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United States v. O'Hagan: Improperly Incorporating Common Law Fiduciary Obligations into 14(e) of the Securties Exchange Act

Michael J. Voves

Comment

United States v. O'Hagan: Improperly Incorporating Common Law Fiduciary Obligations into § 14(e) of the Securities Exchange Act

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Dorsey & Whitney, a Minneapolis law firm, represented Grand Metropolitan[1] in an acquisition of the Pillsbury Company.[2] When James O'Hagan, a Dorsey & Whitney partner, learned that Grand Metropolitan was contemplating making a tender offer[3] for Pillsbury Company's common stock, he engaged in what is commonly called insider trading.[4] Before the proposed tender offer became public, O'Hagan purchased 5,000 shares of Pillsbury Company common stock and 2,500 call options.[5] When Grand Metropolitan publicly announced its tender offer, the price of Pillsbury Company common stock rose from $39 per share to $60 per share.[6] O'Hagan exercised his

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1. Grand Metropolitan is a large, diversified company based in London. United States v. O'Hagan, 92 F.3d 612, 614 (8th Cir. 1996), *cert. granted*, 65 U.S.L.W. 3499, 65 U.S.L.W. 3505 (U.S. Jan. 13, 1997) (No. 96-842).

2. *Id.*

3. A tender offer is a public invitation, made by advertisement or press release, to shareholders of a target corporation to sell their shares. ROBERT W. HAMILTON, CASES AND MATERIALS ON CORPORATIONS 1139 (5th ed. 1994). The tender offeror usually obligates itself to purchase all or a specified portion of the tendered shares if certain specified conditions, namely working control of the target, are met. *Id.* The share-offering price is usually higher than the market price, accounting for the additional control over the target corporation the offeror will have if the tender offer succeeds. *Id.*

4. Insider trading is the purchasing or selling of securities while in possession of information unavailable to the public. *See* William K.S. Wang, *Trading on Material Nonpublic Information on Impersonal Stock Markets: Who Is Harmed, and Who Can Sue Whom Under SEC Rule 10b-5?*, 54 S. CAL. L. REV. 1217, 1219 n.2 (1981) (defining "inside trading" for purposes of the article).

5. *O'Hagan*, 92 F.3d at 614.

6. *Id.*

options, sold all his shares at the new market price, and realized a profit of over $4,000,000.[7]

The Securities and Exchange Commission (SEC) began an investigation of O'Hagan's securities transactions. It charged O'Hagan with securities fraud under SEC Rule 14e-3,[8] which makes it a fraudulent act for anyone to purchase or sell securities while possessing tender offer information unavailable to the public.[9] A jury convicted O'Hagan, and the United States District Court for the District of Minnesota sentenced O'Hagan to forty-one months imprisonment.[10] O'Hagan appealed.[11]

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7. *Id.*

8. Rule 14e-3 reads in pertinent part:

> (a) If any person has taken a substantial step or steps to commence, or has commenced, a tender offer (the "offering person"), it shall constitute a fraudulent, deceptive or manipulative act or practice within the meaning of § 14(e) of the [Exchange Act] for any other person who is in possession of material information relating to such tender offer which information he knows or has reason to know is nonpublic and which he knows or has reason to know has been acquired directly or indirectly from:
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> (1) The offering person,
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> (2) The issuer of the securities sought or to be sought by such tender offer, or
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> (3) Any officer, director, partner or employee or any other person acting on behalf of the offering person or such issuer,
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> to purchase or sell or cause to be purchased or sold any of such securities or any securities convertible into or exchangeable for any such securities or any option or right to obtain or to dispose of any of the foregoing securities, unless within a reasonable time prior to any purchase or sale such information and its source are publicly disclosed by press release or otherwise.

17 C.F.R. § 240.14e-3(a) (1996).

9. The SEC promulgated this rule pursuant to its authority under § 14(e) of the Securities Exchange Act of 1934 ("Exchange Act"). 15 U.S.C. § 78n(e) (1994). Congress added § 14 to the Exchange Act through the Williams Act of 1968. Pub. L. No. 90-439, 82 Stat. 454 (codified at 15 U.S.C. §§ 78*l* to 78n (1994)). Section 14(e) reads in pertinent part:

> It shall be unlawful for any person to make any untrue statement of a material fact or omit to state any material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading or to engage in any fraudulent, deceptive, or manipulative acts or practices, in connection with any tender offer. . . . The [SEC] shall, for the purposes of this subsection, by rules and regulations define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative.

15 U.S.C. § 78n(e).

10. *O'Hagan*, 92 F.3d at 614.

11. *Id.* The SEC also charged O'Hagan under § 10(b), 15 U.S.C. § 78j(b), and Rule 10b-5, 17 C.F.R. § 240.10b-5. The jury convicted O'Hagan on these counts. *O'Hagan*, 92 F.3d at 622. The Eighth Circuit, however, vacated the

The Eighth Circuit Court of Appeals vacated the Rule 14e-3 conviction, holding that the SEC exceeded its rule-making authority under § 14(e) when it promulgated Rule 14e-3.[12] Specifically, the court reasoned that, under the Supreme Court's holding in *Chiarella v. United States*,[13] the SEC could prohibit insider trading only where there was an accompanying breach of fiduciary duty.[14] The court held that the SEC impermissibly omitted a breach of fiduciary duty element in Rule 14e-3.[15]

The *O'Hagan* decision is significant because the Second, Seventh, and Tenth Circuit Courts of Appeals have already upheld Rule 14e-3 over challenges to the SEC's authority to promulgate the rule.[16] The Supreme Court, which has not yet addressed the validity of Rule 14e-3, will now consider the issue and should restore consistency to the regulation of insider trading and provide clearer notice to potential perpetrators of the scope of § 14(e) and Rule 14e-3 insider trading liability.

This Comment critically examines the *O'Hagan* decision, concluding that the Eighth Circuit misinterpreted the SEC's powers to promulgate Rule 14e-3. Part I discusses when insider trading violates the Securities Exchange Act of 1934 (Exchange Act), with particular emphasis on violations under § 10(b). Part II discusses the Eighth Circuit Court of Appeals' reasoning in *O'Hagan*. Finally, Part III argues that the SEC did not exceed its authority to prohibit fraudulent conduct under § 14(e) when it omitted a breach of fiduciary duty element in Rule 14e-3. In particular, it argues that the Eighth Circuit improperly incorporated common law fiduciary principles into § 14(e) fraud when it should have looked to federal policy pro-

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convictions because it found that they were premised solely on the misappropriation theory, which it found was not a valid basis for criminal liability. *Id.* For a discussion of the misappropriation theory, see *infra* Part I.B.

12. *O'Hagan*, 92 F.3d at 627.

13. 445 U.S. 222 (1980).

14. *See O'Hagan*, 92 F.3d at 625 (concluding that Supreme Court precedent requires that a definition of "fraudulent" under § 14(e) include a breach of fiduciary duty).

15. *See id.* at 627 (holding that, in promulgating Rule 14e-3 without a breach of fiduciary duty element, the SEC overstepped its authority).

16. *See* SEC v. Maio, 51 F.3d 623, 635 (7th Cir. 1995) (holding that Rule 14e-3 is clearly within the SEC's statutory grant of authority); SEC v. Peters, 978 F.2d 1162, 1167 (10th Cir. 1992) (same); United States v. Chestman, 947 F.2d 551, 560 (2d Cir. 1991) (en banc) (adopting the view that Congress authorized the SEC to promulgate a rule that extends beyond the common law), *cert. denied*, 503 U.S. 1004 (1992). For a discussion of the *Chestman* court's reasoning, see *infra* notes 91-96 and accompanying text.

hibiting corporate insiders from using corporate information for self-enrichment. This approach would have been consistent with Supreme Court and lower federal court precedent interpreting similar anti-fraud provisions in § 10(b) and Rule 10b-5. Part IV proposes a new model for determining when insider trading violates § 14(e). This model recognizes that insiders to tender offers owe disclosure duties to target company shareholders when they use inside tender offer information for their own personal benefit, but owe no disclosure duties when they use such information to benefit the corporation, such as in the case of warehousing. It also examines whether the "misappropriation theory" of insider trading liability has viability under § 14(e).

I. LIABILITY FOR INSIDER TRADING UNDER FEDERAL SECURITIES LAWS

Sections 10(b) and 14(e) of the Exchange Act empower the SEC to promulgate rules that prohibit fraudulent, manipulative, and deceptive conduct in securities transactions.[17] Section 14(e) targets fraudulent, manipulative, and deceptive conduct in the tender offer context specifically.[18] The SEC has promulgated two rules that prohibit insider trading, Rules 10b-5[19] and 14e-3.[20] To stay within the statutory mandate, these rules may prohibit insider trading only when it is fraudulent, manipulat-

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17. Section 10(b) is strictly an enabling provision. It prohibits any person from using or employing, "in connection with the purchase or sale of any security registered . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [SEC] may prescribe as necessary or appropriate in the public interest or for the protection of investors." 15 U.S.C. § 78j(b) (1994). Section 14(e) expressly forbids fraudulent, manipulative, and deceptive conduct and authorizes the SEC to promulgate rules that prohibit such conduct. *Id.* § 78n(e).

18. *Id.* § 78n(e).

19. In 1942, pursuant to the authority granted in § 10(b), the SEC enacted Rule 10b-5, which states:

> It shall be unlawful for any person, directly or indirectly . . .
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> (a) To employ any device, scheme, or artifice to defraud,
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> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
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> in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5 (1996).

20. § 240.14e-3.

ive, or deceptive.[21] Because these terms are somewhat ambiguous, the federal courts interpreting them have played an important role in establishing the extent to which the Exchange Act prohibits insider trading.[22]

A. SECTION 10(b) AND RULE 10b-5: LIABILITY FOR THE CORPORATE INSIDER

Liability for insider trading under § 10(b) and Rule 10b-5 derives principally from the Supreme Court's holding in *Chiarella v. United States*.[23] *Chiarella* established that certain persons who have access to intimate knowledge of a firm, so-called "corporate insiders,"[24] violate a fiduciary[25] duty to the

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21. Courts have interpreted the terms "fraudulent," "deceptive," and "manipulative" to have the same meaning. *See infra* note 98 (explaining the Supreme Court's reliance on certain principles of statutory construction in Schreiber v. Burlington Northern, 472 U.S. 1 (1985)).

22. *See infra* Part I.A.2 (discussing evolution of § 10(b) and Rule 10b-5).

23. 445 U.S. 222, 235 (1980).

