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United States v. O'Hagan: Agency Law and Justice Powell's Legacy for the Law of Insider Trading

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ARTICLE

UNITED STATES v. O'HAGAN: AGENCY LAW AND JUSTICE POWELL'S LEGACY FOR THE LAW OF INSIDER TRADING

A.C. PRITCHARD*

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INTRODUCTION

The law of insider trading is judicially created; no statutory provision explicitly prohibits trading on the basis of material, non-public information.¹ The Supreme Court's insider trading jurisprudence was forged, in large part, by Justice Lewis F. Powell, Jr. His opinions for the Court in *United States v. Chiarella*² and *SEC v. Dirks*³ were, until recently, the Supreme Court's only pronouncements on the law of insider trading.⁴ Those decisions established the elements of the classical theory of insider trading under § 10(b) of the Securities Exchange Act of 1934 (the "Exchange Act").⁵ Under this the-

¹ The "short-swing" profits rule of § 16(b) of the Securities Exchange Act of 1934, which allows an issuer to sue an insider for "any profit realized by him from any purchase and sale, or any sale and purchase of any equity security of such issuer (other than an exempted security) within any period of less than six months," has a much narrower scope. 15 U.S.C. § 78p(b) (1994).

² 445 U.S. 222, 234-35 (1980) (holding that in an open-market transaction, no duty arose solely from the possession of inside information).

³ 463 U.S. 646, 660 (1983) (holding that "a tippee assumes a fiduciary duty to the shareholders of a corporation . . . only when the insider has breached his fiduciary duty to the shareholders . . . and the tippee knows or should know that there has been a breach").

⁴ See, e.g., *United States v. Carpenter*, 484 U.S. 19, 24 (1987) (raising the question of the validity of the misappropriation theory of insider trading). The Court split 4-4 on the misappropriation theory counts and its opinion therefore did not discuss the theory. See *id.* The Court unanimously affirmed convictions for mail and wire fraud. See *id.*

⁵ 15 U.S.C. § 78j(b) (proscribing the use "in connection with the purchase or sale of any security . . . [of] any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe"). Section 10(b) is implemented through Commission Rule 10b-5, which provides, in relevant part, that:

It shall be unlawful for any person, . . . (a) To employ any device, scheme, or artifice to defraud, [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, in connection with the purchase or sale of any security.

ory, corporate insiders and their tippees who trade in their corporation's securities while in possession of confidential information violate duties owed to the corporation's shareholders with whom they trade.

The Supreme Court's recent decision in *United States v. O'Hagan*,⁶ which upheld the misappropriation theory of insider trading, provides an occasion for reassessing Justice Powell's contributions to the law of insider trading. The misappropriation theory differs from the classical theory in that it applies when an agent or other fiduciary misuses information entrusted to her by her principal to trade in securities, whether or not those securities were issued by her principal. The Court's decision in *O'Hagan* breaks new ground in establishing a foundation for insider trading based on common law agency principles,⁷ thereby departing from Powell's vision of the scope of insider trading prohibited by § 10(b).

This Article explores Justice Powell's legacy for the law of insider trading and traces the development of insider trading jurisprudence through *O'Hagan*. Part I analyzes Justice Powell's opinions in *Chiarella* and *Dirks*. These opinions form the contours of the classical theory, and can be read as Powell's response to what he evidently perceived to be overreaching by the Justice Department and the Securities and Exchange Commission ("SEC"). Powell sought to restrain the government's attack against insider trading by anchoring insider trading law to his interpretation of the common law of deceit. Part I concludes with a discussion of the doctrinal puzzles created by Powell's reliance on the common law of deceit as the basis for insider trading liability under the federal securities laws.

Part II traces the judicial development of the misappropriation theory. First articulated by Chief Justice Warren Burger in his dissenting opinion in *Chiarella*,⁸ the misappropriation theory was adopted and refined by the Second Circuit.⁹ The Second Circuit's development of the theory ultimately

17 C.F.R. § 240.10b-5(b) (1997).

⁶ 117 S. Ct. 2199, 2206-14 (1997) (holding that a person who trades in securities, using confidential information misappropriated in breach of a fiduciary duty to the source of the information, may be held liable for violating § 10(b) and Rule 10b-5).

⁷ See *id.* at 2202-03 (noting that the fiduciary commits the fraud when she uses her principal's confidential information in purchasing or selling securities without prior disclosure).

⁸ See *United States v. Chiarella*, 445 U.S. 222, 239 (1980) (Burger, C.J., dissenting).

⁹ See *United States v. Newman*, 664 F.2d 12 (2d Cir. 1981). Defendant James Mitchell Newman worked as a securities trader and manager of the trading department of a New York brokerage firm. See *id.* at 15. E. Jacques Courtois, Jr. and Adrian Antoniu misappropriated confidential information concerning mergers and acquisitions that was entrusted to their employers, the investment banking firms of Morgan Stanley and Kuhn Loeb & Co., respectively. See *id.* This information was secretly conveyed to Newman, who subsequently purchased stock in companies that were merger and takeover targets of clients Morgan Stanley and Kuhn Loeb & Co. See *id.* The Second Circuit held that Newman's involvement in the transaction operated as a fraud under Rule 10b-5. See *id.* at

lead to *United States v. Carpenter*,¹⁰ the first case involving the misappropriation theory to reach the Supreme Court.

Carpenter highlights the sharp distinction between the misappropriation theory and Justice Powell's view of the law of insider trading. Although the Court originally voted to deny certiorari in *Carpenter*,¹¹ Justice Powell prepared and circulated a dissent from that denial, in which he rejected the misappropriation theory as both inconsistent with *Chiarella* and *Dirks*, and for failing to meet § 10(b)'s requirement that the fraud be "in connection with"¹² the purchase or sale of a security.¹³ Evidently persuaded of the issue's importance by Powell's draft dissent, Justices Antonin Scalia and William F. Brennan, Jr. changed their minds and voted to grant certiorari.¹⁴ Before the following term when *Carpenter* was argued and decided, however, Powell retired from the Court. Consequently, the Court split 4-4 on the misappropriation theory, leaving its validity unresolved.¹⁵ Had Powell remained on the Court for another term, the misappropriation theory almost certainly would have been overturned in 1987.

