

141. Donald Langevoort emphasizes the "centrality of intent" to insider trading. Donald C. Langevoort, *"Fine Distinctions" in the Contemporary Law of Insider Trading* 5 (Georgetown Pub. Law & Legal Theory Research Paper No. 13-032, 2013), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2256641. Yet he views insider trading as "a sui generis form of securities fraud," *id.* at 5, ignoring the similarity (including in the central role of intent) between insider trading and other irredeemable securities law violations.

142. *See* Weiss v. Swanson, 948 A.2d 433, 439–40 (Del. Ch. 2008); *In re* Tyson Foods, Inc., No. Civ.A 1106-CC, 2007 WL 2351071, at *3–6 (Del. Ch. Aug. 15, 2007).

143. *See* 17 C.F.R. § 240.15c1-7(a) (2010) (prohibiting brokers controlling discretionary accounts from entering into "any transactions or purchase or sale which are excessive in size or frequency in view of the financial resources and character of such account").

144. District and circuit court decisions continue to rely on the definition of churning that includes both the purpose prong and the excessiveness prong years after the promulgation of Rule 15c1-7 in 1976, despite citing that rule. *See* Armstrong v. McAlpin, 699 F.2d 79, 90–91 (2d Cir. 1983) (reciting the traditional churning definition though citing Rule 15c1-7); 41 Fed. Reg. 22,826 (June 7, 1976) (enacting the rule).

ernment a choice between a proxy test and a direct-intent inquiry in deterring irredeemable acts. As it turns out, examples of such a dual-track approach are readily available in tax law and securities regulation.

As just explained, insider trading is regulated by the general antifraud provision of the Exchange Act that incorporates a direct inquiry into the actor's state of mind. That provision, Section 10(b), is not the only rule of the Exchange Act dealing with insider trading, however. Section 16(b) of the Exchange Act requires corporate insiders to disgorge so-called short-swing profits—gains from sales of securities made within six months of their purchases.[145] The statute is quite clear about its objective "of preventing the unfair use of information which may have been obtained by" corporate insiders.[146] But what does such unfair use have to do with a six-month waiting period separating a purchase and a sale?

Apparently, Congress believed that many insiders were particularly eager to make a quick buck by, for instance, buying a security shortly before the release of positive information and selling it shortly thereafter.[147] The waiting period made such profits unavailable regardless of the trader's intention.[148] A spokesman at the 1934 congressional hearing described Section 16(b) as a "crude rule of thumb."[149] In this Article's terms, the short-swing profit prohibition is a proxy. Although this Article expresses no view about the optimality of regulating insider trading by combining a proxy-based with an intent-based inquiry (rather than relying on either test), the analysis offered here suggests that this is a plausible approach.

The same is true of a recent codification of the tax law's economic-substance doctrine.[150] This judicially developed rule allows courts to deny tax benefits that follow from a literal reading of the Internal Revenue Code if such reading is clearly inconsistent with congressional intent.[151] For decades, courts could not agree about the precise content of that doctrine, especially about the application of its two prongs. Under the first prong, the doctrine applies if the transaction had no "non-tax business purpose."[152] Under the second prong, tax benefits are denied if the transaction had no "economic substance."[153] Although neither

145. *See* 15 U.S.C. § 78p(b) (2012).

146. *Id*.

147. Another possible justification of the six-month waiting period is that inside information loses its usefulness (in the profit-generating sense) within that period.

148. The provision explicitly states that the profits must be disgorged "irrespective of any intention on the part of" the trader. 15 U.S.C. § 78p(b).

149. LOSS & SELIGMAN, *supra* note 31, at 678 (quoting 15 *Stock Exchange Practices: Hearing Before the S. Comm. on Banking & Currency*, 73d Cong. 6557 (1934) (statement of Thomas G. Corcoran) (internal quotation marks omitted)).

150. *See* I.R.C. § 7701(o) (2006 & Supp. V 2012).

151. For a discussion, see Martin J. McMahon, Jr. et al., *Recent Developments in Federal Income Taxation: The Year 2011*, 12 FLA. TAX REV. 235, 362–67 (2012).

152. *Id.* at 364.

153. *Id.* Confusingly, the second prong of the test uses the same term as does the overall doctrine.

courts nor commentators agree about the meaning of the second prong, courts have interpreted it to refer to any of the following: a profit potential, "practical economic effects,"[154] the magnitude of expected profit compared to the tax benefits, and success in obtaining the stated business objective.[155] To avoid further confusion between the economic-substance doctrine and its second prong, I will refer to that prong as the "profit potential" rather than the "economic substance" part of the test.

The two prongs of the doctrine have created a persistent doctrinal split. Some circuit courts have adopted the so-called conjunctive version of the economic-substance test; other circuits have gone with a disjunctive one. Under the conjunctive version, a taxpayer must demonstrate that his transaction had both a business purpose *and* a profit potential in order to retain the tax benefits in question.[156] Under the disjunctive version, proving either prong suffices to withstand the government challenge.[157] This means that under the disjunctive version, the government must prove that the taxpayer's transaction had *neither* a business purpose *nor* a profit potential—a much heavier burden than that arising under the conjunctive test.

As is probably clear by now, the disagreements that have beset the circuit courts can be easily resolved within the proposed framework. For tax-avoidance strategies that are inconsistent with congressional intent, the basic economic analysis applies. Tax-motivated decisions are irredeemable acts; actions that do not take taxes into account are part of the socially optimal baseline. The two prongs of the economic-substance doctrine are nothing but a direct-intent inquiry (the business-purpose prong) and a proxy (the profit-potential prong).[158] Forcing the government to prevail on both reveals the same misunderstanding of the contingent–irredeemable divide as does requiring potential churning victims to prove both the broker's illicit purpose and the excessiveness of his trading.

Therefore, a recent codification of the economic-substance doctrine that has adopted the conjunctive version of the test is sound policymaking.[159] Tax enforcement is notoriously difficult, especially when it comes to sophisticated tax shelters that often raise the economic-substance concerns. Giving the government a choice of prevailing under either a proxy or a direct-intent inquiry is

154. ACM P'ship v. Comm'r, 157 F.3d 231, 248 (3d Cir. 1998).

155. McMahon, *supra* note 151, at 364–65 (citing cases supporting each interpretation).

156. *See id.*

157. *See id.*

158. Daniel Shaviro compares forcing taxpayers to imbue their tax-motivated transactions with profit potential (or risk) to requiring them to perform back flips. *See* Shaviro, *supra* note 98, at 223. The profit requirement, he argues, has nothing to do with the relevant question of whether the transaction was tax-motivated; it only makes engaging in tax-motivated transactions more costly. Perhaps this view of the profit-potential prong is too pessimistic. Rather than making tax planning more costly, the profit-potential prong may help distinguish tax-motivated and nontax-motivated transactions if the absence of profit potential at least roughly correlates with the presence of tax motivation.