24. Persons traditionally recognized as corporate insiders include directors, officers, and controlling shareholders of a corporation. *See* F.S. Tinio, Annotation, *Who is an "Insider" Within § 10(b) of the Securities Exchange Act of 1934*, 2 A.L.R. FED. 274, 278 (1969). In recent years courts have extended the term to include all employees of a corporation who have access to material, nonpublic information, as well as non-employees who, because of their relationship to the corporation, have access to nonpublic information. *Id.* These individuals include, for example, underwriters, accountants, lawyers, or corporate consultants. Dirks v. SEC, 463 U.S. 646, 655 n.14 (1983).

25. Fiduciary obligations originated at common law. Under the common law, affirmative disclosure of all material information is required where parties to a business transaction stand in a fiduciary relationship. RESTATEMENT (SECOND) OF TORTS § 551 (1977). The common law fails to provide a clear definition of the term "fiduciary," however. *See* Deborah A. DeMott, *Beyond Metaphor: An Analysis of Fiduciary Obligation*, 1988 DUKE L.J. 879, 879, 881 (describing the law of fiduciary obligations as evolving from a "jurisprudence of analogy rather than principle" and "ow[ing] much to the situation-specificity and flexibility that were Equity's hallmarks"). Although elusive, the fiduciary concept derives in part from common law agency and trust principles. Agency law deals with agreements under which persons (the principals) employ others (the agents) to act on their behalf while delegating them discretionary authority. RESTATEMENT (SECOND) OF AGENCY § 1 (1957). The law of trusts deals with situations in which persons (the trustees) have discretionary authority over property owned by others (the beneficiaries). RESTATEMENT (SECOND) OF TRUSTS § 2 (1959). Under both doctrines, this discretionary authority gives rise to duties of loyalty and candor, one of which is the agent/trustee's duty not to misuse confidential information. RESTATEMENT (SECOND) OF AGENCY §§ 379-398 (1957). The federal courts have incorporated similar fiduciary obligations into the federal securities laws. *See, e.g.*, Charles Hughes & Co. v. SEC, 139 F.2d 434, 436-37 (2d Cir. 1943) (holding securities broker/dealer subject to fiduciary standards), *cert. denied*, 321 U.S. 786

firm's shareholders when they fail to disclose any material, nonpublic information prior to trading in others firms' shares.[26] An insider can also breach this duty without trading by "tipping"[27] an outsider who then uses the nonpublic information to trade in the corporation's stock.[28] An insider avoids breaching the fiduciary duty by disclosing the inside information before trading with a stockholder or by abstaining from trading altogether.[29] The development of the fiduciary theory of § 10(b) insider trading liability for corporate insiders owes largely to two factors: the unsatisfactory nature of state common law, which afforded few substantive rights to shareholders against insider traders, and the unsatisfactory nature of some Rule 10b-5 precedents, which imposed broad disclosure duties on the basis of possession of inside information alone.

(1944). With respect to insider trading, however, federal courts have incorporated fiduciary obligations into the securities laws not so much on the basis of the insider's discretionary authority, but rather on the basis of the insider's position of access to inside information. *See infra* Part III.B (arguing that the federal courts have created quasi-fiduciary relationships under § 10(b) of the Exchange Act that do not fit squarely within traditional common law fiduciary principles).

26. *Chiarella*, 445 U.S. at 226-30. The Court noted that "[a]pplication of a duty to disclose prior to trading guarantees that corporate insiders, who have an obligation to place the shareholder's welfare before their own, will not benefit personally through fraudulent use of material, nonpublic information." *Id.* at 230.

27. A tippee is a person who trades in shares of a corporation's stock after receiving nonpublic information from an insider. Tinio, *supra* note 24, at 287.

28. Courts view tippees' obligations as arising from their roles as "participants after the fact" in the insider's breach of fiduciary duty. *Chiarella*, 445 U.S. at 230 n.12. In addition, an insider must intend to benefit personally from the disclosure to the tippee in order for a court to find that the tippee is under an obligation to disclose or to abstain from trading. *See Dirks*, 463 U.S. at 662 ("[T]he test is whether the insider personally will benefit, directly or indirectly, from his disclosure."). Consequently, not only is the insider's direct or indirect benefit necessary for a breach to occur, but an element of scienter must be present as well. *Id.* at 663 n.23. The benefit requirement is not as onerous as it may first seem, however. The Supreme Court has stated that such benefit is not limited to pecuniary gain. *Id.* at 663. A benefit imputes to an insider who tips a friend or a relative as a gift. *Id.* at 664. In other instances, the relationship between the insider and the tippee may be such that a court will presume a quid pro quo exists. *Id.*

29. *See* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 853-54 (2d Cir. 1968) (requiring that the information be disclosed in a manner that insures its availability to the investing public). Where the transaction takes place on a stock exchange, public disclosure through the financial news media (e.g., Dow Jones broad tape) is necessary. *Id.* at 854. Where disclosure would violate the insider's duty of confidentiality to the corporation, the insider must abstain from trading altogether. *Id.* at 848.

1. The Common Law Before the Exchange Act

Before the passage of the Exchange Act, a majority of state courts held that corporate insiders owed a fiduciary duty to the corporate entity, but not to individual shareholders.[30] Consequently, shareholders generally had no cause of action against insiders for insider trading unless there was an actual misrepresentation.[31] Where insiders either actively sought and induced shareholders to sell, or took steps to conceal their identities as purchasers, some courts found sufficient indicia of fraud.[32] A few jurisdictions even recognized a fiduciary relationship, particularly in the case of privately-negotiated transactions.[33] Overall, however, state case law offered shareholders inadequate protection from insider traders. Where insiders purchased their corporation's securities through a stock exchange, they owed no duty to disclose material information to the sellers.[34] Corporate insiders who sold stock to persons

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30. *See* Note, *The Prospects for Rule X-10b-5: An Emerging Remedy for Defrauded Investors*, 59 YALE L.J. 1120, 1125 (1950) (noting that majority of courts adhered to a no-duty rule); R.E. Heinselman, Annotation, *Duty of Officer or Director of Corporation Toward One from Whom He Purchases Stock*, 84 A.L.R. 615, 616-22 (1933) (citing and discussing state cases holding that corporate officers and directors sustained no fiduciary relation with individual shareholders).

31. *See* Heinselman, *supra* note 30, at 616 (noting that neither fraud nor unfair dealing will be inferred when an insider purchases stock from a shareholder).

32. *See, e.g.*, Strong v. Repide, 213 U.S. 419, 428-33 (1909) (noting that no confidential relations exist between directors and stockholders, but finding liability where defendant took affirmative steps to conceal his identity as purchaser from shareholder); George v. Ford, 36 App. D.C. 315, 329 (D.C. Cir. 1911) (holding corporate manager liable where he induced stockholder to sell his shares and secretly bought stock for himself); Goodwin v. Agassiz, 186 N.E. 659, 660-61 (Mass. 1933) (rejecting contention that directors occupy position of fiduciary to individual shareholders but holding that, where director personally sought a stockholder for purpose of buying shares without disclosing material information, relief would be granted in "appropriate instances"); Poole v. Camden 92 S.E. 454, 457 (W. Va. 1916) (holding that, even though the director/shareholder relationship was not strictly fiduciary in character, directors who undertook to give information particularly within their knowledge were bound to give full and correct information in purchasing stock so as not to mislead shareholders).

33. *See, e.g.*, Oliver v. Oliver, 45 S.E. 232, 234-35 (Ga. 1903) (holding that director occupied a fiduciary position to the shareholders individually); Hotchkiss v. Fischer, 16 P.2d 531, 535 (Kan. 1932) (holding director, who negotiated with widow shareholder for the purchase of her shares, liable for failing to act in "scrupulous trust and confidence").

34. In *Goodwin*, the Supreme Judicial Court of Massachusetts noted:

> An honest director would be in a difficult situation if he could neither

buying into the corporation owed no duty to disclose inside information to them, either.[35] Given the limited availability for relief under state law, Rule 10b-5 claims became a more promising avenue for relief in insider trading cases.[36]

2. Evolution of § 10(b) and Rule 10b-5: From Regulating Insider Activity to Regulating All Trading Activity and Back Again

In the 1950s and 1960s, § 10(b) of the Exchange Act and Rule 10b-5 emerged as the primary means for private relief in insider trading cases.[37] Interestingly, § 10(b) does not expressly provide for a private remedy,[38] but federal courts cre-

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> buy nor sell on the stock exchange shares of stock in his corporation without first seeking out the other actual ultimate party to the transaction and disclosing to him everything which a court or jury might later find that he then knew affecting the real or speculative value of such shares. Business of that nature is a matter to be governed by practical rules. Fiduciary obligations of directors ought not to be made so onerous that men of experience and ability will be deterred from accepting such office.

Goodwin, 186 N.E. at 661. Also, in *Geller v. Transamerica Corp.*, 53 F. Supp. 625, 630 (D. Del. 1943), a diversity action involving Kentucky law, the court noted:

> There is another reason why I conclude there was no relationship created here which required disclosure on the part of defendant .... These shares were traded in on the New York Curb Exchange. Trading there is free and open. Only firm "bids" and "offers" are recognized .... Whether a person is a good or poor trader depends in a large measure upon information; and I can see no reason why one trader should be required to furnish information to another trader.

Id. (footnote omitted).

35. It seems that no jurisdiction found a fiduciary relation between insiders and persons buying into the corporation. *See generally* Heinselman, *supra* note 30 (discussing cases dealing exclusively with insider purchases of stock). Many courts reasoned that a fiduciary relationship between the insider and the buyer did not exist until after the transaction was consummated. *See, e.g.*, Gratz v. Claughton, 187 F.2d 46, 49 (2d Cir.) (criticizing traditional rule that directors who sold their shares were not dealing with a beneficiary, but with one whom his purchase made a beneficiary), *cert. denied*, 341 U.S. 920 (1951).

36. *Compare* Geller v. Transamerica Corp., 53 F. Supp. at 630 (dismissing state common law action), *with* Speed v. Transamerica Corp., 71 F. Supp. 457, 457-58 (D. Del. 1947) (dismissing state common law action, but sustaining Rule 10b-5 action).

37. *See* HAMILTON, *supra* note 3, at 915 ("[S]ince there was usually little or no favorable case law in the state courts, plaintiffs naturally preferred the federal forum with its rule 10b-5 precedents and state law either atrophied or never had a chance to develop.").

38. Congress made express provisions for private actions in §§ 9(e), 16(b), and 18(a) of the Exchange Act, but there is no express provision for a private action under § 10(b).

ated an implied one anyway.[39] Moreover, neither § 10(b) nor Rule 10b-5 expressly treat mere non-disclosure of inside information as fraudulent.[40] In view of Congress's expressed intent to promote insider disclosure of information generally,[41] however, courts used § 10(b) to create a new fiduciary relationship between insiders and their corporations' shareholders under federal law.[42] Over time, both the courts and the SEC, through its

39. *See, e.g.*, Kardon v. National Gypsum Co., 69 F. Supp. 512, 514 (E.D. Pa. 1946) ("[I]n view of the general purpose of the Act, the mere omission of an express provision for civil liability is not sufficient to negative what the general law implies."); *see also Speed*, 71 F. Supp. at 458 (following *Kardon*).