Powell's objections to the misappropriation theory were rebuffed by the Supreme Court a decade later in *O'Hagan*, when the validity of the misappropriation theory was finally decided.¹⁶ Part II concludes with a discussion

19. The court reasoned that, "by sully[ing] the reputations of [the investment bankers] as safe repositories of client confidences, [Newman] and his cohorts defrauded those [investment bankers'] clients, whose takeover plans were keyed to target company stock prices fixed by market forces, not artificially inflated through purchases by purloiners of confidential information." *Id.* at 17; *cf.* *Moss v. Morgan Stanley Inc.*, 719 F.2d 5, 5 (2d Cir. 1983) (holding in a private damages action, that although there was a duty to disclose or abstain, the duty was owed to the tipper's employer who was neither a purchaser nor seller of securities, and thus no duty was owed to open-market sellers of the securities in question).

¹⁰ 484 U.S. 19 (1987).

¹¹ Because the Court ultimately granted certiorari in *Carpenter*, Powell's dissent was never published. In the course of my research for the government's brief in *O'Hagan*, I uncovered Justice Powell's draft in the collection of Justice Thurgood Marshall's papers housed at the Library of Congress. Justice Powell's draft is attached as an appendix to this Article. See Draft of Dissent from Denial of Certiorari for *Carpenter v. United States*, Justice Powell (Dec. 10, 1986) [hereinafter Powell's Draft] (reprinted at Appendix) [Editor's Note: Pincites to Powell's Draft correspond to the page numbers on the original document.]. Justice Powell dissented from the initial denial of certiorari, but after a revote, certiorari was granted. See *United States v. Carpenter*, 479 U.S. 1016 (1986).

¹² 15 U.S.C. § 78j(b) (1994).

¹³ See Powell's Draft, *supra* note 11, at 4-5.

¹⁴ See *United States v. Carpenter*, 479 U.S. 1016 (1986).

¹⁵ See *Carpenter*, 484 U.S. at 24 (noting that the Court was evenly divided with respect to the convictions under the securities laws).

¹⁶ See *United States v. O'Hagan*, 117 S. Ct. 2199, 2208 (1997) (holding that a person who trades in securities for profit, using confidential information misappropriated in

of the post-*Carpenter* cases that reject the misappropriation theory, and an analysis of the Court's recent acceptance of that theory in *O'Hagan*.

Part III evaluates the misappropriation theory's support in the common law and its utility in serving the policy goals underlying prohibitions against insider trading. In addition, Part III analyzes the relationship between misappropriation theory and the classical theory. In her opinion for the Court in *O'Hagan*, Justice Ruth Bader Ginsburg described the misappropriation theory as "complementary" to the classical theory.¹⁷ While the two theories are complementary in the sense that they "each address[] efforts to capitalize on non-public information through the purchase or sale of securities,"¹⁸ the misappropriation theory encompasses almost all of the conduct proscribed by the classical theory,¹⁹ and more.

Despite its breadth, the misappropriation theory is in many ways more consistent with the common law than Powell's classical theory. The two theories draw on different sets of common law principles: the classical theory draws heavily on the common law of deceit, whereas the misappropriation theory draws primarily on the common law of agency. Agency law provides a more comprehensive and coherent basis for dealing with the problem of insider trading, which is, at bottom, the misuse by faithless agents of information that belongs to others. Moreover, the misappropriation theory's broad scope allows it to fill a gap left by the classical theory which, if left unfilled, would severely undermine the policy interests served by prohibitions against insider trading. The misappropriation theory, as adopted in *O'Hagan*, secures the law of insider trading to firmer foundations.

breach of a fiduciary duty to the source of the information, may be held liable for violating § 10(b) and Rule 10b-5).

¹⁷ See *O'Hagan*, 117 S. Ct. at 2207.

¹⁸ *Id.*

¹⁹ In some areas the classical theory may reach more broadly. The classical theory proscribes insider trading while "in possession of" confidential information. See *SEC v. MacDonald*, 699 F.2d 47, 50 (1st Cir. 1983) (en banc) (noting that the scienter element of § 10(b) "is satisfied if at the time defendant purchased stock he had actual knowledge of undisclosed material information, knew it was undisclosed, and knew it was material"). Misappropriation requires that the misappropriator "use the information to purchase or sell securities." *O'Hagan*, 117 S. Ct. at 2207 (emphasis added). Very little, however, may turn on this distinction. See *United States v. Teicher*, 987 F.2d 112, 119-21 (2d Cir. 1993) (stating, in dictum, that because a possessor of inside information cannot help but "use" it, proof of possession of inside information is sufficient). The other significant distinction between the two theories is that the misappropriation theory is subject to contractual waiver by the owner of the information, while the classical theory is not. See *infra* notes 216-20 and accompanying text (noting that misappropriation theory does not apply if insiders trade with the approval of their principal, the owner of the information).

I. THE CLASSICAL THEORY: *CHIARELLA* AND *DIRKS*A. United States v. Chiarella: *Requirement of a Duty of Disclosure to Shareholders*

Vincent Chiarella was a “markup man” for a New York financial printer.²⁰ In the course of his work on announcements for corporate takeover bids, he deduced the identity of the target companies and used the information to trade in the securities of the target companies, realizing a gain of slightly more than \$30,000.²¹ His trading violated his employer’s clearly established policy against the use of customer information for personal gain.²²

Chiarella’s trading triggered an investigation by the SEC, leading to a criminal securities fraud conviction under § 10(b) that was affirmed by the Second Circuit.²³ The Supreme Court, in an opinion by Justice Powell, reversed.²⁴ Justice Powell framed the question presented as whether Chiarella’s silence could be deemed deceptive.²⁵ Relying on the *Restatement (Second) of Torts*, Powell reasoned that:

At common law, misrepresentation made for the purpose of inducing reliance upon the false statement is fraudulent. But one who fails to disclose material information prior to the consummation of a transaction commits fraud only when he is under a duty to do so. And the duty to disclose arises when one party has information “that the other [party] is entitled to know because of a fiduciary or other similar relation of trust and confidence between them.”²⁶

Powell incorporated this common law approach into § 10(b).²⁷ He found

²⁰ Chiarella’s duties included the selection of type fonts and page layouts. See *United States v. Chiarella*, 588 F.2d 1358, 1363 (2d Cir. 1978) (discussing Chiarella’s duties as a “markup man”), *rev’d*, 445 U.S. 222 (1980).