159. *See* I.R.C. § 7701(o)(1) (2006 & Supp. V 2012).

quite reasonable in this setting.

C. AVOIDING AGGRESSIVENESS-BASED GRADUATION OF SANCTIONS

One of the key payoffs of the proposed analysis is that aggressiveness-based graduation of sanctions is inappropriate for irredeemable acts. Most irredeemable acts are regulated by what appear to be harm-based regimes (making such graduation doubly ill-advised).[160] Liability for embezzlement, price fixing, insider trading, churning, option backdating, and other irredeemable acts attaches after the acts occur, not when the risk of these acts arises. Yet all of the regimes in question are not really harm-based because they do not force offenders to internalize external harms. Rather, these regimes impose sanctions that are determined by offenders' gains,[161] victims' losses,[162] some other factors,[163] or arbitrary numbers.[164] In quite a few cases, the statute all but invites an imposition of graduated penalties. Even where it does not, scholars have considered graduation.

For instance, the Exchange Act contains an explicit three-tier schedule of sanctions for most securities law violations.[165] The same act provides that the penalty for insider trading "*shall not exceed three times* the profit gained or loss avoided."[166] Importantly, this rule does not merely establish a greater penalty for greater illicit profits (or losses avoided). It also anticipates a threefold variation in sanctions for a *given* profit (or loss). Another example comes from the criminal area. Sanctions for many federal offenses (including various forms of fraud and antitrust violations) may be imposed under the Criminal Fines Improvement Act of 1987.[167] That act anticipates graduation as well, setting the penalty at "*not more than the greater of twice* the gross gain or twice the gross loss" captured or caused by the defendant, respectively.[168] Graduation is seemingly embedded in the sanctions imposed by the U.S. Sentencing Guidelines for price fixing, bid rigging, and related offenses as well. For natural persons, these fines vary *"from one to five percent* of the volume of [affected] commerce."[169]

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160. That is because there appears to be no reason for aggressiveness-based graduation in *any* harm-based regime; in addition, there is no reason for such graduation in any regime (harm- or act-based) dealing with irredeemable acts.

161. *See, e.g.*, 15 U.S.C. § 78u-1 (2012) (penalty for insider trading based on profit gained); 18 U.S.C. § 3571(d) (2012) (penalty for a variety of offenses based on offender's gain); I.R.C. § 6662 (2006) (penalty for tax avoidance based on the amount of taxes underpaid).

162. *See, e.g.*, 15 U.S.C. § 15 (2012) (sanctions based on damages sustained by victims of antitrust violations); 18 U.S.C. § 3571(d) (2012) (penalty for variety of offenses based on losses caused by offenders).

163. *See, e.g.*, U.S. SENTENCING GUIDELINES MANUAL § 2R1.1 (2012) (imposing sanctions for price-fixing, bid rigging, and market-allocation agreements based on the volume of affected commerce).

164. *See, e.g.*, 15 U.S.C. §§ 78u to -2 (2012) (setting forth penalties for securities law violations ranging from $5,000 to $100,000 for natural persons and from $50,000 to $500,000 for other persons).

165. 15 U.S.C. §§ 78u, -2.

166. 15 U.S.C. § 78u-1(2) (emphasis added).

167. Pub. L. No. 100-185, 101 Stat. 1279 (codified as amended in scattered sections of 18 U.S.C.).

168. 18 U.S.C. § 3571(d) (2012) (emphasis added).

169. U.S. SENTENCING GUIDELINES MANUAL § 2R1.1(c) (2012) (emphasis added).

Though the treble damages imposed by the Clayton Act do not provide for graduation,[170] antitrust scholars have argued that aggressiveness-based graduation would be appropriate.[171]

It is heartening to note, in light of this Article's conclusions, that all of these opportunities to impose (or allow) graduated sanctions have *not* lead to sanctions that vary based on aggressiveness. Despite an open statutory invitation to adjust penalties for insider trading, the government practice is to impose a flat penalty equal to 100% of profit made or loss avoided (plus a disgorgement of profits).[172] Statutory sanctions for irredeemable acts that constitute securities fraud (other than insider trading) do not depend on aggressiveness despite the explicit three-tiered penalty structure.[173] Although sanctions for price fixing, bid rigging, and related antitrust offenses vary based on several considerations, aggressiveness is not among them.[174] Finally, even though Congress listed eight factors to guide courts in applying the "not more than twice" instruction in the Criminal Fines Improvement Act, aggressiveness is not on the list.[175] Given this Article's analysis, these are all examples of the appropriate regulation of irredeemable acts. On the other hand, penalties for tax violations are a clear case of aggressiveness-based graduation that is inappropriate for irredeemable acts.[176]

D. EMBRACING SEPARATE REGULATION

The overarching conclusion of the preceding Part was that contingently and irredeemably inefficient acts should be regulated separately. Is this recommendation reflected in reality? It is, but only to a point.

The Model Penal Code's rearrangement of various common law offenses typically grouped under the rubric of theft is the first example of separate

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170. *See* 15 U.S.C. § 15 (2012).

171. *See* HERBERT HOVENKAMP, THE ANTITRUST ENTERPRISE: PRINCIPLE AND EXECUTION 65 (2005) (suggesting that "as the behavior moves further and further from anything that can be characterized as an agreement," statutory sanctions should decline because the conduct underlying the price increase becomes more and more "ambiguous"); Edward D. Cavanagh, *Detrebling Antitrust Damages: An Idea Whose Time Has Come?*, 61 TUL. L. REV. 777, 828 (1987) (stating that "[i]t seems harsh to multiply damages when the person involved is found barely liable" even if the liability is for price fixing and related offenses).

172. *See* Arthur B. Laby & W. Hardy Callcott, *Patterns of SEC Enforcement Under the 1990 Remedies Act: Civil Money Penalties*, 58 ALB. L. REV. 5, 48 (1994).

173. In fact, that structure comes close to an explicit *prohibition* of aggressiveness-based graduation. All irredeemable-act offenses are intentional acts. Therefore, they always qualify as second-tier offenses because that tier encompasses offenses involving "fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement." 15 U.S.C. § 78u(d)(3)(B)(ii) (2012). At the same time, graduation between the second and the third tiers is based on the size and risk of losses, not the strength of the legal position.