40. Section 10(b) authorizes the SEC to prohibit manipulative and deceptive conduct, but does not expressly state that the mere nondisclosure of material information in a securities transaction is manipulative or deceptive. 15 U.S.C. § 78j(b) (1994). Also, Rule 10b-5 on its face only prohibits omissions that would make a statement misleading. 17 C.F.R. § 240.10b-5(b) (1996).

41. Both the Securities Act of 1933 and the Exchange Act of 1934 impose registration and prospectus requirements for new securities, registration and report requirements for corporations, brokers, and dealers, and regulation of exchanges and over-the-counter markets. 15 U.S.C. §§ 77e-77j (codifying §§ 5-10 of the Securities Act of 1933); *id.* §§ 78f-78i (codifying §§ 6-9 of the Exchange Act of 1934); *id.* §§ 78*l*, 78m, 78o, 78q (codifying §§ 12, 13, 15, 17(b) of the Exchange Act of 1934).

42. In *Speed v. Transamerica Corp.*, 99 F. Supp. 808, 828 (D. Del. 1951), the court noted the following:

> The duty of disclosure stems from the necessity of preventing a corporate insider from utilizing his position to take unfair advantage of the uninformed minority stockholders. It is an attempt to provide some degree of equalization of bargaining position in order that the minority may exercise an informed judgment in any such transaction . . . . One of the primary purposes of the [Exchange Act] was to outlaw the use of inside information by corporate officers and principal stockholders for their own financial advantage to the detriment of uninformed public security holders.

Id. at 829. In *McClure v. Borne Chemical Co.*, 292 F.2d 824 (3d Cir. 1961), the Third Circuit stated:

> Sections 10(b) and 29(b) of the Securities Exchange Act . . . are a part of a statutory scheme which had as its purpose the creation of a new federal law of management-stockholder relations . . . . That Act deals with the protection of investors, primarily stock-holders. It creates many managerial duties and liabilities unknown to the common law. It expresses federal interest in management-stockholder relationships which theretofore had been almost exclusively the concern of the states. Section 10(b) imposes broad fiduciary duties on management vis-à-vis the corporation and its individual shareholders.

Id. at 834; *see also* Kohler v. Kohler Co., 319 F.2d 634, 637 (7th Cir. 1963) (holding that the Exchange Act covered more than omissions of material facts that would constitute badges of fraud and deceit, thus that the Act was intended to create a fiduciary relationship between corporate insiders and outsiders with whom they deal in company securities); Ellis v. Carter, 291 F.2d 270, 274 (9th Cir. 1961) (rejecting defendants' contention that plaintiffs must allege genuine fraud, as distinct from an omission, under Rule 10b-5 and administrative rulings, extended this duty to reach insider purchases on stock exchanges,[43] stock sales to non-shareholders,[44] tips to outsiders,[45] and even purchases of stock options[46] and corporate bonds.[47]

Section 10(b)'s scope grew most dramatically in 1968. In *SEC v. Texas Gulf Sulphur Co.*, the Second Circuit held several insiders and their tippees liable under § 10(b), reasoning that § 10(b) and Rule 10b-5 prohibited all trading on inside information.[48] Even the ordinary investor who, having no inside sources to nonpublic information, by chance came to possess such in-

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stating that "[h]ad Congress intended to limit this authority to regulations proscribing common-law fraud, it would probably have said so").

43. In *Matter of Cady, Roberts & Co.*, 40 S.E.C. 907 (1961), the SEC extended the scope of Rule 10b-5 to transactions on open exchanges, noting that "[i]t would be anomalous indeed if the protection afforded by the anti-fraud provisions were withdrawn from transactions effected on exchanges, primary markets for securities transactions." *Id.* at 914.

44. The defendants in *Cady* contended that their stock sales were to persons who had not been shareholders of the corporation. *Id.* at 913 & n.21. The SEC, however, refused to accept the purchase/sale distinction for purposes of § 10(b) and Rule 10b-5 liability:

> Whatever distinctions may have existed at common law based on the view that an officer or director may stand in a fiduciary relationship to existing stockholders from whom he purchases but not to members of the public to whom he sells, it is clearly not appropriate to introduce these into the broader anti-fraud concepts embodied in the securities acts.

Id. at 913-14 (footnote omitted); *see also* Gratz v. Claughton, 187 F.2d 46, 49 (2d Cir.) (noting "it would be a sorry distinction to allow [an insider] to use the advantage of his position to induce the buyer into the position of a beneficiary although he was forbidden to do so once the buyer had become one"), *cert. denied*, 341 U.S. 920 (1951).

45. *See* Shapiro v. Merrill Lynch, 495 F.2d 228, 237 (2d Cir. 1974) (holding insiders liable for divulging inside information); *Cady*, 40 S.E.C. at 907 (suspending broker tippee for selling securities on the basis of inside information).

46. *See, e.g.*, SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 839-43 (2d Cir. 1968) (holding insiders liable for purchasing stocks and call options with inside information).

47. An early SEC Rule 10b-5 injunctive action involved repurchases of bonds by the issuer's subsidiary. SEC v. Greenfield, Litigation Release No. 333, 1946 SEC LEXIS 34 (E.D. Pa. Apr. 3, 1946) (dismissed on stipulation containing offer of rescission to bondholders). One court also held an issuer of a bond convertible into stock liable under Rule 10b-5 for failing to disclose to the investor that the bond was pledged. Kingstone v. Oceanography Dev. Corp., [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,387, at 93,348 (S.D.N.Y. Apr. 11, 1978). The court noted that the duty existed despite the fact that the plaintiff did not become a bondholder until after the sale. *Id.*; *see also* Green v. Hamilton Int'l Corp., 437 F. Supp. 723, 729 n.4 (S.D.N.Y. 1977) (noting that holders of convertible bonds were part of "community of interest" in corporation and owed fiduciary duties).

48. 401 F.2d 833, 848 (2d Cir. 1968).

formation, had to either publicly disclose the information or abstain from trading altogether.[49] The *Texas Gulf* court read the Exchange Act broadly to promote "equal access to information," rather than to regulate the behavior of insiders specifically.[50]

The SEC later used the *Texas Gulf* equal-access doctrine to bring § 10(b) charges in nontraditional insider trading cases.[51] This prompted the Supreme Court's decision in *Chiarella v. United States*.[52] The Court observed that "not every instance of financial unfairness constitutes fraudulent activity under § 10(b)."[53] The Court found no evidence in the language or legislative history of § 10(b) suggesting a general duty to disclose for every market participant who possessed nonpublic information.[54] Instead, the Court held that liability under § 10(b) arose only from a fiduciary or similar relationship of trust between the transactional parties.[55]

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49. *Id.*

50. *Id.* The court reasoned:

> [T]he Rule is based in policy on the justifiable expectation of the securities marketplace that all investors trading on impersonal exchanges have relatively equal access to material information .... The essence of the Rule is that anyone who, trading for his own account in the securities of a corporation has "access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone" may not take "advantage of such information knowing it is unavailable to those with whom he is dealing," i.e., the investing public.

Id. (quoting *Cady*, 40 S.E.C. at 912).

51. In *United States v. Chiarella*, 588 F.2d 1358 (2d Cir. 1978), the SEC charged an employee of a financial printing company with a 10b-5 violation. The financial printing company was engaged by certain corporations to print corporate takeover bids. *Id.* at 1363. The defendant deduced the names of the target companies from information contained in the documents, subsequently purchased stock in the target companies, and then immediately sold the stock after the takeover attempts were made public. *Id.* A jury convicted him, and the Second Circuit affirmed his conviction, holding that "[*a*]*nyone* corporate insider or not who regularly receives material nonpublic information may not use that information to trade in securities without incurring an affirmative duty to disclose." *Id.* at 1365 (emphasis in original).

52. 445 U.S. 222, 233 (1980).

53. *Id.* at 232 (citing Santa Fe Industries, Inc. v. Green, 430 U.S. 462, 474-77 (1977)).

54. *Id.* at 233. Such a general duty, the Court concluded, would impose liability "more broadly than [the Exchange Act's] language and the statutory scheme reasonably permit." *Id.* at 234 (quoting SEC v. Sloan, 436 U.S. 103, 116 (1978)).

55. *Id.*

While rejecting the equal access theory, *Chiarella* validated the insider-shareholder fiduciary relationship established in prior § 10(b) administrative and judicial proceedings.[56] The Court noted that the SEC and the lower federal courts recognized a relationship of trust and confidence between shareholders and insiders of the same corporation in order to prevent insiders from taking unfair advantage of the shareholders.[57] With respect to insider sales, the Court affirmed precedent holding insiders also stood in a fiduciary position to persons buying into the corporation.[58] Additionally, the Court held "tippees" could be liable as "participants after the fact" in the insider's breach of fiduciary duty.[59] In *Dirks v. SEC*,[60] the Court introduced scienter and personal benefit elements for tipper/tippee liability.[61]

B. THE MISAPPROPRIATION THEORY UNDER § 10(b) AND RULE 10b-5

An additional basis for insider trading liability arises under § 10(b) as a result of questions left open in *Chiarella*. *Chiarella* based liability specifically on a corporate insider's silence as a breach of a fiduciary duty to a buyer or seller of securities.[62] The language in § 10(b), however, does not state that a breach must be to the purchaser or seller.[63] It states the fraud must occur "in connection with" a securities transaction.[64] The *Chiarella* Court did not address whether an individual could commit fraud in connection with a securities transaction by breaching a fiduciary duty to someone other than the buyer or seller.

To illustrate, when the defendant in *Chiarella* purchased securities on inside information, he did not commit fraud upon the seller of the securities because he owed the seller no duty

56. *Id.*

57. *Id.* at 228-29. The Court placed primary emphasis on the SEC's *Cady* ruling. *Id.*

58. *Id.* at 227 n.8; *see also supra* note 44 and accompanying text (discussing § 10(b) precedent that abandoned common law purchase/sale distinction).

59. *Chiarella*, 445 U.S. at 230 n.12.

60. 463 U.S. 646 (1983).

61. *See supra* note 28 (discussing § 10(b) scienter and personal benefit elements).

62. *See supra* notes 52-57 and accompanying text (discussing *Chiarella*).

63. 15 U.S.C. § 78j(b) (1994).