²¹ See *Chiarella*, 445 U.S. at 224 (explaining that although the names of the companies were concealed, Chiarella deduced these names from other information in the documents and traded in the securities of the target company to gain \$30,000 in 14 months).

²² See *Chiarella*, 588 F.2d at 1369 (noting that the employer’s rules were posted on bulletin boards throughout the office and described the prohibited conduct and the potential criminal consequences).

²³ See *id.* at 1373.

²⁴ See *Chiarella*, 445 U.S. at 237.

²⁵ See *id.* at 226 (“[Section] 10(b) does not state whether silence may constitute a manipulative or deceptive device.”).

²⁶ *Id.* at 227-28 (quoting RESTATEMENT (SECOND) OF TORTS § 551(2)(a) (1976)). The general common law rule is well established that silence, absent a duty to disclose, is not fraudulent. See *Laidlaw v. Organ*, 15 U.S. (2 Wheat.) 178, 193 (1817) (holding that failure to disclose end of the War of 1812—which caused price of tobacco to increase—was not fraud in purchase of tobacco).

²⁷ See *Chiarella*, 445 U.S. at 230 (“[S]ilence in connection with the purchase or sale of

that the common law of deceit recognized “a relationship of trust and confidence between the shareholders of a corporation and those insiders who have obtained confidential information by reason of their position with that corporation.”²⁸ In Chiarella’s case, the jury was not instructed to find any such specific duty; rather, the jury instruction implied that Chiarella owed a “duty to everyone; to all sellers, indeed, to the market as a whole. The jury simply was told to decide whether petitioner used material, non-public information at a time when ‘he knew other people trading in the securities market did not have access to the same information.’”²⁹ Powell rejected the notion that Congress intended § 10(b) to function as a “parity-of-information rule” prohibiting any informational advantages in the securities markets.³⁰ To this end, Powell looked to the common law of deceit to confine § 10(b); that body of law did not support a sweeping duty to all market participants:

[T]he element required to make silence fraudulent—a duty to disclose—is absent in this case. No duty could arise from petitioner’s relationship with the sellers of the target company’s securities, for petitioner had no prior dealings with them. He was not their agent, he was not a fiduciary, he was not a person in whom the sellers had placed their trust and confidence. He was, in fact, a complete stranger who dealt with the sellers only through impersonal market transactions.³¹

Because Chiarella had breached no duty of disclosure to the sellers of the securities, his silence could not be fraudulent, and therefore, his conviction could not stand.

Powell declined to decide—on the ground that it had not been submitted to the jury—the merits of the government’s alternative theory. That alternative theory argued that Chiarella had breached a duty to the acquiring corporation when he traded information that he obtained in his position as an employee of the printer employed by the corporation.³²

securities may operate as a fraud actionable under § 10(b) But such liability is premised upon a duty to disclose arising from a relationship of trust and confidence between parties to a transaction.”).

²⁸ *Id.* at 228 (citations omitted).

²⁹ *Id.* at 231 (citation omitted).

³⁰ *Id.* at 233.

³¹ *Id.* at 232-33.

³² *See id.* at 235-36. Chief Justice Warren Burger dissented. *See id.* at 239-40 (Burger, C.J., dissenting) (arguing that “a person who has misappropriated non-public information has an absolute duty to disclose that information or to refrain from trading”). He believed that the jury had been adequately instructed on this theory, *see id.* at 243-44, and that any deficiency in the instruction was harmless error, *see id.* at 245. Chief Justice Burger’s views are discussed in greater detail in Part II. *See infra* notes 109-14 and accompanying text (discussing Justice Burger’s acceptance of the misappropriation theory in his dissenting opinion in *Chiarella*).

B. SEC v. Dirks: *Duty Acquired as a Tippee*

Ray Dirks was an investment analyst for a New York broker-dealer whose research focused on the securities of insurance companies.³³ Ronald Secrist, a former officer of Equity Funding of America, told Dirks that Equity Funding was carrying on a massive fraud by grossly overstating the value of its assets and urged Dirks to bring the fraud to light.³⁴ Dirks's investigation confirmed Secrist's allegations. Dirks shared this information with the *Wall Street Journal*,³⁵ the SEC,³⁶ and his clients, who proceeded to unload their more than \$16 million in Equity Funding securities.³⁷ Dirks's clients avoided massive losses by selling in advance of the public disclosure of the Equity Funding fraud.³⁸

After the fraud was disclosed, the SEC began an investigation into Dirks's role in uncovering the Equity Funding fraud, leading to the filing of an administrative complaint against him.³⁹ The SEC found that Dirks had aided and abetted insider trading violations by passing on information about the Equity Funding fraud to his clients.⁴⁰ Conceding that Dirks had played an important role in bringing the fraud to light, however, the SEC imposed only a censure on him.⁴¹ Dirks appealed to the D.C. Circuit Court of Appeals, which affirmed the SEC's censure.⁴² The Supreme Court granted Dirks's petition for certiorari,⁴³ and reversed.⁴⁴

Writing for the majority, Justice Powell strongly suggested that he viewed the SEC's censure of Dirks as overreaching by the agency.⁴⁵ Once again, Powell rejected what he perceived to be the SEC's view that "the antifraud

³³ See SEC v. Dirks, 463 U.S. 646, 648 (1983).

³⁴ See *id.* at 649.

