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The Insider Story

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If "misappropriation" theory is rejected, Wall Street will breathe a sigh of relief.

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Rules against trading stocks, other securities with confidential information may broaden

BY RICHARD C. REUBEN

After a 10-year break, the U.S. Supreme Court has returned to an important securities fraud question that has dogged the lower federal courts for years.

The central issue in *United States v. O'Hagan*, No. 96-842, is the validity of the so-called "misappropriation theory" of insider trader liability under Section 10(b) of the Securities and Exchange Act of 1934. 15 U.S.C. 78(j)(b). The justices heard oral arguments in April.

If the theory propounded by federal regulators is endorsed by the Court, it would expand insider trader liability under U.S. law.

Right now, the prohibitions against using confidential information to deal in stocks and other securities apply largely to corporate officers and directors, as well as persons who receive information from them. Under the misappropriation theory, any person who trades stock on the basis of wrongfully obtained nonpublic information would be in violation of Section 10(b).

In briefs to the Court, the government insists adopting the theory is crucial to upholding "the integrity of the securities markets against abuses by 'outsiders' to a corporation who have access to confidential information that will affect that corporation's security price when revealed, but who owe no fiduciary or other duty to that corporation's shareholders."

Insider trading appears to be on the rise. The National Association of Securities Dealers in 1996 referred 121 cases of possible violations to the Securities and Exchange Commission for further investigation, topping the previous high of 115 set in 1986. The association already has made 53 referrals in the first quarter of 1997.

The Court first considered the issue during the height of the 1980s trading boom in *Carpenter v. United States*, 484 U.S. 19 (1987). There, the justices deadlocked 4-4 on the question of whether *Wall Street Journal* stock columnist R. Foster Winan and a colleague used inside information he had obtained in the course of his reporting to trade stocks for personal gain. (The justices affirmed his conviction on other grounds.)

But a much different lineup of justices is considering *O'Hagan*. Five members from the Court that deadlocked in *Carpenter* are gone, their seats occupied now by Stephen G. Breyer, Ruth Bader Ginsburg, Anthony M. Kennedy, David H. Souter and Clarence Thomas.

As a result, "All bets are off," says former SEC Commissioner Joseph A. Grundfest, now teaching at Stanford Law School in California, when asked to handicap the outcome in *O'Hagan* on the basis of *Carpenter*.

Did a Partner Defraud His Firm?

The egregious nature of the wrongdoing of James O'Hagan, a former partner at the Minneapolis-based law firm of Dorsey & Whitney, prompts many experts to predict that his conviction will be upheld on some theory, just as the justices let stand the convictions in *Carpenter*. (Dorsey & Whitney has never been implicated in any wrongdoing in the case.)

O'Hagan was convicted in 1990 for using information obtained after his firm had been retained as local counsel by a British firm preparing a tender offer of Pillsbury Co. stock. He bought a large block of Pillsbury stock that eventually raked in a profit exceeding $4.3 million.

A federal jury convicted O'Hagan on a total of 57 counts of securities fraud, money laundering and fraud. But the 8th U.S. Circuit Court of Appeals based in St. Louis tossed out the convictions, rejecting the government's misappropriation theory because O'Hagan had never actually defrauded anyone.

The government contends in its briefs that, "[b]y deceiving his firm and its clients into believing he remained a loyal partner and agent, while in fact pursuing personal gain by trading on their information, [O'Hagan] was able to earn enormous and virtually risk free profits in the securities markets."

But O'Hagan's attorney, John D. French of Faegre & Benson in Minneapolis, argues against that view by citing prior cases holding that "the mere breach of a fiduciary duty, without misrepresentation or nondisclosure, is not deception within the meaning of Section 10(b)."

Regardless of how the Court eventually rules, the kind of activity engaged in by O'Hagan "will be found to be a violation of insider trading law," French predicts, "even if takes new legislation to get there." ■

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