64. *Id.*

to disclose.[65] The defendant was not an insider to the issuer of the traded securities.[66] Rather, he was an employee of a financial printing company, and he obtained nonpublic information relating to other companies by stealing it from the printing company.[67] The government argued, however, that the defendant breached a fiduciary duty to his employer when he stole information that was properly usable for a corporate purpose only.[68] By misappropriating nonpublic information and subsequently trading in securities, the government argued the fraud was sufficiently "in connection with" the securities transaction to support a § 10(b) criminal conviction.[69]

This theory of liability is commonly called the "misappropriation theory."[70] The victim of the fraud is the owner of the inside information, which in *Chiarella* was the financial printing company.[71] The *Chiarella* Court declined to address the validity of this argument since the government did not submit it to the jury.[72] After *Chiarella,* three federal circuits upheld Rule 10b-5 convictions under the misappropriation theory.[73] The *O'Hagan* court and the Fourth Circuit rejected the theory, however, reasoning that the misappropriation of inside information is not sufficiently "in connection with" the securities transaction to fall within § 10(b)'s coverage.[74]

65. Chiarella v. United States, 445 U.S. 222, 232 (1980).

66. *Id.*

67. *Id.* at 224.

68. *Id.* at 235.

69. *Id.*

70. *See, e.g.*, MICHAEL P. DOOLEY, FUNDAMENTALS OF CORPORATION LAW 803 (1995) (discussing the misappropriation theory).

71. *Chiarella*, 445 U.S. at 235.

72. *Id.* at 236. In a later case, *Carpenter v. United States*, 484 U.S. 19 (1987), the Supreme Court divided evenly on the validity of the misappropriation theory and declined to issue an opinion on the matter. *Id.* at 24.

73. SEC v. Maio, 51 F.3d 623, 631 (7th Cir. 1995); United States v. Chestman, 947 F.2d 551, 564 (2d Cir. 1991); SEC v. Clark, 915 F.2d 439, 453 (9th Cir. 1990). The Third Circuit arguably accepted the validity of the misappropriation theory in *Rothberg v. Rosenbloom,* 771 F.2d 818, 822 (3d Cir. 1985). Usually, the source of the information is the trader's employer. *See, e.g.*, SEC v. Materia, 745 F.2d 197, 197 (2d Cir. 1984) (holding copy-holder breached duty to his printing company); United States v. Newman, 664 F.2d 12, 17 (2d Cir. 1981) (holding investment banker breached duty to his firm). However, federal courts have applied this theory in other contexts. *See, e.g.*, United States v. Willis, 737 F. Supp. 269, 269 (S.D.N.Y. 1990) (denying motion to dismiss indictment of psychiatrist who traded on the basis of information obtained from patient in breach of duty arising from relationship of trust and confidence).

74. *See* United States v. O'Hagan, 92 F.3d 612, 615-22 (8th Cir. 1996),

C. SECTION 14(e) AND RULE 14e-3: INSIDER TRADING IN CONNECTION WITH A TENDER OFFER

Another context for insider trading liability involves the tender offer. Section 14(e) of the Exchange Act, which was added by Congress as part of the Williams Act of 1968,[75] is a general anti-fraud provision modeled in part after § 10(b) and Rule 10b-5.[76] It prohibits any person from engaging in "any fraudulent, deceptive, or manipulative acts" in connection with a tender offer.[77] In 1970, Congress added an enabling provision that sets forth the SEC's powers to "define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative."[78] The SEC enacted Rule 14e-3 under this provision in 1980.[79] Rule 14e-3 deems it a fraudulent act for anyone to purchase or sell stock in the target of the tender offer while in possession of nonpublic information relating to the tender offer.[80]

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cert. granted, 65 U.S.L.W. 3499, 65 U.S.L.W. 3505 (U.S. Jan. 13, 1997) (No. 96-842); United States v. Bryan, 58 F.3d 933, 948-51 (4th Cir. 1995).

75. Pub. L. No. 90-439, 82 Stat. 454 (codified at 15 U.S.C. §§ 78*l* to 78n (1994)). The Williams Act added to the Exchange Act provisions that placed certain registration and disclosure requirements upon persons planning a tender offer or other significant acquisition of publicly held securities. *Id.* For example, §§ 13(d) and 14(d) require those who acquire at least five percent of the target company's stock to file a statement with the Commission disclosing information such as the purchaser's background and identity, the source of the funds to be used in making the purchase, the extent of the purchaser's holdings in the target company, and the purpose of the purchase such as to acquire control of, liquidate, or merge the target company. 15 U.S.C. § 78n(d) (1994). Section 14(e) authorizes the Commission to prescribe rules to require disclosure of information that it deems to be material to a determination of whether stock should be tendered. *Id.* § 78n(e). Section 14(f) also requires tender offerors to make certain disclosure requirements if they intend to choose new directors for the target companies. *Id.* § 78n(f).

76. Sections 10(b) and 14(e) are textually similar, with the most significant differences being the addition of the term "fraudulent" and the reference to "acts" rather than "devices" in § 14(e). *Compare id.* § 78j(b), *with id.* § 78n(e). In addition, § 14(e) contains similar language to Rule 10b-5 expressly forbidding persons from making false or misleading statements or from engaging in fraudulent or deceptive conduct. *Compare id.* § 78n(e), *with* 17 C.F.R. § 240.10b-5 (1996).

77. 15 U.S.C. § 78n(e).

78. *Id.*

79. 17 C.F.R. § 240.14e-3. The SEC adopted Rule 14e-3 in Exchange Act Release Nos. 33-6239, 34-17120, IC-11336, 45 Fed. Reg. 60,410 (1980).

80. 17 C.F.R. § 240.14e-3. The SEC recognized that, in the case where an insider of the target company obtains tender offer information from the target company and trades on that information, liability under Rule 14e-3 may overlap with Rule 10b-5. Tender Offers, Exchange Act Release Nos. 33-6239, 34-17120, IC-11336, 45 Fed. Reg. 60,410-413 (1980).

1. The Controversy Surrounding Rule 14e-3

Under the *Texas Gulf* equal-access rule, any person who trades on inside information falls under the reach of § 10(b) and Rule 10b-5.[81] Under *Chiarella*, however, insider trading is only fraudulent within the meaning of § 10(b) where corporate insiders breach a fiduciary or similar duty to the purchaser or seller of the securities.[82] When insiders trade on the basis of inside information relating to a tender offer, they often trade not in the securities of their own corporations, but in the securities of the tender offer target. Unless the misappropriation theory applies, most insider trading in connection with a tender offer is not fraudulent under § 10(b) because insiders of tender offer bidders often have no fiduciary or other similar relationship with the target company's shareholders.[83]

As corporate takeovers became more frequent in the 1960s and 1970s,[84] more insider trading cases involved trading on information about possible tender offer bids.[85] In light of *Chiarella*, the SEC opted not to prohibit insider trading in this area under an expanded reading of § 10(b).[86] Instead, it enacted Rule 14e-3 pursuant to its authority under § 14(e).[87] In contrast to Rule 10b-5, which imposes disclose-or-abstain obligations where there is a fiduciary or other similar relationship, Rule 14e-3 imposes a duty to disclose or abstain on all traders who possess inside tender offer information.[88] Unsurprisingly, Rule 14e-3 has been challenged as an impermissible extension of SEC authority to prescribe fraudulent conduct under § 14(e).[89]

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81. *See supra* notes 48-50 and accompanying text (discussing *Texas Gulf*).

82. *See supra* notes 52-57 and accompanying text (discussing *Chiarella*).

83. *See, e.g.*, Walton v. Morgan Stanley & Co., Inc., 623 F.2d 796, 799 (2d Cir. 1980) (dismissing complaint alleging that advisor to tender offeror owed fiduciary duties to target corporation); Gilbert v. El Paso Co., 490 A.2d 1050, 1056 (Del. Ch. 1984) (holding that tender offeror owed no fiduciary duties to target).

84. *See* HAMILTON, *supra* note 3, at 1141-51 (discussing increase in takeover movement).

85. *Id.* at 1040 (discussing insider trading cases).

86. *See* SEC Institutional Investor Study Report, H.R. DOC. NO. 92-64, at xxxii (1971) (recognizing the Rule 10b-5 fiduciary requirement as problematic in the context of tender offers).

87. 15 U.S.C. § 78n(e) (1994).

88. 17 C.F.R. § 240.14e-3(a) (1996).

89. *See supra* note 16 (discussing *Maio*, *Peters*, and *Chestman*).

Defendants in Rule 14e-3 cases contend that § 14(e) fraud requires a breach of fiduciary duty element.[90]

2. Cases Interpreting the Validity of Rule 14e-3

In *United States v. Chestman*,[91] the Second Circuit upheld the validity of Rule 14e-3 as an extension of common law fraud.[92] The court reasoned that *Chiarella* had limited precedential value because the enabling provision of § 14(e) represented a broader delegation of rule-making authority than § 10(b).[93] Specifically, the court noted that the statute directed the SEC to "define" fraudulent practices and thereby empowered the SEC to set forth the meaning of "fraudulent" itself.[94] The court also upheld the rule under the SEC's authority to "prescribe means reasonably designed to prevent" fraud.[95] It reasoned that this provision authorized the SEC to prohibit all insider trading in the area of tender offers, even if nonfraudulent, to handle the "difficult task of ferreting out and proving fraud."[96]

The Supreme Court has yet to consider the validity of Rule 14e-3, but it has examined § 14(e). In *Schreiber v. Burlington*

90. *See supra* note 16 (discussing *Maio*, *Peters*, and *Chestman*).

91. 947 F.2d 551 (2d Cir. 1991) (en banc).

92. *Id.* at 560.

93. *Id.* at 558, 560-61.

94. *Id.* at 558.

95. *Id.* Two other circuits followed the Second Circuit's reasoning. *See* SEC v. Maio, 51 F.3d 623, 635 (7th Cir. 1995) (holding that Rule 14e-3 was "clearly within the SEC's . . . authority to 'prescribe means reasonably designed to prevent [fraud]'"); SEC v. Peters, 978 F.2d 1162, 1167 (10th Cir. 1992) (upholding Rule 14e-3 as a valid exercise of SEC's "broad prophylactic power to 'define and prescribe means reasonably designed to prevent [fraud]'").

96. *Chestman*, 947 F.2d at 559. Where insiders tip outsiders, parties alleging § 10(b) and Rule 10b-5 violations have the burden of proving that the insiders intended to benefit personally from their tips. *See supra* note 28 (discussing § 10(b) scienter and benefit requirements); *see also* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 194-214 (1976) (requiring element of scienter in § 10(b) and Rule 10b-5 violations). Some courts have maintained that the scienter requirement is particularly onerous in the context of a tender offer. For example, in *Peters*, the Court stated:

> In the context of a tender offer, there is a fairly wide circle of people with confidential information who may lack a long-term loyalty to the issuer and who may be tempted to take advantage of the very large short-term profits potentially available through insider trading just prior to the announcement of the tender offer . . . . [It is] almost impossible to prove that the trader obtained such information in breach of a fiduciary duty owed either by the trader or by the ultimate insider source of the information.