³⁵ See *id.* at 649-50 (noting that William Blundell, the *Wall Street Journal* bureau chief who Dirks contacted, doubted "that such a massive fraud could go undetected and declined to write the story").

³⁶ See *id.* at 650 n.3 (noting that the SEC was currently conducting its own investigation of Equity Funding).

³⁷ See *id.* at 649.

³⁸ See *id.* at 650 (noting that the price of Equity Funding stock fell from \$26 per share to \$15 per share).

³⁹ See *id.*

⁴⁰ See *id.* at 650-51 (finding that Dirks had aided and abetted violations of § 17(a) of the Securities Act of 1933, 15 U.S.C. § 77q(a), § 10(b) of the Exchange Act, 15 U.S.C. § 78j(b), and SEC Rule 10b-5, 17 C.F.R. § 240.10b-5).

⁴¹ See *id.* at 651-52.

⁴² See SEC v. Dirks, 681 F.2d 824, 826 (D.C. Cir. 1982).

⁴³ See SEC v. Dirks, 459 U.S. 1014, 1014 (1982).

⁴⁴ See *Dirks*, 463 U.S. at 652.

⁴⁵ See *id.* at 664 n.24 ("Without legal limitations, market participants are forced to rely on the reasonableness of the SEC's litigation strategy, but that can be hazardous, as the facts of this case make plain.").

provisions require equal information among all traders."⁴⁶ He reiterated that "[a] duty [to disclose] arises from the relationship between parties . . . and not merely from one's ability to acquire information because of his position in the market."⁴⁷ Nevertheless, Powell recognized that there was a "need for a ban on some tippee trading . . ."⁴⁸ Looking to the Court's prior decisions for the limits of such trading, Powell found that limit in common law principles involving a fiduciary's breach of duty, noting that "the transactions of those who knowingly participate with the fiduciary in such a breach are 'as forbidden' as transactions 'on behalf of the trustee himself.'"⁴⁹ The absence of such a rule would "open up opportunities for devious dealings in the name of the others that the trustee could not conduct in his own."⁵⁰ But Powell also recognized that imposing a broad-based duty to the market on tippees such as Dirks could have a chilling effect on the process by which information makes its way to the market:

Imposing a duty to disclose or abstain solely because a person knowingly receives material nonpublic information from an insider and trades on it could have an inhibiting influence on the role of market analysts, which the SEC itself recognizes is necessary to the preservation of a healthy market. It is commonplace for analysts to "ferret out and analyze information," and this is often done by meeting with and questioning corporate officers and others who are insiders. And information that the analysts obtain normally may be the basis for judgments as to the market worth of a corporation's securities.⁵¹

Balancing these factors, Powell concluded that a tippee's duty to disclose derives from an insider's fiduciary duty of disclosure, which would be breached only when the insider has improperly provided that inside information to the tippee.⁵²

Not all disclosures of corporate information are considered improper. A corporate official, for example, might mistakenly believe that the information was already public or not material.⁵³ The test of whether a disclosure is improper is "whether the insider personally will benefit, directly or indirectly, from his disclosure. Absent some personal gain, there has been no breach of duty to stockholders. And absent a breach by the insider, there is no deriva-

⁴⁶ *Id.* at 657.

⁴⁷ *Id.* at 657-58 (quoting *United States v. Chiarella*, 445 U.S. 222, 231-32 n.14 (1980)).

⁴⁸ *Id.* at 659.

⁴⁹ *Id.* (quoting *Mosser v. Darrow*, 341 U.S. 267, 272 (1951) (holding trustee personally liable for authorizing employee to trade in securities of the debtors' subsidiaries)).

⁵⁰ *Id.* (quoting *Mosser*, 341 U.S. at 271).

⁵¹ *Id.* at 658-59 (citations omitted).

⁵² *See id.* at 659-60.

⁵³ *See id.* at 662.

tive breach.”⁵⁴ Secrist, the source of Dirks’s information, was motivated to expose the fraud and had obtained no personal advantage by disclosing it to Dirks.⁵⁵ Because Secrist had violated no duty to Equity Funding’s shareholders, Dirks could not be derivatively liable.⁵⁶ Thus, *Dirks* confirmed *Chiarella*’s holding that insider trading liability—consistent with the common law of deceit—must be based on a breach of duty to the purchasers or sellers of the corporation’s shares.⁵⁷

C. *Puzzles of the Classical Theory*

Justice Powell’s efforts to limit the law of insider trading by incorporating the common law of deceit into § 10(b) of the Exchange Act create a series of doctrinal problems and unresolved issues. This Part explores those problems and questions.

1. No Reliance in Open-Market Transactions

The first and most notable problem is that the common law of deceit provides scant support for the proposition that a corporate insider defrauds a shareholder when the insider does not engage in a face-to-face transaction, but instead trades in an impersonal market on the basis of confidential information.⁵⁸ In the leading case of *Goodwin v. Agassiz*,⁵⁹ the Supreme Judicial Court of Massachusetts rejected a claim that an insider commits fraud when trading over a stock exchange.⁶⁰ The plaintiff-shareholder sold his shares in a mining company to two of the company’s insiders, its president and general

⁵⁴ *Id.*

⁵⁵ *See id.* at 666-67.

⁵⁶ *See id.* at 667 (holding that Dirks “could not have been ‘a participant after the fact in [an] insider breach of a fiduciary duty’” (citation omitted)). In dissent, Justice Blackmun, joined by Justices Brennan and Marshall, disagreed that personal gain by the insider was required for a breach of duty. *See id.* at 673-74 (Blackmun, J., dissenting) (citations omitted) (arguing that personal gain is not an element of the breach of the duty because the duty does not look to the insiders’ motives, but rather to the insiders’ actions and the consequences to shareholders).

⁵⁷ *See supra* notes 24-32 and accompanying text (discussing Powell’s opinion in *Chiarella*, which required that a tippee breach a duty that the tippee has with the shareholders).