174. *See* U.S. SENTENCING GUIDELINES MANUAL § 2R1.1 (2012). Although there is a reference to "seriousness" of the offense in the Application Notes, the context makes clear that "seriousness" refers to the magnitude of harm rather than aggressiveness of a legal position. *Id.* § 2R1.1 cmt. n.1.

175. *See* 18 U.S.C. § 3572(a) (2012).

176. For a description of this penalty structure, see, for example, Kyle D. Logue, *Optimal Tax Compliance and Penalties When the Law Is Uncertain*, 27 VA. TAX REV. 241, 251–57 (2007).

regulation. Although the common law offense of larceny generally covers irredeemable acts, its peculiar subset—larceny by trick—does not. Larceny by trick consists of obtaining possession (but not title) of property by lying to the victim.[177] Because a clear lie and a full truth are points on the falsity–veracity continuum (rather than a binary choice), larceny by trick is not an irredeemable act. The same is true of a separate offense of false pretenses (which differs from larceny by trick only in that the offender acquires title rather than possession of an object by lying).[178] Embezzlement, on the other hand, is a clear irredeemable act.[179] Given all of this, it should be evident why the Model Penal Code is entirely consistent with this Article's argument for separate regulation. Though the Code includes many different offenses under the common rubric of "theft," it combines (regular) larceny and embezzlement to form a new category of "theft by unlawful taking or disposition," while grouping larceny by trick and false pretenses under a separate rubric of "theft by deception."[180]

Competition law is also consistent with the separate regulation suggestion. Irredeemable acts of naked price fixing and bid rigging belong to a special category of per se offenses, although most contingently inefficient, potentially anticompetitive acts belong to the rule-of-reason category.[181] Moreover, the doctrinal development has been to shrink the per se category to include only irredeemable acts.[182] Criminal sanctions for antitrust violations are limited to irredeemable acts as well.[183]

The line roughly corresponding to the contingent–irredeemable divide in corporate law is the distinction between the duty of care and the duty of loyalty. The Delaware Chancery Court decided that option backdating, spring loading,

177. *See* LAFAVE, *supra* note 49, at 969.

178. *See id.* at 976.

179. *See id.* at 995 (defining embezzlement); *id.* at 1003–05 (explaining the requisite mental state).

180. *See id.* at 1029.

181. Per se offenses are "so plainly anticompetitive that no elaborate study of the industry is needed to establish their illegality." Nat'l Soc'y of Prof'l Eng'rs v. United States, 435 U.S. 679, 692 (1978). The assessment under the rule of reason requires an inquiry into "whether the challenged agreement is one that promotes competition or one that suppresses competition." *Id.* at 691. For a discussion, see HOVENKAMP, *supra* note 7, at 253–59. The intermediate "quick look" review is a more recent development. *See id.* at 265–66. Note that the rule-of-reason category is not limited to potentially anticompetitive activities that have little in common with irredeemable acts, such as mergers and joint ventures. It extends even to price fixing and horizontal market division as long as they are not "naked." Thus, the so-called facilitating devices usually receive the rule-of-reason treatment, *see id.* at 170, as do ancillary (rather than naked) restraints of trade. *See id.* at 194–95.

182. For a recent demonstration of that trend, see Leegin Creative Leather Prods., Inc. v. PSKS, Inc., 551 U.S. 877, 882 (2007) (abandoning the per se rule for minimum resale price maintenance agreements); *see also* Edward D. Cavanagh, *Detrebling Antitrust Damages in Monopolization Cases*, 76 ANTITRUST L.J. 97, 97 n.5 (2009) (concluding that "[t]he law of tying has become unsettled" and the law of resale price maintenance "is in a state of flux"); Cavanagh, *supra* note 171, at 797–98 (recapping the treatment of vertical territorial restraints that were analyzed under the rule of reason in 1963, migrated into the per se category four years later, only to reacquire the rule-of-reason status a decade after that, and concluding that the per se category has been shrinking since a 1975 Supreme Court decision).

183. *See* U.S. SENTENCING GUIDELINES MANUAL § 2R1.1 cmt. background (2012).

and bullet dodging are all breaches of the duty of loyalty and, more precisely, the obligation to act in good faith.[184] Though the doctrinal treatment of all these options-related shenanigans is clear, the economic justification for denying the directors engaged in them the business judgment rule protection has been missing, at least where the directors are not self-interested. A clear inefficiency of irredeemable acts supplies a reason to view the options-related misconduct as violating the duty of loyalty even where no conflicts exist. This misconduct is indeed different from other board decisions that are contingently inefficient acts and are scrutinized under a more forgiving duty of care inquiry.[185]

Securities regulation, on the other hand, is inconsistent with the separate regulation suggestion. The general antifraud provision of the Exchange Act, Section 10(b), covers just about every plausible irredeemable act. Insider trading, churning, scalping, and cherry-picking are all covered.[186] Front-running is likely to violate Section 10(b) as well.[187] Though market manipulation is mostly dealt with via its own section,[188] it is also subject to the general antifraud rule.[189] The same provision applies to all sorts of contingently inefficient acts as well.[190]

The results are unfortunate. Liability for contingently and irredeemably inefficient acts depends on both materiality and the mental state—a combination that may well be appropriate for the former but not the latter. That mental state, moreover, is recklessness.[191] This leads to misguided academic arguments about

184. *See* Weiss v. Swanson, 948 A.2d 433, 439–40 (Del. Ch. 2008); *In re* Tyson Foods, Inc., No. Civ. A 1106-CC, 2007 WL 2351071, at *3–6 (Del. Ch. Aug. 15, 2007).

185. The justification is partial because not all duty of loyalty breaches in no-conflict situations involve irredeemable acts. For instance, the leading case of Stone v. Ritter, 911 A.2d 362, 369 (Del. 2006), held that corporate directors breach the duty of loyalty when they intentionally cause the corporation to violate the law. Such a violation may or may not be an irredeemable act, depending on the law in question.

186. *See, e.g.*, United States v. O'Hagan, 521 U.S. 642, 658–59 (1997) (finding that insider trading, even by a corporate outsider, violates Rule 10b-5); SEC v. K.W. Brown & Co., 555 F. Supp. 2d 1275, 1304 (S.D. Fla. 2008) ("[B]y its very nature, the cherry-picking scheme operated as a fraud on the [defendant's] clients, which is prohibited under 10b-5(a) and (c)."); LOSS & SELIGMAN, *supra* note 31, at 1016 (concluding that the Supreme Court's decision in *O'Hagan* applies to scalping); *id.* at 1097 (stating that churning has been held to violate Rule 10b-5).