Peters, 978 F.2d at 1167.

Northern, Inc.,[97] the Court acknowledged the SEC's power under § 14(e) to prescribe broad regulations, but remarked that such regulations must not change the statutory meaning of "fraud" itself.[98] The Court also indicated that it would construe § 14(e)'s terms in a manner similar to those in § 10(b) unless they served a different purpose.[99] Commentators who argue that the fiduciary element and state common law fiduciary principles are the principal focus of § 10(b) insider trading liability often read *Schreiber* as requiring application of common law fiduciary principles under § 14(e).[100]

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97. 472 U.S. 1 (1985).

98. *Id.* at 11 n.11. In *Schreiber*, the plaintiff, a shareholder of a target company, claimed that the defendant's withdrawal of a tender offer coupled with the substitution of a later tender offer was a "manipulative" distortion of the market for the target's stock in violation of § 14(e). *Id.* at 4. The Court rejected the plaintiff's claim, holding that an act was not manipulative within the meaning of § 14(e) unless there was an accompanying misrepresentation or nondisclosure. *Id.* at 12. In discussing § 14(e)'s enabling provision, the court noted, "[This provision] gives the Securities and Exchange Commission latitude to regulate nondeceptive activities as a 'reasonably designed' means of preventing manipulative acts, without suggesting any change in the meaning of the term 'manipulative' itself." *Id.* at 11 n.11. Although the Court dealt specifically with the term "manipulative," its reasoning is likewise applicable to "fraudulent," since no § 10(b) or § 14(e) cases make a material distinction between the terms "manipulative, deceptive, or fraudulent." *See id.* at 8. "[I]t is a 'familiar principle of statutory construction that words grouped in a list should be given related meaning . . . . All three species of misconduct, i.e., fraudulent, deceptive, or manipulative, listed by Congress are directed at failures to disclose.'" *Id.* (quoting Securities Industry Ass'n v. Board of Governors, 468 U.S. 207, 218 (1984)); *see also* DOOLEY, *supra* note 70, at 813 (noting that dozens of Rule 10b-5 decisions have obliterated any practical differences in the meanings of the terms).

Schreiber, therefore, injects some uncertainty into the validity of *Chestman*. The *Chestman* court acknowledged footnote 11 in the *Schreiber* opinion, but stated that "[w]hatever may be gleaned from the footnote on the SEC's definitional authority under § 14(e), the footnote plainly endorses the SEC's authority to draft prophylactic rules under § 14(e)." *Chestman*, 947 F.2d at 563.

99. *Schreiber*, 472 U.S. at 8-12. The Court noted that Congress directed both §§ 10(b) and 14(e) at a policy to facilitate disclosure of information, rather than to assure the substantive fairness of tender offers. *Id.* The Court held that it would not find an act manipulative when nondisclosures were not involved; otherwise, it would be deviating from its own interpretation of § 10(b) manipulative acts and a "congressional concern with disclosure which is the core of the Act." *Id.* at 8. The Court also discussed textual similarities between §§ 10(b) and 14(e) and noted that the differences in § 14(e) did not bear on the meanings to be given to the terms. *Id.* at 10-11 n.10.

100. *See, e.g.*, Stephen M. Bainbridge, *Incorporating State Law Fiduciary Duties into the Federal Insider Trading Prohibition*, 52 WASH. & LEE L. REV. 1189, 1196 (1995) ("In light of the well-established fiduciary duty requirement

II. *UNITED STATES V. O'HAGAN*

In *United States v. O'Hagan*,[101] defendant James O'Hagan challenged the validity of Rule 14e-3 as a permissible exercise of the SEC's § 14(e) rule-making authority.[102] He argued that Rule 14e-3 impermissibly redefined fraud in § 14(e) by omitting a fiduciary duty requirement.[103] The Eighth Circuit agreed and vacated O'Hagan's conviction.[104]

In defense of Rule 14e-3, the SEC pointed to the enabling provision of § 14(e) granting the SEC authority to "define" fraudulent acts and practices.[105] The SEC contended that this provision authorized it to define all insider trading on tender offer information as fraudulent within the meaning of § 14(e), even if no breach of fiduciary duty was present.[106] The Eighth Circuit rejected this argument, stating that the plain language of the statute merely permitted the SEC to identify and regulate acts and practices that met the statutory meaning of § 14(e) fraud, not to define fraud itself.[107]

The court then addressed whether Rule 14e-3's lack of a fiduciary breach element impermissibly changed the statutory meaning of § 14(e) fraud.[108] The court remarked that, in interpreting the provisions of § 14(e), the *Schreiber* Court turned to § 10(b) for guidance.[109] Accordingly, it used the Supreme Court's interpretation of § 10(b) fraud from *Chiarella*.[110] The court found it significant that the *Chiarella* Court drew upon common law concepts to define § 10(b) fraud,[111] and it used that fact to conclude that the duty under § 10(b) had to arise out of

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under Rule 10b-5, however, [Rule 14e-3] may run afoul of *Schreiber v. Burlington Northern, Inc.*").

101. 92 F.3d 612 (8th Cir. 1996), *cert. granted*, 65 U.S.L.W. 3499, 65 U.S.L.W. 3505 (U.S. Jan. 13, 1997) (No. 96-842).

102. *Id.* at 623.

103. *Id.* at 623-24.

104. *Id.* at 627.

105. *Id.* at 624.

106. *Id.* at 624-25.

107. "[T]he enabling provisions simply permit the SEC to 'define' and 'prescribe' 'acts and practices' which meet § 14(e)'s meaning of 'fraudulent.'" *Id.*

108. *Id.* at 625.

109. *Id.*

110. *Id.*

111. *Id.* The court observed that the *Chiarella* Court quoted the *Restatement (Second) of Torts*, which states that failure to disclose in a business transaction is fraudulent only when there is a fiduciary duty to speak. *Id.* at 625-26.

a common law fiduciary or other similar obligation.[112] Because § 10(b) and § 14(e) were part of the same statutory scheme, the court concluded that § 14(e) contained the same common law fiduciary requirement.[113]

The SEC then argued that the statutory meaning of § 14(e) fraud was irrelevant because § 14(e) authorized it to prohibit all insider trading in the tender offer context, even if nonfraudulent, as a "means reasonably designed to prevent" fraud.[114] The Eighth Circuit rejected this argument too. The court acknowledged the SEC's authority to regulate certain activities in order to prevent the commission of fraud, but it noted that, consistent with the Supreme Court's holding in *Schreiber*, such regulations could not, in effect, change the statutory meaning of the term.[115] Because Rule 14e-3 lacked a breach of fiduciary duty requirement, the court concluded that the SEC exceeded its authority by promulgating the rule.[116]

III. POLICY TAKES PRECEDENT OVER COMMON LAW FIDUCIARY PRINCIPLES FOR PURPOSES OF DETERMINING § 10(b) AND § 14(e) INSIDER TRADING LIABILITY

O'Hagan presents two distinct but related questions involving the SEC's authority to prohibit fraudulent conduct in the tender offer context. First, *O'Hagan* questions whether the Exchange Act's enabling provision in § 14(e) grants the SEC general authority to define what conduct constitutes fraud in § 14(e) or whether the term has an independent statutory meaning. Second, assuming that § 14(e) fraud has an independent statutory meaning, *O'Hagan* queries whether a breach of a common law fiduciary duty is a necessary component of § 14(e) insider trading fraud.

The *O'Hagan* court correctly held that the enabling provision in § 14(e) does not delegate complete authority to the SEC to define the meaning of § 14(e) fraud.[117] The court incorrectly

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112. *Id.*

113. *Id.* The court found it inexplicable why the *Restatement (Second) of Torts* should have force in § 10(b) but not in § 14(e). *Id.* at 626.

114. *Id.* at 627.

115. *Id.*

116. *Id.*

117. *See supra* notes 105-115 and accompanying text (discussing SEC authority to define § 14(e) fraud and prohibit nonfraudulent acts as a means to prevent § 14(e) fraud).

defined § 14(e) fraud, however, by reading common law fraud concepts into § 14(e).[118] Instead, the court should have chosen a meaning that best carried out the statute's overriding purpose. This approach would have been consistent with what the Supreme Court did in *Chiarella*[119] and *Dirks*.[120]

A. THE EIGHTH CIRCUIT CORRECTLY HELD THAT THE SEC DID NOT HAVE AUTHORITY TO DEFINE § 14(e) FRAUD NOR TO REGULATE NONFRAUDULENT ACTS IN THE TENDER OFFER CONTEXT

In *O'Hagan*, the SEC argued that § 14(e)'s enabling provision empowered it to define fraudulent conduct for § 14(e) purposes.[121] The SEC argued in the alternative that, even if it could not define § 14(e) fraud, § 14(e) empowered it to prohibit nonfraudulent acts as a "means reasonably designed to prevent" fraud.[122] The *O'Hagan* court rejected both arguments on the ground that they would, in effect, impermissibly give the SEC authority to change the statutory meaning of § 14(e).[123] This holding is an express rejection of the Second Circuit's reasoning in *Chestman*.[124] *Chestman* held that the enabling provision did authorize the SEC to define fraudulent conduct, or in the alternative, to prohibit nonfraudulent acts as a means to prevent fraud.[125]

The *O'Hagan* court's reasoning is more persuasive. Interpreting § 14(e) to allow the SEC to either define § 14(e) fraud

118. *See supra* notes 111-113 and accompanying text (noting the court's use of *Chiarella* to interpret § 14(e)).

119. *See supra* notes 52-57 and accompanying text (discussing *Chiarella* and the requirement of a fiduciary relationship for liability).

120. *See supra* notes 28 & 61 and accompanying text (discussing *Dirks* and the scienter requirement).

121. *See supra* notes 105-107 and accompanying text (addressing SEC authority to define § 14(e) fraud).

122. *See supra* note 114 and accompanying text (discussing SEC authority to prohibit nonfraudulent acts as a means to prevent § 14(e) fraud).

123. *See supra* notes 107 & 115 and accompanying text (noting *O'Hagan* court's reasoning).

124. *See supra* notes 91-96 and accompanying text (explaining the *Chestman* holding and reasoning).