⁵⁸ *See* Lawrence A. Hamermesh, *Calling Off the Lynch Mob: The Corporate Director’s Fiduciary Disclosure Duty*, 49 VAND. L. REV. 1087, 1153 n.296 (1996) (“Research has not disclosed any case in which a stockholder selling in the market has successfully invoked fiduciary disclosure duty, as opposed to Rule 10b-5, to recover compensatory damages from a director who concurrently bought stock.”).

⁵⁹ 186 N.E. 659 (Mass. 1933).

⁶⁰ *See id.* at 661 (explaining the impracticability of requiring directors and other insiders who buy or sell shares of their corporation to seek out the other transacting party and disclosing to him everything that a court or jury may later find to affect the value of such shares).

manager.⁶¹ The insiders were also directors.⁶² The insiders were aware of a geologist's theory that the land owned by the company might contain valuable copper deposits.⁶³ They kept this information secret, however, in order to obtain options on surrounding land that might also contain copper.⁶⁴ Knowing that the company's stock price would rise if the theory panned out, the insiders bought heavily in the company's shares.⁶⁵ These purchases, done over the Boston Stock Exchange, were completely anonymous.⁶⁶

The court rejected the plaintiff's claim of fraud.⁶⁷ While the court recognized that the directors of a corporation "stand in a relation of trust to the corporation and are bound to exercise the strictest good faith in respect to its property and business,"⁶⁸ it held that directors do not "occupy the position of trustee toward individual stockholders."⁶⁹ Thus, there was "no fiduciary relation between them and the plaintiff in the matter of the sale of his stock."⁷⁰ This result was supported by the "imposing weight of authority in other jurisdictions."⁷¹ The court acknowledged that the result might have been different in a face-to-face transaction, but concluded that any such duty to shareholders did not carry over to an anonymous exchange transaction.⁷²

Goodwin sets forth the "majority rule," which holds that there can be no liability for insider trading carried out over an exchange.⁷³ Even before pas-

⁶¹ See *id.* at 659 (discussing the transactions in question in which the defendants, through brokers, bought 700 shares from plaintiff).

⁶² See *id.*

⁶³ See *id.* at 659-60 (noting that the plaintiff did not have this information).

⁶⁴ See *id.* at 660 (noting that the defendants agreed that the theory should be disclosed only if absolutely necessary).

⁶⁵ See *id.* (noting that the defendants bought many shares of the stock through agents).

⁶⁶ See *id.* (discussing the plaintiff's lack of knowledge regarding the defendants' identity and that "[t]here was no communication between them touching the subject").

⁶⁷ See *id.*

⁶⁸ *Id.*

⁶⁹ *Id.*

⁷⁰ *Id.* (citations omitted).

⁷¹ *Id.* (citing cases from Arizona, Illinois, Indiana, Kentucky, Michigan, Minnesota, New Jersey, New York, Tennessee, and Utah).

⁷² See *id.* at 661 (discussing, in dictum, that had the transaction been face-to-face, relief may have been granted in appropriate circumstances).

⁷³ See Barbara A. Ash, *State Regulation of Insider Trading—A Timely Resurgence?*, 49 OHIO ST. L.J. 393, 399 (1988) ("Under what has been referred to as the 'majority rule,' an officer or director owed no duty to disclose any information even when the trading transaction was with an existing shareholder."); Charles C. Cox & Kevin S. Fogarty, *Bases of Insider Trading Law*, 49 OHIO ST. L.J. 353, 361 (1988) (noting that at the time the "Securities Act and the Securities Exchange Act were passed, classic insider trading—transactions between uninformed shareholders and corporate officials possessing inside information—was not regarded as fraudulent in most jurisdictions" and that "[t]he corporate official's fiduciary duties were considered to run to the corporation as an entity, not to

sage of the Securities Exchange Act of 1934, however, a minority of courts had adopted an exception to the majority rule, known as the "special facts" doctrine.⁷⁴ Under that exception, a corporate officer or director has a duty to disclose in a face-to-face transaction with a shareholder if there are special facts that would make nondisclosure unconscionable.⁷⁵

The United States Supreme Court first adopted the "special facts" doctrine in *Strong v. Repide*.⁷⁶ In *Strong*, the managing director of a land development company was negotiating the sale of the company's land, its only valuable asset, when he arranged to purchase Mrs. Strong's shares from her agent.⁷⁷ The managing director, rather than simply going from his own office to the agent's office next door, took elaborate steps to conceal his identity.⁷⁸ He employed his own agent, who in turn employed a broker "who had an office some distance away," to approach the plaintiff's agent concerning the purchase of her stock.⁷⁹ The managing director continued the concealment by paying for the shares with the check of a third person.⁸⁰ The Supreme Court concluded from these facts that:

[T]he concealment of identity was not a mere inadvertent omission, an omission without any fraudulent or deceitful intent, but was a studied and intentional omission to be characterized as part of the deceitful machinations to obtain the purchase without giving any information whatever as to the state and probable result of the negotiations, to the vendor of the stock, and to in that way obtain the same at a lower price.⁸¹

Based on this finding of deceitful concealment, the Court granted rescission

individual shareholders"). Although *Goodwin* is often described as following the "majority" rule, it is worth noting that few courts had addressed the issue at the time *Goodwin* was decided.

⁷⁴ See, e.g., Todd A. Bauman, Comment, *Insider Trading at Common Law*, 51 U. CHI. L. REV. 838, 853 (1984) (noting that "the traditional common law rule allowed insider trading in anonymous markets, while regulating such activity in face-to-face transactions in shares of closely held corporations").

⁷⁵ See Ash, *supra* note 73, at 399-400.

⁷⁶ 213 U.S. 419, 434 (1909) (holding that there was a legal obligation to make the disclosures because of the special facts).

⁷⁷ See *id.* at 425 (noting that the defendant knowingly purchased 800 shares from Mrs. Strong's agent). The Court stated that "[i]f the sale should not be consummated . . . the defendant also knew that the value of the lands and of the shares in the company would be almost nothing." *Id.* at 424-25. Apparently, the government had failed to provide any protection to the lands, thus rendering it essentially worthless. See *id.* at 425.