187. *See* Bovi, *supra* note 54, at 121. Adoption of the misappropriation theory by the Supreme Court in *O'Hagan* makes this conclusion even more likely. The SEC's current view is that at least some forms of front-running are illegal under current law. *See* Concept Release on Equity Market Structure, Exchange Act Release No. 34-61358, 97 SEC Docket 2115 (Jan. 14, 2010).

188. *See* 15 U.S.C. § 78i (2012).

189. *See* 15 U.S.C. § 78j(b) (applying to "manipulative" acts).

190. Rule 10b-5 covers a wide variety of corporate misconduct ranging from overly optimistic forecasts to questionable accounting practices. *See, e.g.*, Stephen J. Choi, *The Evidence on Securities Class Actions*, 57 VAND. L. REV. 1465, 1501 n.180 (2004) (citing reports suggesting that most securities class actions alleging Rule 10b-5 violations involve forward-looking statements, accounting irregularities, and insider trading).

191. Though the Supreme Court held that the prohibition of "any manipulative or deceptive device or contrivance," 15 U.S.C. § 78j(b), refers to intentional or knowing misconduct, the Court did not

whether sanctions for irredeemable acts such as insider trading should depend on the "defendant's degree of culpability."[192] It also confuses courts.[193] A judge who sensibly concludes that reckless (and even knowing) conduct may not possibly give rise to an irredeemable act of stock manipulation gets overruled because Section 10(b), allegedly violated by the defendant, definitely applies to reckless acts.[194] The appellate tribunal fails to appreciate that, although some forms of securities fraud prohibited by Section 10(b) may indeed be carried out recklessly, other forms (including the irredeemable act of stock manipulation) may not. Lack of appreciation for the contingent–irredeemable distinction leads to inevitable doctrinal and conceptual confusion.[195] Finally, with the exception of insider trading, penalties for contingently and irredeemably inefficient securities law violations are determined by the same provisions.[196] If this Article's analysis persuades securities law experts, there may be reasons to rethink this state of affairs.

Turning from securities to commodities regulation brings no relief. In fact, the major recent development in this increasingly important area is particularly ill-advised. Prior to the enactment of the Dodd–Frank Act,[197] the Commodity Exchange Act (CEA)[198] had roughly reflected the contingent–irredeemable distinction. Market manipulation—the most important and multifaceted irredeemable act in commodities trading—included only intentional violations.[199] Antifraud provisions (such as they were) mostly occupied their own section,[200] resulting in a largely separate regulation of contingently and irredeemably

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decide whether recklessness is covered as well. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 n.12 (1976). Lower courts did address the question, and concluded that recklessness is covered. *See* Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 319 n.3 (2007) (noting that "[e]very Court of Appeals that has considered the issue has held that a plaintiff may meet the scienter requirement by showing that the defendant acted intentionally or recklessly"); LOSS & SELIGMAN, *supra* note 31, at 1025–27.

192. *See* Carole B. Silver, *Penalizing Insider Trading: A Critical Assessment of the Insider Trading Sanctions Act of 1984*, 1985 DUKE L.J. 960, 985, 1020 (1985) (discussing recklessness and arguing for lower insider-trading sanctions for less culpable defendants).

193. In dealing with securities fraud, "[f]ederal courts—especially the Supreme Court—have badly elided distinctions among intent, knowledge, recklessness, and negligence, as well as between an actor's goals and her state of mind with respect to the tendency of her words or conduct to mislead." Buell, *supra* note 110, at 580.

194. *See* SEC v. U.S. Envtl., Inc., 155 F.3d 107, 108–12 (2d Cir. 1998).

195. *See, e.g.*, *In re* Parmalat Sec. Litig., 376 F. Supp. 2d 472, 501 (S.D.N.Y. 2005) (referring to the "unclear message" of the appellate decision in *U.S. Environmental, Inc.*, regarding participation in manipulation by financial intermediaries who do not have manipulative intent).

196. *Compare* 15 U.S.C. §§ 78u(d), 78ff (2012), *with* 15 U.S.C. § 78u-1 (2012).

197. Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified as amended in scattered sections of the U.S. Code).

198. 7 U.S.C. §§ 1–26 (2012).

199. *See* Prohibition on the Employment, or Attempted Employment, of Manipulative and Deceptive Devices and Prohibition on Price Manipulation, 76 Fed. Reg. 41,398, 41,407, 41,410 (July 14, 2001) (codified at 17 C.F.R. pt. 180).

200. *See* 7 U.S.C. §§ 6b, 6o (2012). The anti-manipulation and anti-insider trading provisions were contained in 7 U.S.C. §§ 9, 13. Admittedly, section 13 also contained penalties for certain forms of fraud.

inefficient acts. Granted, the same sanctions applied to all commodities law violations,[201] and the sanctions provided for graduation based on "the gravity of the violation."[202] Yet nothing suggests that Congress, courts, or the Commodity Futures Trading Commission (CFTC) interpreted "gravity" to refer to variation in aggressiveness, at least for irredeemable acts.[203]

The Dodd–Frank Act changed matters for the worse. Along with many other major reforms, it significantly expanded the CEA's antifraud provisions. Specifically, it more or less imported the famous Section 10(b) of the Exchange Act into commodities and derivatives regulation.[204] The CFTC followed this statutory change by enacting a new rule that mimics the equally famous Rule 10b-5.[205] Going beyond the Exchange Act's provisions, the CFTC rule specifically covers reckless conduct. Unfortunately, while enacting these changes, Congress called the new antifraud rule a "[p]rohibition against manipulation,"[206] clarified this rule through a "[s]pecial provision for manipulation by false reporting,"[207] and specified that such manipulation may result from "reckless disregard" of the falsity of certain information.[208] As if to maximize the confusion, the new provision prohibits actual manipulation as well, under the heading "Other manipulation."[209] At the same time, the Dodd–Frank Act added an express prohibition on "spoofing"—a quintessential manipulative practice consisting of placing orders with an intent to cancel them prior to execution—in a different section of the CEA.[210] As a result, the CFTC now distinguishes between fraud-based manipulation (meaning good old fraud) and non-fraud-based manipulation (meaning actual manipulation).[211] The agency refuses to endorse a correct view that, although the former type of "manipulation" may indeed be reckless, the latter requires intent.[212]

201. *See* 7 U.S.C. § 9.

202. 7 U.S.C. § 9a (2012).

203. The relevant legislative history is not illuminating. *See* H.R. REP. NO. 102-978 (1992) (Conf. Rep.); S. REP. NO. 102-22 (1991). Limited judicial precedents do not appear to interpret "gravity" as referring to aggressiveness, at least for irredeemable acts. The most extensive judicial discussion of the "gravity" term refers to numerous factors, suggesting that violations of both antifraud (contingently inefficient) and anti-manipulation (irredeemably inefficient) provisions are particularly serious offenses. *See* JCC, Inc. v. Commodity Futures Trading Comm'n, 63 F.3d 1557, 1570–71 (11th Cir. 1995) (interpreting the "gravity" term while applying the antifraud provision of CEA).