125. Chestman v. United States, 947 F.2d 551, 558-59 (2d Cir. 1991) (en banc). The *Chestman* court reasoned that, if § 14(e) limited the SEC to prohibiting insider trading only when there was a breach of fiduciary duty, the SEC would rarely catch fraud because of the difficulty in proving such a breach of fiduciary duty. *See supra* note 96 and accompanying text (discussing *Chestman*'s and other courts' reasoning).

itself or prohibit insider trading in the absence of fraud infringes on the independent statutory meaning of § 14(e)'s antifraud provisions, and thus conflicts directly with the Supreme Court's holding in *Schreiber*.[126] The *Schreiber* Court held that § 14(e)'s enabling provision provided the SEC with broad authority to prohibit fraud, but rejected the SEC's argument that it could prohibit nonfraudulent acts in a manner that would effectively change the statutory meaning of § 14(e) fraud.[127] Reading § 14(e) to allow the SEC to define § 14(e) fraud, moreover, would allow the SEC to place a duty on all market participants to disclose inside tender offer information before trading on the basis of such information.[128] Yet, the *Chiarella* Court rejected such a broad duty under § 10(b),[129] and *Schreiber* indicates that courts should look to § 10(b) to interpret § 14(e)'s terms unless it is apparent that the terms serve a different purpose than their § 10(b) counterparts.[130]

There is little evidence that § 14(e) serves a purpose to regulate the mere possession of tender offer information. The Exchange Act, as amended by the addition of §§ 13 and 14 in 1968 (the Williams Act), subjects tender offers to the regulatory supervision of the SEC.[131] Congress narrowly tailored the Williams Act's provisions to regulate disclosure of information between persons making tender offers and target companies.[132]

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126. *See supra* notes 98-99 and accompanying text (discussing *Schreiber*).

127. *See supra* notes 98-99 and accompanying text (explaining the *Schreiber* holding).

128. This is, of course, what the liberal language of Rule 14e-3 accomplishes. Rule 14e-3 on its face forbids any person in possession of tender offer information from trading on the basis of that information. 17 C.F.R. § 240.14e-3 (1996).

129. *See supra* notes 52-57 and accompanying text (discussing *Chiarella*). As the *Chiarella* Court stated, "Formulation of such a broad duty . . . should not be undertaken absent some explicit evidence of congressional intent." Chiarella v. United States, 445 U.S. 222, 233 (1980).

130. *See supra* note 99 and accompanying text (discussing *Schreiber* and its interpretation of the § 14(e) term "manipulative").

131. *See supra* note 75 (noting SEC regulation under the Williams Act's provisions).

132. The Williams Act's provisions impose specific registration and disclosure requirements only on those planning to make a tender offer or other significant acquisition of publicly traded securities. *See supra* note 75 (discussing Williams Act's provisions); *see also* H.R. REP. NO. 1711, 90th Cong., 2d Sess. 11 (1968) ("Proposed subsection (e) would . . . affirm the fact that persons engaged in the making or opposing tender offers or otherwise seeking to influence the decision of investors or the outcome of the tender offer are under an obligation to make full disclosure of material information to those with whom they deal.").

These provisions do not regulate all market participants, nor do they deal with insider trading generally.[133] Even reading the Williams Act broadly as a statutory scheme designed to prohibit insider trading, it at most evidences a policy specifically aimed at curbing misuse of information by insiders involved in tender offers. Thus, the SEC's and *Chestman's* § 14(e) interpretations impermissibly stretch the Williams Act to cover more than just insider misconduct by redefining § 14(e) to regulate all market participants in possession of inside tender offer information.

B. THE EIGHTH CIRCUIT MISINTERPRETED THE MEANING OF § 10(b) AND § 14(e) FRAUD

Once the Eighth Circuit concluded that the SEC did not have the authority to define § 14(e) fraud, it attempted to ascertain Congress's intended meaning of the term.[134] In doing so, the *O'Hagan* court misread *Chiarella* as mandating an interpretation of § 14(e) fraud drawing heavily on common law fiduciary principles.[135] The § 10(b) fiduciary element, as developed by the Supreme Court and the lower courts, is not the straight-forward adoption of common law fiduciary principles that the *O'Hagan* court found it to be. To the extent § 10(b) precedents have absorbed common law fiduciary concepts into § 10(b) fraud, they did so not because these concepts were the necessary source of law, but because they were consistent with a broader federal policy aimed at preventing insiders from using inside information for self-enrichment. The importance of this policy, rather than the common law principles *O'Hagan* embraced, is evident in at least three related contexts: § 10(b) precedent that formed the basis for the *Chiarella* holding, the *Dirks* holding, and post-*Chiarella* and *Dirks* § 10(b) cases.

1. Pre-*Chiarella* cases and *Chiarella v. United States*: The Fiduciary Element in § 10(b) Fraud

Although the *Chiarella* Court added a fiduciary element to § 10(b) fraud and discussed common law fiduciary principles generally,[136] the Court did not simply incorporate state com-

133. *See supra* note 75 (identifying Williams Act's provisions).

134. *See supra* notes 108-116 and accompanying text (explaining the *O'Hagan* court's attempt to ascertain the meaning of § 14(e) fraud).

135. *See supra* notes 111-113 and accompanying text (addressing the court's use of *Chiarella* and common law fiduciary principles to interpret § 14(e)).

136. Chiarella v. United States, 445 U.S. 222, 229 (1980). Referring to the

mon law fiduciary principles into § 10(b) fraud. Rather, *Chiarella* based its holding on § 10(b) precedent.[137] The insider-shareholder relationship commonly recognized today as part of § 10(b) fraud is traceable to these early § 10(b) decisions, not the common law.[138] While a few state courts recognized an insider-shareholder fiduciary relationship,[139] the overall lack of favorable case law in the state courts,[140] combined with federal courts' unwillingness to dismiss Rule 10b-5 insider trading actions, resulted in a federal expansion of conventional common law fiduciary obligations that eventually engulfed common law actions altogether.[141]

Early § 10(b) decisions only recognized fiduciary obligations for insider purchases of stock in private transactions,[142]

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general common law rule that affirmative disclosure is required where a fiduciary relationship exists, the Court noted that "[federal courts] have emphasized, in accordance with the common-law rule, that '[t]he party charged with failing to disclose market information must be under a duty to disclose it.' " *Id.* (second alteration in original).

137. The *Chiarella* Court principally relied on the SEC's *Cady* ruling, but also cited *Speed v. Transamerica Corp.*, *Kohler v. Kohler*, and *Texas Gulf* (discussed *supra* in notes 42-50 & 48-50) as the basis for its holding. *Chiarella*, 445 U.S. at 226-29, 229 n.11.

138. *See supra* notes 42-47 (discussing SEC and circuit court decisions regarding § 10(b) from the mid-1940s to the late 1960s).

139. *See supra* note 33 and accompanying text (identifying minority rule cases recognizing this fiduciary relationship). Perhaps hastened by federal Rule 10b-5 decisions, the common law under the states over time has shifted, if not to the old minority rule, at least to a more liberal rule imposing fiduciary obligations on insiders. *See* P.A. Agabin, Annotation, *Duty and Liability of Closely Held Corporation, Its Directors, Officers, or Majority Stockholders, in Acquiring Stock of Minority Shareholder*, 7 A.L.R.3d 500, 507-11 (1966 & Supp. 1996) (discussing cases requiring disclosure of information in securities transactions). A significant number of states, however, still adhere to the old majority rule or find liability upon a showing that "special facts" exist. *See, e.g.*, Goodman v. Poland, 395 F. Supp. 660, 680 (D. Md. 1975) (holding that, under Maryland law stockholders, directors, and officers of corporations did not stand in confidential and fiduciary relationship to minority stockholders); Hardy v. South Bend Sash & Door Co., 603 N.E.2d 895, 900 (Ind. App. 1992) (holding that corporate director who buys or sells shares for personal ownership owes no fiduciary duty to disclose information regarding the value of the shares to other shareholders); Drapeau v. Joy Technologies, Inc., 670 A.2d 165, 172 & n.8 (Pa. Super. Ct. 1996) (concurring opinion) (stating that, under Pennsylvania law, the purchase of shares by an officer or director from a stockholder does not, in the absence of special circumstances, create a fiduciary relationship between them).

140. *See supra* note 30 and accompanying text (noting majority rule cases refuse to recognize an insider-shareholder fiduciary relationship).

141. *See supra* notes 36 (comparing state common law actions with Rule 10b-5 actions) and 37 (discussing growth of Rule 10b-5 actions).

142. *See, e.g.*, Speed v. Transamerica Corp., 99 F. Supp. 808, 812 (D. Del.

but the federal courts eventually applied these fiduciary obligations in other unconventional situations. For example, the *Chiarella* Court acknowledged that the federal courts and the SEC expanded § 10(b) fraud to cover insider stock sales to persons buying into the corporation, despite the lack of a preexisting fiduciary relationship.[143] The SEC also departed from traditional state common law by imposing liability on insiders who traded on open stock exchanges[144] where state courts had been hesitant to impose such disclosure duties.[145] In most instances, federal courts and the SEC readily looked to federal policy to prohibit insiders from using inside information for their own benefit, rather than strictly following the common law.[146]

2. *Dirks v. SEC* and the Personal Benefit Requirement

Dirks lays out the test for tipper/tippee insider trading liability.[147] The *O'Hagan* court failed to discuss *Dirks* and how it broke from traditional state common law fiduciary principles

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1951) (involving majority stockholder's failure to disclose facts in written offer to purchase minority stockholders' shares); Kardon v. National Gypsum Co., 73 F. Supp. 798, 800-01 (D. Pa. 1947).

143. *See supra* note 58 and accompanying text (discussing *Chiarella*'s application of § 10(b) to insider sales).

144. *See supra* note 43 (identifying *Cady* ruling extending liability to transactions on open exchanges).

145. *See supra* note 34 (discussing common law cases dealing with stock exchange transactions).

146. In *Cady*, 40 S.E.C. 907 (1961), the Commission noted:

> [W]e have indicated that the purchase and sale of securities is a field in special need of regulation for the protection of investors. To this end one of the major purposes of the securities acts is the prevention of fraud, manipulation or deception in connection with securities transactions. Consistent with this objective, [§ 10(b) and Rule 10b-5] . . . are broad remedial provisions aimed at reaching misleading or deceptive activities, whether or not they are precisely and technically sufficient to sustain a common law action for fraud and deceit.

Id. at 910 (footnote omitted); *see also supra* notes 42-44 (quoting excerpts from and discussing several SEC and circuit court § 10(b) decisions). In addition, although it noted that "the common law in some jurisdictions imposes on 'corporate insiders' . . . an 'affirmative duty of disclosure . . . when dealing in securities,' " the *Dirks* Court ultimately held that breaches of this duty to shareholders violated § 10(b) because it was the Exchange Act's purpose to " 'eliminate the idea that use of inside information for personal advantage was a normal emolument of corporate office.' " Dirks v. SEC, 463 U.S. 646, 653 & n.10 (1983) (citation omitted).