⁷⁸ See *id.* (describing the scheme the defendant followed in order to purchase the shares).

⁷⁹ *Id.*

⁸⁰ See *id.* at 433.

⁸¹ *Id.*

to Mrs. Strong.⁸²

The special facts doctrine of *Strong* is readily distinguished from the transactions over impersonal exchanges at issue in *Goodwin*, *Chiarella*, and *Dirks*. The "special facts" found by the Court in *Strong* indicate that active concealment of the defendant's identity deprived the plaintiff-shareholder of a basis for inquiring about the transaction and the company's prospects.⁸³ In an impersonal exchange market, by contrast, the insider need not conceal his identity from the outsider on the other side of the transaction because there is no individual matching of trades in the securities markets.⁸⁴ An insider makes no investment in concealment, and an outsider has no expectation of receiving any disclosure from the insider because the outsider does not know that she is trading with an insider. The identity of the person on the other side of the transaction is a mere fortuity, irrelevant to the shareholder's decision to sell.⁸⁵ Because of this anonymity in exchange markets, there can be no reliance on the insider's duty to disclose, and the insider cannot be said to have induced the trade.⁸⁶

⁸² See *id.* at 435.

⁸³ See *id.* at 433 (noting that by concealing his identity, the defendant could "more easily avoid any questions relative to the negotiations for the sale of the lands and their probable result, and could also avoid any actual misrepresentations on that subject, which he evidently thought were necessary in his case to constitute a fraud"). Professor Keeton describes *Strong* as a case involving concealed identity. See W. Page Keeton, *Fraud—Concealment and Non-Disclosure*, 15 TEX. L. REV. 1, 26 (1936) ("[I]t has been held to constitute fraud for a director to conceal his identity along with another fact which makes the stock of much greater worth, and which the stockholder would probably have discovered, either by investigation or inquiry, if he had known that the purchaser was a director." (citing *Strong*, 213 U.S. at 431)). Keeton notes that "these cases often distinguish between facts which could be discovered by an inspection of the books and facts which are peculiarly within the knowledge of the director." *Id.*

⁸⁴ See Lawrence E. Mitchell, *The Jurisprudence of the Misappropriation Theory and the New Insider Trading Legislation: From Fairness to Efficiency and Back*, 52 ALB. L. REV. 775, 799 (1988) (arguing that "the existence of national securities markets makes the use of agents unnecessary, since the anonymity of the markets is sufficient to conceal the fact that insiders are trading in a manner analogous to that accomplished through the use of agents").

⁸⁵ See Donald C. Langevoort, *Insider Trading and the Fiduciary Principle: A Post-Chiarella Restatement*, 70 CAL. L. REV. 1, 7 (1982) (arguing that investors don't know nor do they care "who their buyers or sellers are, there is no bargaining similar to that in face-to-face transactions" and that "given the essential independence of buyer and seller decisions, causation and injury are difficult to trace").

⁸⁶ See Alison Grey Anderson, *Fraud, Fiduciaries, and Insider Trading*, 10 HOFSTRA L. REV. 341, 366-67 (1982) ("Silence by a fiduciary is fraudulent primarily because the beneficiary is likely to interpret that silence in a face-to-face transaction as meaning that the fiduciary is aware of no additional material information."). The government is not required, however, to prove reliance to establish a claim of securities fraud because the government was not a party to the transaction. See *SEC v. Blavin*, 760 F.2d 706, 711 (6th

From a doctrinal perspective, Powell's invocation in *Chiarella* of the common law of deceit is strained. The majority rule is that there can be no liability for insider trading carried out over a stock exchange. The logic of the "special facts" exception to that rule, while protecting face-to-face transactions, cannot be stretched to encompass transactions over exchanges.⁸⁷ As Michael Dooley observes, "insider trading in no way resembles deceit. No representation is made, nor is there any reliance, change of position, or causal connection between the defendant's act and the plaintiff's losses."⁸⁸ For these reasons, the common law of deceit does not support the proposition that a corporate insider defrauds a shareholder when trading in an impersonal market on the basis of confidential information.

2. No Fiduciary Duty to Prospective Shareholders

Another doctrinal problem with the classical theory is that the fiduciary obligation of corporate officers and directors generally extends only to current shareholders.⁸⁹ That obligation does not extend to prospective shareholders who may purchase their shares for the first time when an insider sells.⁹⁰ The classical theory fails to account adequately for this inconsistency with the common law. The Court's only response to this problem was set forth in *Chiarella*, in which the Court quoted Judge Learned Hand:

[T]he director or officer assumed a fiduciary relation to the buyer by the very sale; for it would be a sorry distinction to allow him 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.⁹¹

Although this distinction may be "sorry," it is the common law rule.⁹² Pow-

Cir. 1985) (holding that the Commission is not required to prove reliance on the misrepresentations or that the misrepresentations caused damages).

⁸⁷ See Stephen Bainbridge, *The Insider Trading Prohibition: A Legal and Economic Enigma*, 38 U. FLA. L. REV. 35, 38 (1986).

⁸⁸ Michael P. Dooley, *Enforcement of Insider Trading Restrictions*, 66 VA. L. REV. 1, 59 (1980). Although *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972), holds that reliance can be presumed in the case of a fraudulent omission, that case involved non-disclosure by fiduciaries in a face-to-face transaction. As such, the case is indistinguishable from *Strong v. Repide*, but readily distinguished from *Chiarella* and *Dirks*.

⁸⁹ See 18 DEL. J. CORP. L. 740, 743 (1992) (providing the unreported case *Marhart, Inc. v. Calmat Co.* (Del. Ch. Aug. 19, 1992)) ("[F]iduciary duties run to stockholders, not prospective stockholders.").

⁹⁰ See *id.*

⁹¹ *United States v. Chiarella*, 445 U.S. 222, 227 n.8 (quoting *Gratz v. Claughton*, 187 F.2d 46, 49 (2d Cir. 1951)).