204. *See* 7 U.S.C. § 6(c); Prohibition on the Employment, or Attempted Employment, of Manipulative and Deceptive Devices and Prohibition on Price Manipulation, 76 Fed. Reg. at 41,399.

205. *See* 17 C.F.R. § 180.1 (2011); Prohibition on the Employment, or Attempted Employment, of Manipulative and Deceptive Devices and Prohibition on Price Manipulation, 76 Fed. Reg. at 41,399.

206. 7 U.S.C. § 9(1).

207. *Id.* § 9(1)(A).

208. *Id.*

209. *Id.* § 9(3).

210. *Id.* § 6c(a)(5)(C).

211. Prohibition on the Employment, or Attempted Employment, of Manipulative and Deceptive Devices and Prohibition on Price Manipulation, 76 Fed. Reg. 41,398, 41,404–05 (July 14, 2011) (codified at 17 C.F.R. pt. 180).

212. *Id.*

The CFTC guidance also explains that half-truths[213] and misleading reporting[214] are both forms of manipulation (of the fraud-based variety).

It may well be the case that fraud, broadly understood, is a serious problem in commodities and derivatives trading regulated by the CFTC, especially as this regulation expands in response to the Dodd–Frank Act. It may also be true that, historically, manipulation has been a particularly great concern in commodities markets. But conflating contingently inefficient fraud and irredeemably inefficient manipulation is a poor way of emphasizing the gravity of either violation.

Shifting the focus to taxation, one concludes that the implications of this Article's analysis are decidedly mixed. On one hand, the problem of failing to separate contingently and irredeemably inefficient acts does not arise here because all tax-motivated actions belong to the irredeemable category.[215] Necessarily, the same is true of all such actions that are also inconsistent with congressional intent and are scrutinized via the economic-substance doctrine.

But the more important conclusion is that the proposed framework has only a limited use in the tax setting. Although tax-motivated income shifting and character conversion may be plausibly analyzed by reference to the optimal income-tax baseline, a myriad of other tax reduction strategies may not. One cannot say much about the entire tax law by reference to a framework that applies only to a small portion of it. Similarly, although the earlier discussion may be useful to tax scholars thinking about the economic-substance doctrine, limiting the analysis to economic-substance violations is itself an arbitrary decision. In the end, tax law is largely impervious to the optimization analysis that may be usefully deployed to evaluate many other legal regimes.

What is the overall takeaway from this Part's discussion? The proposed framework may claim a limited success. Policy prescriptions following from the analysis of irredeemable acts find reflections in several areas of the law, including the content of substantive rules and sanctions for their violations. The match is imperfect in some areas and absent in others. The same can be said, of course, about the traditional economic analysis of contingently inefficient acts.

IV. TESTING THE BOUNDARIES OF IRREDEEMABLY INEFFICIENT ACTS

In presenting the core analysis of irredeemable acts, the discussion in Part II skipped over some complications and qualifications. This Part tests the boundaries of the irredeemable-acts category and the assumptions underlying the earlier analysis.

A. IS INEFFICIENCY INEVITABLE?

The most important characteristic of irredeemable acts is their inescapable

213. *Id.* at 41,403.

214. *Id.* at 41,406.

215. If the ideal baseline is the optimal income tax, then tax-motivated adjustments between labor and leisure are not irredeemable acts because they are part of the ideal baseline. *See* Raskolnikov, *supra* note 37, at 548.

inefficiency. However, this inefficiency is ensured only if three conditions are met. First, the transfer of money is welfare neutral. Second, that transfer gives rise to no (meaningful) positive externalities. Third, the second-best considerations do not change the irredeemable–inefficiency conclusion. Are all these conditions likely to be satisfied?

The transfer is welfare neutral only if the utility gain to the winner is fully offset by the utility loss to the loser. If the winner's gain is smaller than the loser's loss, the transfer itself is welfare reducing, and the general argument about the inevitable inefficiency of irredeemable acts is strengthened further. If the opposite is true, however, it is no longer clear that every irredeemable act is inefficient.

The uncertainty about winners' and losers' utilities is the main reason this Article limits irredeemable acts to money transfers. Property theft by a starving hiker who breaks into a cabin in the woods and whose utility gain from stealing a loaf of bread vastly exceeds the utility loss to the cabin owner need not be addressed. Nevertheless, even a transfer of something as impersonal and fungible as money may give rise to divergent utilities due to the declining marginal utility of money. A starving thief may value $10 stolen from a wealthy passerby much higher than the passerby himself.[216]

There is no categorical answer to this objection. A starving thief may indeed steal cash rather than food, and his marginal utility of money may be higher than the victim's. In fact, it may be so much higher that it exceeds both the victim's utility loss and the substantial transfer costs of theft, at least in theory. There are reasons to think, however, that the example of a starving money thief is not nearly as problematic as it may appear.

First, there is considerable empirical uncertainty regarding the variations in the utility of money, not to mention the rate of its decline.[217] Second, fungibility of cash means that arguments relying on the declining marginal-utility variations are relatively weak. Unlike a lost hiker starving in the wilderness who is certain to consume the stolen food, a destitute pickpocket has many ways of disposing of the stolen cash. These include purchasing food, but also buying lock-breaking tools to engage in theft on a greater scale. Needless to say, variations here are endless. Finally, larceny is only one of many examples of irredeemable acts. Most other examples are unlikely to present the starving thief and wealthy victim pattern.[218] For all these reasons—and subject to the caveats

216. An argument that a transfer may be welfare increasing because the thief will use the money more efficiently than the victim need not be seriously considered. Allowing transfers based on this justification would undermine the entire market economy, at which point the concerns about efficiency improvements fade in light of the pressing need to address the impending war of all against all.

217. *See generally* Daniel Friedman & Shyam Sunder, *Risky Curves: From Unobservable Utility to Observable Opportunity Sets* (Cowles Found., Discussion Paper No. 1819, 2011), *available at* http://ssrn.com/abstract=1858769.

218. Embezzlers are usually not worse off financially than their victims. Market manipulators are probably not poorer, on average, than ordinary investors in securities or commodities whose prices are manipulated. The same is true of corporate executives, bankers, and lawyers engaged in insider trading.

made at the end of this section—the marginal utility of money variations does not appear to raise a substantial challenge to the coherence of the irredeemable-acts category.