147. *See supra* note 28 (explaining § 10(b) scienter and personal benefit elements).

by adding the personal benefit requirement for § 10(b) fraud.[148] The insider's intent to personally benefit is not an element for fiduciary breach under state common law.[149] The requirement is consistent, however, with federal policy aimed specifically at prohibiting insider use of corporate information for self-enrichment.[150]

3. Post-*Chiarella* and *Dirks* Cases: More Unconventional Fiduciary Obligations under § 10(b)

Corporate insiders owe no traditional common law fiduciary duties to holders of stock options because the option holders' relationship with the corporation is strictly contractual.[151] Yet, the *Chiarella* Court cited approvingly to § 10(b) precedent holding insiders liable for insider trading in options, again suggesting that a broader federal policy supports *Chiarella's* reasoning.[152] Many post-*Chiarella* holdings also applied § 10(b)

148. The § 10(b) benefit element limits liability to instances where insiders divulge inside information for their own personal gain. *See supra* notes 28 & 61 and accompanying text (discussing *Dirks* benefit requirement). The Court imposed this requirement largely to avoid an inhibiting effect on the activities of market analysts. *Dirks*, 463 U.S. at 658 & nn.17-18. Where insiders release inside information to market analysts or reporters for valid corporate purposes, there is no § 10(b) fiduciary breach. *Id.* The Court reasoned that, if § 10(b) prohibited analysts from obtaining inside information from corporate insiders, it would ultimately hurt the investing public's ability to make informed decisions about the value of stock. *Id.* at 658-59. The Court stated specifically that imposing a duty to disclose would make it more difficult for analysts to "ferret out" market information and disseminate that information to the investing public either directly or through their clients. *Id.* Of course, where insiders selectively disclose inside information to certain analysts to enhance their reputation, they might be breaching a duty to their shareholders. Donald C. Langevoort, *Commentary—The Insider Trading Sanctions Act of 1984 and Its Effect on Existing Law*, 37 VAND. L. REV. 1273, 1293 (1984).

149. *See* Langevoort, *supra* note 148, at 1292 ("[I]f there is one clear understanding in the common law of fiduciary responsibility, it is that an intent to benefit is not a necessary element.").

150. The *Dirks* Court noted that:

> Whether disclosure is a breach of duty therefore depends in large part on the purpose of the disclosure. This standard was identified by the SEC itself in *Cady, Roberts:* a purpose of the securities laws was to eliminate "use of inside information for personal advantage." Thus, the test is whether the insider personally will benefit, directly or indirectly, from his disclosure.

Dirks, 463 U.S. at 662 (citation omitted).

151. *See, e.g.*, Simons v. Cogan, 549 A.2d 300, 304 (Del. 1988) (holding that officers of corporation owe no fiduciary duties to holders of convertible debentures, and reasoning that "a mere expectancy interest does not create a fiduciary relationship").

152. Chiarella v. United States, 445 U.S. 222, 229 (1980) (noting that fed-

to reach insider trading in options.[153] Courts did not have long to test the applicability of the fiduciary theory of insider trading liability to options trading, however, because the Insider Trading Sanctions Act of 1984 made the jurisprudence of insider trading applicable to options.[154]

A fragmentary body of post-*Chiarella* and *Dirks* case law has also allowed bondholder § 10(b) challenges for fiduciary breach against insiders who traded in debt securities while possessing inside information.[155] There has been considerable controversy about the SEC's and private plaintiffs' ability to bring insider trading actions involving bonds.[156] Generally, under state law, insiders do not owe bondholders, even those with convertible bonds, any fiduciary duties.[157]

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eral courts found § 10(b) violations where insiders used inside information for their own benefit, and citing *Texas Gulf*). In *Texas Gulf*, several defendants either personally purchased call options or divulged information to others for use in purchasing call options. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 839-41 (2d Cir. 1968).

153. *See, e.g.*, Bianco v. Texas Instruments, Inc., 627 F. Supp. 154, 163-64 (N.D. Ill. 1985) (holding option traders had standing to sue insider traders and stating that insiders' duties ran "not only to the shareholders of the corporate employer, but also to the investing public at large"); O'Connor & Assoc. v. Dean Witter Reynolds, Inc., 529 F. Supp. 1179, 1187 (S.D.N.Y. 1981) (holding that option holders had standing to sue insiders and their tippees who traded in options based on inside information). Where option holder plaintiffs did not trade directly or contemporaneously with the insider traders, courts have been unwilling to impose liability. *See, e.g.*, Laventhall v. General Dynamics Corp., 704 F.2d 407, 412 (8th Cir. 1983) (holding that option holder plaintiff had no cause of action against corporation that purchased its own shares without disclosing cash dividend where plaintiff failed to show that he contemporaneously traded in the same market); Deutschman v. Beneficial Corp., 668 F. Supp. 358, 364 (D. Del. 1987) (holding that purchaser of call options lacked standing to sue corporation where no insider traded in corporation's options or stock).

154. Pub. L. No. 98-376, 98 Stat. 1264 (codified at 15 U.S.C. § 78(t) (1994)).

155. *See, e.g.*, Pittsburgh Terminal Corp. v. Baltimore & O.R. Co., 680 F.2d 933, 941 (3d Cir.) (holding that securities holders with equity options are entitled to fiduciary obligations from issuers and insiders), *cert. denied.*, 459 U.S. 1056 (1982); SEC v. Karcher, Litigation Release No. 11,702, [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,709, at 98,284 (Apr. 14, 1988) (ruling that restaurant executive violated § 10(b) and Rule 10b-5 when he sold his company's debentures before disclosing negative earnings).

156. *See, e.g.*, R. René Pengra, *Insider Trading, Debt Securities, and Rule 10b-5: Evaluating the Fiduciary Relationship*, 67 N.Y.U. L. REV. 1354, 1355 (1992) (noting disagreement among commentators regarding applicability of federal insider trading laws to debt securities).

157. *See, e.g.*, Katz v. Oak Indus., Inc., 508 A.2d 873, 879 (Del. Ch. 1986) ("Under our law—and the law generally—the relationship between a corporation and the holders of its debt securities, even convertible debt securities, is contractual in nature.").

For the most part, however, the current state of insider trading jurisprudence in bonds is consistent with federal policy, rather than common law fiduciary principles. Where corporations issue or repurchase their debt securities without disclosing inside information, most § 10(b) precedent seems to favor no § 10(b) liability.[158] According to *Dirks*, this result is justified because the primary purpose of the transaction was not to benefit the insider personally, but to benefit the issuing corporation and its shareholders.[159] Recognition of a duty to disclose to the bondholders in this instance, moreover, would conflict with the insiders' duties to act in the shareholders' best interests.

When insiders engage in insider trading in debt securities for their personal benefit or divulge inside information to close associates, however, they are not redistributing value from the bondholders to the corporation; they are redistributing value to themselves. Recognizing a duty in this instance would not conflict with that owed to shareholders, and it meets the *Dirks* personal benefit requirement. Although few cases involve facts where insiders traded in bonds for self-enrichment or divulged inside information to outsiders,[160] at least one case suggests that courts might find § 10(b) liability where elements of self-enrichment are involved.[161] Additionally, *Chiarella's* fiduciary

158. *See, e.g.*, Broad v. Rockwell Int'l Corp., 642 F.2d 929, 958 (5th Cir. 1981) (en banc) (holding that issuer owed no disclosure duties to debenture holders in cash-out merger because debenture holders received only that to which they were contractually entitled under the indenture); Lorenz v. CSX Corp., 736 F. Supp. 650, 659 (W.D. Pa. 1990) (dismissing debenture holders' claim against issuer for failing to disclose stock dividend and holding that relationship between corporation and bondholders was strictly contractual in nature).

159. For example, where a corporation buys back securities at a depressed price immediately prior to the announcement of good news relating to the condition of the corporation, the shareholders benefit because value is appropriated from the bondholders to the corporation.

160. This is explainable in part because bonds have fixed obligations whose market prices do not fluctuate as sharply as stocks, thereby reducing the opportunity for exploitation by insider trading. Thomas A. McGrath III, Note, *The Rise and Fall (and Rise?) of Information-Based Insider Trading Enforcement*, 61 FORDHAM L. REV. S127, S146 (1993). In recent years, however, insider trading in more volatile junk bonds has increased. *Id.*

161. *In re* Worlds of Wonder Securities Litigation, No. C 87 5491 SC [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,689, at 98,239 (N.D. Cal. Oct. 19, 1990) (granting debenture holders standing to sue insiders and their tippees individually on grounds that "insiders have a 'fiduciary duty' to debenture purchasers, and the Defendants as tippees can be liable to the Debenture Subclass for trading on the basis of a tip that violated the tippers' fiduciary

theory of § 10(b) liability has had less opportunity to develop in the context of debt securities because the SEC continues to file charges in such cases under the misappropriation theory.[162]

While perhaps not all the decisions finding § 10(b) insider trading liability fit squarely within this self-enrichment theoretical justification,[163] the above-cited instances demonstrate that the federal courts have clearly abandoned strict common law fiduciary principles. In developing a broader framework for fiduciary obligations under the federal security laws, the federal courts appear to have been driven somewhat by perceived notions of unfairness in allowing insiders to use their unique position of access to corporate information for personal benefit. Admittedly, this justification supports imposing § 10(b) disclosure duties on insiders when they trade on the basis of tender offer information because such trading also involves abuses of the insider position. If *Chiarella*'s special "relationship" requirement is to mean anything, however, it must at least limit § 10(b) disclosure protections to those investors who have or will have an interest in the insider's corporation specifically.

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duty"). The court also noted that bondholders are "justified in presuming that corporate insiders are not abusing their position by profiting from undisclosed corporate information." *Id.* Because the defendants only traded in stock, and never bought or sold debt securities, the court's holding is contrary to those which require claimants to have traded directly or contemporaneously with the insider traders. *Id.* at 98,238-39; *see also supra* note 153 (discussing option contract cases lacking transactional nexus).

162. *See, e.g.*, SEC v. Cooper Cos., 52 SEC Docket 2439, No. 92-8166 (JFK), 1992 WL 345225 (SEC) (Nov. 10, 1992) (announcing SEC charges against persons who traded in junk bonds based on tips from insider analyst); SEC v. Morse, 51 SEC Docket 1285, No. 92-64, 1992 WL 151070 (SEC) (June 24, 1992) (announcing that officer of governmental corporation consented to stipulation ordering disgorgement of profits from his purchase of municipal bonds while in possession of inside information).