⁹² See Anderson, *supra* note 86, at 356 (noting that "under state law corporate officers and directors generally have a fiduciary obligation to existing shareholders but not to prospective shareholders").

ell's reliance on the common law of deceit is, at best, selective.

3. Transformation of a Breach of a Tipper's Duty of Confidentiality Into a Breach by the Tippee of a Duty of Disclosure to Shareholders

Additional problems with the classical theory are raised by the tension between *Dirks* and *Chiarella*. In *Chiarella*, Powell treats insider trading as a breach of a duty of disclosure to the shareholders,⁹³ but the tipper's breach is more readily seen as a breach of his duty of confidentiality owed to the corporation.⁹⁴ Although Powell's justification of the need for prohibitions against trading by tippees makes sense, his transformation of the tipper's breach of his duty of confidentiality owed to the corporation into a breach by the tippee of a duty of disclosure to shareholders is harder to accept.⁹⁵

4. Causation

The classical theory also poses puzzles of causation. The "victim" of insider trading would likely have sold her shares regardless of whether or not the insider entered the market to purchase them.⁹⁶ Moreover, identifying the "victim" of insider trading is problematic due to the near impossibility of matching trades in an impersonal market.⁹⁷ Congress has addressed this tracing problem by allowing all contemporaneous traders to sue insider traders.⁹⁸ Their damages are limited, however, to the insider's profit gained or

⁹³ See *Chiarella*, 445 U.S. at 227 ("[A] corporate insider must abstain from trading in the shares of his corporation unless he has first disclosed all material inside information known to him.").

⁹⁴ See Mitchell, *supra* note 84, at 796 (noting that at common law, corporate directors owe a fiduciary duty to the corporation, and that only a few jurisdictions recognize a fiduciary duty to shareholders with respect to purchases of company stock).

⁹⁵ I am indebted to Steve Thel for the argument presented here.

⁹⁶ See Cox & Fogarty, *supra* note 73, at 359 (arguing that a purchaser "is rarely the person whose intermediary meets the insider's intermediary on the exchange floor" and that "[t]he latter person was already in the market and probably would have bought or sold even if the insider had abstained"); Frank H. Easterbrook, *Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information*, 1981 SUP. CT. REV. 309, 324 ("[The shareholder] who sold to *Chiarella*, might well have sold no matter what *Chiarella* did. There is no reason to think that *Chiarella*'s 'buy' order, placed through a broker, caused additional investors to sell.").

⁹⁷ See Steven R. Salbu, *The Misappropriation Theory of Insider Trading: A Legal, Economic, and Ethical Analysis*, 15 HARV. J.L. & PUB. POL'Y 223, 238 (1992) (stating that "it is virtually impossible for a private plaintiff trading in the stock exchange to establish either privity with a particular defendant or causality of the trade by any trader's particular transaction").

⁹⁸ See 15 U.S.C. § 78t-1(a) (1994). The statute states that:

Any person who violates any provision of this chapter or the rules or regulations thereunder by purchasing or selling information shall be liable in action in any court of competent jurisdiction to any person who, contemporaneously with the purchase or

loss avoided, and the damages are offset by any disgorgement paid to the SEC.⁹⁹ The limitations on this statutory remedy suggest that Congress intended to deprive the insider of his gains rather than to compensate the "victims" of insider trading for their losses.¹⁰⁰

5. No Fiduciary Duty to Bondholders

Another problem with the classical theory is that the common law also does not recognize a fiduciary duty running from officers and directors to bondholders, at least while the corporation is solvent.¹⁰¹ Therefore, the classical theory does not prevent insider trading in bonds. The failure to prevent insider trading in bonds is a large loophole in the classical theory.¹⁰²

6. The Corporation's Property Rights in Information

Powell's efforts to ground the classical theory of insider trading in the common law of deceit ignore the corporation's interest in protecting its property rights in information. In *Dirks*, Powell distinguished "[t]he duty that insiders owe to the corporation's shareholders not to trade on inside information . . . from the common-law duty that officers and directors also have to the corporation itself not to mismanage corporate assets, of which confidential information is one."¹⁰³ As discussed above, that duty of disclosure to shareholders is not well grounded in the common law of deceit. Nor is it grounded in the law of property, because the corporation's confidences belong to the corporation, not the shareholders.¹⁰⁴ Consequently, the insider's

sale of securities that is the subject of such violation, has purchased . . . or sold . . . securities of the same class.

Id.

⁹⁹ See *id.* § 78t-1(b)(1)-(2). The statute states that:

The total amount of damages . . . shall not exceed the profit gained or loss avoided in the transactions that are the subject of the violation The total amount of damages imposed against any person . . . shall be diminished by the amounts, if any, that such person may be required to disgorge, pursuant to a court order obtained at the instance of the [Securities and Exchange] Commission.

Id.

¹⁰⁰ Cf. Salbu, *supra* note 97, at 236 (arguing that the "proper justification for the granting of surrogate status to contemporaneous traders is to achieve 10b-5's goal of deterrence").

¹⁰¹ See A.C. Pritchard, *O'Melveny & Myers v. FDIC: Imputation of Fraud and Optimal Monitoring*, 4 SUP. CT. ECON. REV. 179, 188-89 (1995).

¹⁰² See R. Rene Pengra, Note, *Insider Trading, Debt Securities, and Rule 10b-5: Evaluating the Fiduciary Relationship*, 67 N.Y.U. L. REV. 1354, 1366 (1996) (arguing for Rule 10b-5 liability for insider trading in debt securities).

¹⁰³ SEC v. *Dirks*, 463 U.S. 646, 653 n.10 (1983).

¹⁰⁴ See Dooley, *supra* note 88, at 32 ("Neither insiders nor outside investors have any property right in non-public corporate information. The corporate principal owns the information and may withhold it so long as withholding serves a valid corporate purpose.").

duty to protect the confidentiality of the corporation's information is much better established,¹⁰⁵ and the corporation has a better claim than the shareholder that its rights have been infringed by the insider trading.¹⁰⁶ The breach of this duty of confidentiality has given rise to liability to the corporation under state corporate law.¹⁰⁷ But given the restrictions on purchasers or sellers that the Court has put on the private right of action under § 10(b),¹⁰⁸ the corporation will have a difficult time collecting under the securities laws for the misuse of its information.