The second condition that must be satisfied in order to conclude that irredeemable acts are always welfare reducing is that the externalities produced by these activities are negative overall. This is the case if a particular irredeemable act produces no positive externalities, or if the resulting positive externalities are definitely smaller than the negative ones.

The greatest debate about the nature of externalities resulting from any of the acts discussed above relates to insider trading. Arguments about its efficiency have continued for decades.[219] Though insider-trading proponents appear to be in the minority, the debate has reached no final resolution. Moreover, insider trading is not unique. Scholars have discovered socially beneficial potential of other seemingly wasteful practices as well. For instance, they have pointed out that in some industries and under certain conditions and assumptions, price fixing may facilitate innovation or reduce unproductive competition.[220] Even tax evasion may be socially beneficial if it results in more efficient redistribution than progressive taxation does, at least in theory.[221]

This Article is not a place to debate any of these points. Some of the examples discussed above may give rise to *some* positive externalities under *certain* conditions. Whether these conditions are likely, and whether these externalities may possibly be comparable to (let alone greater than) the social costs that are certain to result from irredeemable acts is, ultimately, an empirical question. Robert Bork's view of price fixing appears to apply to many irredeemable acts. Bork—hardly a proponent of government intervention in private markets—had the following to say: "The efficiencies arising from a naked price-fixing or market-division agreement, if any ever do arise, must be so

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It is difficult to know with certainty who are the real beneficiaries of price fixing, bid rigging, and related antitrust offenses, but some combination of shareholders, employees, and suppliers comes to mind. There is no reason to expect that all these individuals are poorer, on average, than consumers forced to pay higher prices. Finally, taxpayers engaged in character conversion and income shifting are probably not extremely poor, and neither are tax shelter users potentially violating the economic-substance doctrine. The transferor in this instance is the group of all other U.S. taxpayers. By definition, that group has average wealth.

219. The early pro-insider trading position is staked out in HENRY G. MANNE, INSIDER TRADING AND THE STOCK MARKET (1966). Proponents of insider trading argue that it facilitates delivery of information to the market, diminishes stock price fluctuations, and provides an efficient compensation mechanism for corporate insiders. This Article is not the place to evaluate these arguments. Their dismissal by other scholars summarized in the leading securities law treatise appears persuasive. *See* LOSS & SELIGMAN, *supra* note 31, at 919–27; *cf.* Stephen Clark, *Insider Trading and Financial Economics: Where Do We Go from Here?*, 16 STAN. J.L. BUS. & FIN. 43, 57–63 (2010).

220. *See, e.g.*, MICHAEL D. WHINSTON, LECTURES ON ANTITRUST ECONOMICS 16–17 (2006); Mark F. Grady, *Toward a Positive Economic Theory of Antitrust*, 30 ECON. INQUIRY 225, 228–29 (1992) (describing conditions under which the inability of firms in the industry to fix prices "leads to ruin").

221. *See* Wojciech Kopczuk, *Redistribution When Avoidance Behavior Is Heterogeneous*, 81 J. PUB. ECON. 51, 53–54 (2001).

minor that the law is justified in ignoring them."[222] Other antitrust scholars share this view.[223]

The third challenge to the conclusion regarding the ultimate inefficiency of irredeemable acts comes from the focus on second-best considerations. There is a theoretical possibility that an irredeemable act, clearly inefficient on its own terms, may be efficiency increasing if it offsets a pre-existing distortion. Decades ago, Jagdish Bhagwati called this the "paradox" of beneficial outcome from engaging in DUP activities.[224] If the status quo includes an inefficient tariff, he argued, tariff evasion "may be welfare improving."[225] The same may be said about tax evasion,[226] and perhaps even churning and price fixing.

It is instructive that while Bhagwati explicitly includes theft in his framework,[227] and although he clearly anticipates that a DUP activity may be efficient despite being illegal,[228] he does not argue that theft may be efficiency increasing. No doubt, this is because such argument would be highly implausible empirically. It is easy to imagine how a tariff evasion may be socially desirable because economists generally view tariffs as inefficient.[229] The case for tax evasion is much weaker even if a particular tax (such as a tax on capital income) is viewed as welfare reducing.[230] If tax enforcement is relaxed, there is no assurance that taxpayers will evade the inefficient tax and comply with the relatively efficient one. When the discussion shifts to embezzlement, churning, or price fixing, the paradox of beneficial outcome becomes even less plausible. What argument would support efficiency of any of these activities? What pre-existing distortions would these acts alleviate to such a great degree that their obvious and substantial costs would pale in comparison?[231] Though the second-best problems are pervasive in the real world, irredeemable acts cannot plausibly be offered as a solution to these problems.

The broader point is apparent by now. Perhaps some claims may be advanced to suggest certain socially valuable effects of this or that irredeemable act. If these effects exist, they are highly unlikely to raise a meaningful doubt about

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222. ROBERT H. BORK, THE ANTITRUST PARADOX: A POLICY AT WAR WITH ITSELF 268 (1978).

223. *See, e.g.*, Frank H. Easterbrook, *The Limits of Antitrust*, 63 TEX. L. REV. 1, 18 (1984) ("[I]f a group of firms agree on price but do not integrate any of their productive facilities . . . [they] reduce output and produce nothing in return."); Louis Kaplow, *supra* note 36, at 361 ("[W]hile permitting oligopolistic price elevation may produce some dynamic gains, there is insufficient nexus to justify price fixing.").

224. *See* Bhagwati, *supra* note 6, at 991–96.

225. *Id.* at 995.

226. *See* Kopczuk, *supra* note 221.

227. *See* Bhagwati, *supra* note 6, at 991.

228. *See id.* at 995.

229. *See, e.g.*, Paul Krugman, *What Should Trade Negotiators Negotiate About?*, 35 J. ECON. LITERATURE 113, 113, 115 (1997) (summarizing the well-known economic case for free trade).

230. Whether a capital income tax is welfare reducing is the subject of a vigorous debate in the economics literature. *See* Raskolnikov, *supra* note 37, at 565.

231. Perhaps one may argue that larceny could offset a suboptimal income inequality, reducing the need for a distortionary redistributive taxation. One would have to hold the tax and transfer system in truly low regard to view this argument as even remotely plausible.

the act's overall inefficiency. At the same time, another observation made about per se antitrust violations such as price fixing may be extended to all irredeemable acts. "The *per se* rule is an empirical rule. . . . Like all empirical rules [it] is not based on logical necessity but on accumulated observation."[232] If one day economists realize that churning or market manipulation leads to remarkable efficiency gains, these acts should lose their irredeemably inefficient label.