163. Many courts fail to make a distinction between the situation in which the issuer of corporate bonds sells or purchases its bonds with inside information and the situation in which insiders trade for personal self-interest or tip associates. *See supra* note 155 (discussing cases imposing § 10(b) liability on bond issuers); *see also* Broad v. Rockwell Int'l Corp., 614 F.2d 418, 429-30 (5th Cir. 1980) (utilizing common law contract principles to impose a good faith duty of disclosure on the issuer of a corporate bond that overrode the bond's terms).

IV. A NEW MODEL FOR § 14(e) INSIDER TRADING LIABILITY

A. INSIDER TRADING DURING TENDER OFFERS AND THE NEW § 14(e) DUTY TO TARGET COMPANY SHAREHOLDERS

The *O'Hagan* court should have interpreted § 14(e) fraud to create a quasi-fiduciary duty between insiders and target company stockholders. The rationale for imposing the duty is similar to that for § 10(b): insiders are in a position of access to their company's tender offer plans, and it would be unfair to allow them to use this access for self-enrichment. Whereas § 10(b) expresses a federal interest in regulating disclosure in an intra-corporate context, however, § 14(e)'s zone of interest is in regulating disclosure between tender offer bidders and target company shareholders.[164] Consistent with federal policy against insider use of corporate information for self-enrichment, insiders involved in tender offers come under a § 14(e) duty to place the welfare of the bidder and target company shareholders before their own. Insiders who fail to disclose inside tender offer information before purchasing target company stock for self-gain would breach a duty to disclose to target shareholders who sell their shares. Moreover, insiders could not tip outsiders for the purpose of trading in the target's stock where the tip is intended to be self-serving.[165]

Insiders often tip institutional investors in advance of their companies' plans to make a tender offer with the expectation that the institutions will buy large amounts of the targets' stocks at the pre-offer price and then offer their shares to the tendering corporations when the tender offers are announced.[166] This practice, which is commonly called "warehousing," facilitates takeovers by enabling tender offerors to acquire target stock at a lower price than if they purchased all

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164. Although § 14(e) does not expressly prohibit insider trading, the Williams Act generally expresses an interest in regulating disclosure of information by tender offerors to target companies and imposes numerous duties on tender offerors vis-à-vis target company shareholders. *See supra* notes 75 & 132 (discussing William's Act's provisions and legislative history). Despite the absence of statutory language addressing the matter, moreover, courts have applied § 10(b) fraud to prohibit insider trading. Chiarella v. United States, 445 U.S. 222, 230 (1980). It would not be a gross misreading of § 14(e) fraud, therefore, to find that it applies to insider trading in a tender offer context.

165. *Cf.* Dirks v. SEC, 463 U.S. 646, 662 (1983) (introducing the personal benefit and scienter elements).

166. *Chiarella*, 445 U.S. at 234.

the target shares at tender offer prices. If the disclosure was intended to benefit the bidding corporation only, and not the insiders personally, neither the insiders nor the tippees should be liable.[167] As the *Dirks* Court stated, "Absent some personal gain, there has been no breach of duty . . . ."[168]

Where insiders trade for self-enrichment, as in *O'Hagan*, § 14(e) liability would apply.[169] Although O'Hagan was not an officer of Grand Metropolitan, the *Dirks* Court recognized that attorneys working closely with corporations become insiders to the corporation itself.[170] Even if O'Hagan was not sufficiently involved with the tender offer to become an insider of Grand Metropolitan, he could still face derivative liability as a tippee.[171] As an insider or tippee, O'Hagan owed Pillsbury Company's shareholders a duty not to trade in Pillsbury Company shares without disclosing inside tender offer information. Because the SEC never submitted charges to the jury based on a theory of § 14(e) liability like the one proposed here, the Eighth Circuit's reversal of O'Hagan's conviction should stand.

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167. The tender offer bidder and a warehousing institution may act as a "group" in acquiring securities of the issuer and, therefore, violate § 13(d) of the Williams Act by failing to file a report when the group's holdings reach five percent. 15 U.S.C. § 78m(d) (1994).

168. *Dirks*, 463 U.S. at 662.

169. It is conceivable that § 14(e) could allow target company shareholders, in addition to the SEC, a private right of action to recover profits from the bidder's insiders. Courts have in certain instances limited § 14(e) private rights of action. *See, e.g.*, Piper v. Chris-Craft Indus., Inc., 430 U.S. 1, 42 (1977) (finding no private right of action for defeated tender offeror). They have been virtually uniform, however, in granting target companies standing to sue bidders. *See, e.g.*, Florida Commercial Banks v. Culverhouse, 772 F.2d 1513, 1519 (11th Cir. 1985) (holding that target corporation had § 14(e) private right of action to seek corrective disclosures from tender offeror); American Carriers, Inc. v. Baytree Investors, Inc., 685 F. Supp. 800, 808 (D. Kan. 1988) (recognizing plaintiff's standing to bring § 14(e) injunctive action against tender offeror); *cf.* Piper v. Chris-Craft Indus., Inc., 430 U.S. 1, 42 n.28 (1977) (reserving the question).

170. *See supra* note 24 (noting the types of individuals who may be corporate insiders under *Dirks*). Grand Metropolitan retained Dorsey & Whitney in July 1988, as local counsel in its hostile takeover of Pillsbury Company. After initially accepting the assignment, Dorsey & Whitney withdrew from representing Grand Metropolitan in September 1988, following a debate within the firm over the merits of representing a foreign company in a hostile takeover of a local company. David Phelps, *O'Hagan Guilty of Insider Trading in Pillsbury Buyout*, STAR TRIB., Feb. 11, 1994, at A1.

171. The SEC's complaint alleged that O'Hagan learned of the hostile takeover from another Dorsey & Whitney law partner who represented Grand Metropolitan in the transaction. SEC v. O'Hagan, 901 F. Supp. 1461, 1463 (D. Minn. 1995).

In the future, however, insiders like O'Hagan would fall within the scope of this rule.

Under this expanded construction of § 14(e) fraud, it is still questionable whether Rule 14e-3 is a valid exercise of § 14(e) authority. A literal reading of Rule 14e-3 would impose a duty to disclose on all persons with tender offer information, not just on insiders involved in the making of the tender offer.[172] Moreover, it is apparent from the rule's administrative history that the SEC contemplated that the rule would prohibit warehousing, which lacks the *Dirks* insider self-benefit element.[173] If Rule 14e-3 is not salvageable, insiders can still violate § 14(e) in the rule's absence because, unlike § 10(b), § 14(e) expressly prohibits fraudulent, manipulative, and deceptive conduct in connection with a tender offer.[174]

B. A MISAPPROPRIATION THEORY UNDER § 14(e)?

The administrative history accompanying Rule 14e-3 also suggests the SEC viewed breaches of fiduciary duty under the misappropriation theory as providing one basis for the rule's validity.[175] By prematurely striking down Rule 14e-3, the Eighth Circuit missed the opportunity to analyze the validity of the misappropriation theory under § 14(e).

Section 14(e) merely requires that fraud occur "in connection with any tender offer,"[176] so it would not be a gross misreading to find that misappropriation of information relating to a tender offer in breach of a fiduciary duty is "in connection with" the tender offer. However, although this reasonably liberal construction of § 14(e) might accommodate the misappropriation theory, the theory runs into the same difficulties as

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172. *See supra* note 8 (quoting Rule 14e-3). The rule also emphasizes that the tippee need only have a "reason to know" state of mind. This does not appear to be inconsistent with the *Dirks* scienter element because the *Dirks* Court stated that tippees need only know, or have reason to know, of the insider's breach to satisfy the fiduciary breach element. *Dirks*, 463 U.S. at 660.

173. *See* 1 SEC Institutional Investor Study Report, H.R. DOC. NO. 92-64, pt. 1, at xxxii (1971) (discussing possibility of developing new rule to prohibit warehousing).

174. 15 U.S.C. § 78n(e) (1994).

175. In discussing its authority to adopt the rule in the face of the *Chiarella* holding, the Commission noted that "the *Chiarella* Court did not resolve whether trading while in possession of material, nonpublic market information misappropriated or obtained or used by unlawful means violates Rule 10b-5." Exchange Act Release Nos. 33-6239, 34-17120, IC-11336, 45 Fed. Reg. 60,410, 60,412 (1980).

176. 15 U.S.C. § 78n(e).

the equal-access-to-information theory[177] by pushing the scope of § 14(e) beyond regulating the relationship between the tender offeror and target company shareholders.[178] Anyone who acquired tender offer information through a relationship of trust and confidence would come under the scope of the theory.[179] The focus of the misappropriation theory, moreover, is on the defrauded corporate source of the information.[180] The corporation always retains discretion to authorize its insiders to trade on inside information, possibly leaving target company shareholders with no disclosure protections at all. A sounder policy would simply recognize that the insider owes a § 14(e) duty to target company shareholders, the persons with whom the insider traded. This rationale fits more comfortably within the securities laws' goal of investor protection and would leave the door open for courts to imply a § 14(e) private cause of action for target shareholders.[181]

CONCLUSION

The huge number of tender offers, mergers, and leveraged buyouts in recent years has contributed to increased securities trading on inside information about possible takeover bids. In response, the SEC promulgated Rule 14e-3 specifically to curb insider trading in this area. In *United States v. O'Hagan*, the Eighth Circuit became the first circuit to invalidate Rule 14e-3. Basing its decision on common law principles and past interpretations of § 10(b), the court concluded that the rule was an impermissible exercise of the SEC's authority to prohibit § 14(e) fraudulent conduct because the rule lacked a breach of fiduciary requirement.

Although Rule 14e-3 exceeds its statutory mandate, the Eighth Circuit ultimately misinterpreted the SEC's authority to prohibit fraud under § 14(e). In particular, the court improperly incorporated common law fiduciary principles into § 14(e) fraud

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177. *See supra* notes 49-50 and accompanying text (discussing *Texas Gulf* and its reading of the Exchange Act to promote equal access to information).

178. *See supra* Part III.A (arguing that § 14(e) at best regulates disclosure between insiders of tender offer bidders and target company shareholders).

179. *See supra* note 73 (discussing cases involving misappropriation theory).

180. *See supra* notes 62-74 and accompanying text (discussing misappropriation theory).

181. *See supra* note 169 (discussing cases that have granted a private right of action under § 14(e)).

when it should have looked to federal policy prohibiting insiders from using inside information for self-enrichment. This approach is consistent with Supreme Court precedent interpreting similar anti-fraud provisions in § 10(b) and Rule 10b-5. This Comment proposes a new model of § 14(e) insider trading liability which would recognize that insiders to tender offers owe disclosure duties to target company shareholders. Recognition of such a duty would further the federal securities laws' general goal of investor protection and would compel insiders who trade on possible takeover bids to "make their money the old fashion way"— earn it.