B. ARE IRREDEEMABLE ACTS REALLY DIFFERENT?

Even if one is convinced about the certain inefficiency of irredeemable acts, doubts may linger. There are plenty of other activities that are surely inefficient. There are many actions that are certain to be resisted by some of the parties involved. Is there anything unique about irredeemable acts? The only way to answer this question is to consider other possibly indistinguishable categories one by one. Fortunately, the list of such categories is not long, and the distinctions can be readily made.

To begin with, is there anything special about irredeemable acts' inefficiency? What about other certainly inefficient acts? Imagine, for instance, a coal-fueled power plant operating without any pollution-control equipment. This is inefficient—the plant owner's profit is lower than the environmental harm (in this case, both on average and at the margin). The plant's operation is socially harmful, just like theft, churning, and so on. Is there a difference?

There are a few. First, the inefficiency of the plant's operation can be determined without any inquiry into the state of mind of the plant operator. Maybe the operator negligently failed to notice that the emissions controls stopped working. Maybe he deliberately failed to install them to save costs. Whatever the reason, the plant's operation without emission controls is socially harmful. In contrast, it is impossible to evaluate the social costs of an outcome possibly caused by an irredeemable act without understanding the intent of the actor.[233]

Moreover, though the plant's operation without emission controls is clearly inefficient, it does not follow that the socially optimal solution is to close the plant. It may be the case that installing the controls, though reducing the operator's profit, will still enable the operator to make money. In other words, the efficient amount of the external harm produced by the plant (pollution) need not be zero. In contrast, the optimal amount of external harm of irredeemable acts is zero when these acts are considered on their own terms.

What if the plant's technology is so outdated that no equipment can reduce pollution to a point at which the plant's operation is efficient? In this case, the optimal solution is to shut down the plant. In other words, the optimal level of the activity in question is zero, just like the optimal level of theft and other irredeemable acts taken in isolation. Yet even in this case, the distinction between contingently and irredeemably inefficient acts is important. Although

232. HOVENKAMP, *supra* note 7, at 256.
233. *See supra* text accompanying notes 41–46.

the conclusion about the zero activity level happens to be the same in both cases, the reasons underlying this conclusion are different. Needless to say, understanding these reasons is important in order to conduct an appropriate analysis in every case, including those where the optimal activity level is *not* zero.

One of the points emphasized throughout this Article is that regulation of irredeemable acts is challenging because it is difficult to differentiate between irredeemable acts and their efficient look-alike counterparts. What about contingently inefficient acts that give rise to the uncertainty about the efficiency of the underlying behavior? To make the comparison even closer, what about such acts that are also intentional?

Imagine a car speeding at 80 mph on a highway where the speed limit is 55 mph. Assume that when a police officer stops the car, the driver confesses that he deliberately set the cruise control at 25 mph over the speed limit, so there is no doubt that the act of speeding was intentional. Is this example of a contingently inefficient act fundamentally different from churning and price fixing?

It certainly is. The uncertainty in the speeding example arises due to our lack of knowledge of private benefits of speeding. We know that each act of driving gives rise to costs and benefits. We know that 55 mph is the optimal speed limit on average. But we are not sure about the exact cost–benefit tradeoff for every driver. The speeding driver may be joy riding and hoping to avoid detection, or he may be rushing a sick child to the hospital, fully prepared to pay a high fine. Fortunately, we do not need to determine the driver's private benefits of speeding in each case in order to optimally regulate speeding. All we need to determine is the expected external harm of driving 80 mph—the negative externality of speeding. Once this is known, the speeding fines will give drivers appropriate incentives to abstain from speeding in most cases and, as importantly, to speed in some circumstances. In other words, not only is it true that driving in some form is efficient, there is even such a thing as efficient speeding. The same is true for many other contingently inefficient acts.

But efficient churning does not exist. There is no uncertainty about the private benefits of churning because the benefit of stealing $100 from a client is the same for every broker.[234] Moreover, unlike in the speeding example, where determining the driver's intent does not end the inquiry into the efficiency of a given act of speeding, determining the broker's intent does resolve all uncertainty about the efficiency of the broker's trading. This is because, in contrast with contingently inefficient acts, intent is the only factor that determines the efficiency of an observed outcome possibly caused by an irredeemable act.

Perhaps irredeemable acts are not the only offenses that turn *solely* on the offender's state of mind. But contingently inefficient acts whose efficiency may depend solely on the actor's mental state are different from irredeemable ones. Consider employment discrimination. Assume that this offense is defined as an

234. I ignore possible variations in the marginal utility of money among brokers for the reasons already discussed.

employer changing a hiring or firing decision due to the employer's animus toward a particular category of people (compared to what the decision would have been in the absence of such animus). Though surely not the only possible definition of discrimination,[235] this is the definition that results in the closest analogy to irredeemable acts. Under this definition, intent is both hidden and determinative of the efficiency analysis. Discriminators are likely to expend resources to conceal their animus-based decisions, and those discriminated against are sure to resist discrimination. Thus, social costs are inevitable.

Yet discrimination is not an irredeemable act because its inefficiency is uncertain. Although the victims of discrimination surely experience a utility loss because of it, the discriminators just as certainly gain satisfaction. Whatever one may think about this kind of utility, economic analysis has no way of distinguishing it from the utility of a speeding driver rushing a sick child to a hospital or, for that matter, the utility of any other member of society doing anything he or she prefers to do. Law and economics writers occasionally suggest that we should discount or even completely disregard the utility of actors whose conduct the author finds to be repulsive. These authors refer to such utility as "illicit,"[236] not "legitimate,"[237] or falling "outside the welfare space."[238] Unfortunately, this argument simply defines the fundamental problem away. Its fatal flaws are acknowledged by economists and noneconomists alike.[239] Without a reason to disregard the discriminator's utility gain, we cannot conclude that this gain is necessarily smaller than the victim's utility loss. All of this is not to say that discrimination is socially desirable, only to point out the limits of the economic analysis of discrimination. These limits do not constrain the analysis of irredeemable acts because the assumption about the lack of net social gain from money transfers is much easier to make.[240]

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235. Even economic conceptualizations of discrimination (not to mention the legal tests) are more varied than this definition. *See* John J. Donohue, *Antidiscrimination Law*, *in* 2 HANDBOOK OF LAW AND ECONOMICS 1387, 1394 (A. Mitchell Polinsky & Steven Shavell eds., 2007).

236. George J. Stigler, *The Optimum Enforcement of Laws*, 78 J. POL. ECON. 526, 527 (1970).

237. Kaplow, *supra* note 85.

238. Jeff L. Lewin & William N. Trumbull, *The Social Value of Crime?*, 10 INT'L REV. L. & ECON. 271, 278 (1990).

239. *See, e.g.*, John J. Donohue III, *The Law and Economics of Tort Law: The Profound Revolution*, 102 HARV. L. REV. 1047, 1067–69 (1989) (book review); Claire Finkelstein, *The Inefficiency of Mens Rea*, 88 CALIF. L. REV. 895, 903 (2000); Fred S. McChesney, *Boxed In: Economists and Benefits from Crime*, 13 INT'L REV. L. & ECON. 225, 225–29 (1993); Joel Slemrod & Shlomo Yitzhaki, *Tax Avoidance, Evasion, and Administration*, *in* 3 HANDBOOK OF PUB. ECON. 1423, 1447 (Alan J. Auerbach & Martin Feldstein eds., 2002).

240. Fred McChesney's theory of criminal law is similar to this Article's argument both because it relies on Tullock's analysis of theft and because it rejects the assertions that anyone's gains should not be counted. *See* McChesney, *supra* note 239. However, his argument sweeps too broadly. McChesney applies Tullock's analysis of theft to all conduct branded as criminal by the society. Following Tullock's lead, he emphasizes the social costs that arise from crime (that is, the transfer costs) in addition to the victim's loss. These costs, he argues, "mean that *criminals' gains must inevitably fall short of crime's costs*. When these costs are included—regardless of whether criminals' gains are counted—the optimal amount of crime is a corner solution," (that is, zero). *Id.* at 228 (emphasis added). McChesney's

The final question is the most challenging one: are contingently and irredeemably inefficient acts distinct when the former involve deception? What distinguishes market manipulation from corporate misstatements? The former involves misleading acts, the latter misleading statements. In either case, the affected parties are likely to resist being misled, so social costs are likely to arise. Is there a difference?

Indeed there is. Although every inquiry into (irredeemable) manipulation presents us with a binary choice, an inquiry into (contingently inefficient) misstatements does not. In evaluating corporate misstatements, perhaps we may identify a full truth and a complete lie. But there is a vast terrain in between these two opposites, and there is no sharp line separating the two. Securities fraud litigation is a stark example of the difficulties encountered by courts in deciding what misleading statements are false enough.[241] These difficulties are understandable because corporate misstatements lie on the same continuum as truthful corporate statements, and the latter belong to the ideal efficient capital market baseline.[242]

One may try to reestablish clarity by focusing on the speaker's own view of falsity. If we had a mind-reading machine, would we not be able to set a clear boundary between deliberate lies and full truth in corporate misstatement cases? We would not, because in this context, intent is much more complex than it is for irredeemable acts. A corporate executive may intend to flat-out mislead the market, just like a market manipulator may. But the executive also may intend to confuse the market, or to buy time, or to convey only partial information, or to give a correct overall impression without revealing a critical fact. None of these shades of gray are possible for market manipulators. They either act with a bad purpose or they do nothing wrong. This is just another way of stating that, though irredeemable acts involve binary decisions, contingently inefficient acts do not.[243]

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conclusion depends critically on the assumption that criminals' gains do not exceed victims' losses to such an extent that the excess is greater than other costs of crime. To be sure, that assumption is much more plausible than the assertion that criminals' gains are zero or that they simply do not count. Yet it is just an empirical guess for which McChesney offers no support. This Article limits irredeemable acts to money transfers precisely in order to avoid the need to rely on this conjecture.

241. False enough, that is, to give rise to liability. *See* Alexander, *supra* note 58, at 1498 n.39 ("[P]rojections or statements about the future can turn out to be wrong through bad luck or bad judgment as well as fraud. Before discovery, plaintiffs cannot always distinguish losses caused by bad luck from loses caused by fraud . . . ."); Donald C. Langevoort, *Capping Damages for Open-Market Securities Fraud*, 38 ARIZ. L. REV. 639, 652 (1996) (referring to "the dimly illuminated margins of the half-truth doctrine and the duty to update").

242. That is, unlike a zero-net-gain money transfer, a process of disseminating information about corporate issuers is efficiency enhancing when the information is correct and efficiency reducing when it is false. Given the lack of clear boundary between true and false information, regulation of its disclosure presents the typical challenge of optimal regulation of contingently inefficient acts. For an explanation of social costs of false disclosure, see Merritt B. Fox, *Civil Liability and Mandatory Disclosure*, 109 COLUM. L. REV. 237, 252 (2009).

243. The earlier discrimination example presents a contingently inefficient act featuring binary intent. It is important to remember, however, that this example is purposefully constructed to come as

Here is another way to make the same point. Intent is crucial in differentiating irredeemable acts from their benign look-alikes. If that intent is known, the differentiation is easy to make. Intent is also important in evaluating some contingently inefficient acts. However, even if this intent is discovered, it will still be unclear whether the act is inefficient. If we had a mind-reading machine, the overdeterrence problem for irredeemable acts would cease to exist, but it would remain for contingently inefficient ones.

In sum, irredeemable acts present a unique package of features. The money-transfer condition ensures the absence of any net social benefit. The intentional and nonconsensual nature requirement ensures the existence of the transfer costs, leading to the irredeemable–inefficiency conclusion. The dispositive role of intent and its binary nature distinguish irredeemable acts from contingently inefficient ones. The two types really are fundamentally different from the social-welfare perspective.

CONCLUSION

On reflection, the existence of the irredeemable-acts category is entirely unsurprising. Life reminds us again and again that occupation, social status, personal wealth, and financial sophistication are no cure for some basic human flaws. There will always be pickpockets and bank robbers; there will always be Madoffs, Helmsleys, and Kozlowskis, as well. Other people's money is too irresistible for some of us, and the ways of misappropriating other people's money are apparently endless. Because these theft-like activities raise unique regulatory design challenges, it is important to recognize irredeemable acts in whatever setting they arise and to regulate them separately from their contingently inefficient counterparts.

It may also make sense to expand the inquiry beyond money transfers. Perhaps the example of a starving hiker in the woods is not representative of most property theft, or it may be addressed along with other exceptional cases. Perhaps we can distinguish outright lies in corporate disclosures from misleading, but not clearly false, statements. Perhaps we may agree that, though the private gain of someone engaged in discrimination is not zero, it is extremely unlikely to exceed the private loss of those discriminated against combined with other social costs of discrimination, at least in most cases. Perhaps we should do so. This Article adopts a narrow definition of irredeemable acts in order to set forth and explore this basic argument. If this argument is persuasive, it should inform—if not determine—our analysis of a much broader range of socially undesirable acts.

close to an irredeemable act as possible. The example reflects neither the doctrinal treatment of discrimination nor a theoretical position regarding how discrimination should be defined from a welfarist perspective.