In sum, the classical theory of insider trading grounded in the law of deceit gives incomplete protection to the integrity of the market because it only addresses breaches of duty to shareholders. This gap was the driving force behind the development of the misappropriation theory. The next Part examines the development of that theory.

¹⁰⁵ See RESTATEMENT (SECOND) OF AGENCY § 395 (1958) (stating that an agent is under "a duty . . . not to use or to communicate information confidentially given him by the principal or acquired by him during the course of or on account of his agency or in violation of his duties as agent, in competition with or to the injury of the principal").

¹⁰⁶ See Dooley, *supra* note 88, at 21 (arguing that requiring insiders to forfeit any profit resulting from a breach of a fiduciary duty should result in payment to the issuer because it has the superior property interest in the information); see also Easterbrook, *supra* note 96, at 323 ("Chiarella's trading . . . reduced the returns available to the bidders. His trading may have alerted the market to the impending offers and so made them more difficult to consummate. Chiarella's conduct subjected his principals to uncompensated risk.").

¹⁰⁷ See *Diamond v. Oreamuno*, 248 N.E.2d 910, 916 (N.Y. 1969) (requiring that officers and directors account to the corporation for profits made in trading on inside information); cf. *Brophy v. Cities Serv. Co.*, 70 A.2d 5, 8 (Del. Ch. 1949) (requiring that corporate officers account for trading profits made in competition with the corporation's planned repurchase of its shares). But see *Freeman v. Decio*, 584 F.2d 186, 187 (7th Cir. 1978) (rejecting duty to corporation under Indiana law).

Section 16(b) also puts recovery for short-swing profits by insiders in the hands of the corporation. See 15 U.S.C. § 78p (1994) (requiring that any profit derived from the purchase or sale of a security by an insider within six months is to be recoverable by the issuer).

¹⁰⁸ See *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 754-55 (1975) (holding that a private right of action is limited to persons who purchased or sold securities). The purchaser/seller limitation is inapplicable to SEC enforcement actions and to criminal cases. See *id.* at 751 n.14 (holding that the purchaser-seller rule "imposes no limitation on the standing of the SEC to bring actions for injunctive relief"); see also *Holmes v. Securities Investor Protection Corp.*, 503 U.S. 258, 281 (1992) (O'Connor, J., concurring in part and concurring in the judgment) ("[T]he purchaser/seller standing requirement for private civil actions under § 10(b) and Rule 10b-5 is of no import in criminal prosecutions for willful violations of those provisions.").

II. THE MISAPPROPRIATION THEORY: *CARPENTER* AND *O'HAGAN*A. *Background of the Misappropriation Theory*

The misappropriation theory has its judicial genesis in Chief Justice Burger's dissent in *Chiarella*.¹⁰⁹ The Chief Justice agreed with Justice Powell that, "[a]s a general rule, neither party to an arm's-length business transaction has an obligation to disclose information to the other unless the parties stand in some confidential or fiduciary relation."¹¹⁰ Burger parted company with Powell, however, where a trader obtained a trading advantage based on information that had been "misappropriated."¹¹¹ In Burger's view, "a person who has misappropriated non-public information has an absolute duty to disclose that information or to refrain from trading."¹¹² Burger argued that imposing such a duty would not have any negative effect on legitimate business practices because the misappropriator's "conduct quite clearly serves no useful function except his own enrichment at the expense of others."¹¹³ Burger's theory, while much broader than Powell's, shared one feature with the majority opinion in *Chiarella*: the duty endorsed by Burger was owed to the

¹⁰⁹ See *United States v. Chiarella*, 445 U.S. 222, 240 (1980) (Burger, C.J., dissenting) (reasoning that "a person who has misappropriated nonpublic information has an absolute duty to disclose that information or to refrain from trading"). Justices Brennan, Blackmun, and Marshall also indicated support for the theory or the broader parity of information theory. See *id.* at 238 (Brennan, J., concurring) (arguing that "a person violates § 10(b) whenever he improperly obtains or converts to his benefit nonpublic information which he then uses in connection with the purchase or sale of securities"); *id.* at 245 (Blackmun, J., dissenting, joined by Marshall, J.) (stating agreement "with much of what is said in . . . the dissenting opinion" of the Chief Justice).

¹¹⁰ *Id.* at 239-40 (Burger, C.J., dissenting) (citing W. PROSSER, *LAW OF TORTS* § 106 (2d ed. 1955)).

¹¹¹ See *id.* at 240 (Burger, C.J., dissenting) (arguing that "the rule should give way when an informational advantage is obtained, not by superior experience, foresight, or industry, but by some unlawful means").

¹¹² *Id.* (Burger, C.J., dissenting) (citing Keeton, *supra* note 83, at 25-26). Keeton offers scant authority for this proposition, asserting that "[a]ny time information is acquired by an illegal act it would seem that there should be a duty to disclose that information, irrespective of the nature of the remedy." Keeton, *supra* note 85, at 25-26; see also *id.* at 35 (stating that a duty of disclosure exists when information is acquired by an illegal act). But the only authorities offered by Keeton are cases seeking specific performance. See *id.* at 25 ("There are cases denying the remedy of specific performance in instances where material information undisclosed has been acquired by a tortious act."). These cases denying specific performance are, of course, grounded in the equity doctrine of "unclean hands," which would not apply in an action at law. See, e.g., *Precision Instrument Mfg. Co. v. Automotive Maintenance Mach. Co.*, 324 U.S. 806, 814 (1945) (discussing the equitable notion of "unclean hands," which prohibits relief to those "tainted with inequity or bad faith relative to the matter in which he seeks relief").

¹¹³ *Chiarella*, 445 U.S. at 241 (Burger, C.J., dissenting).

shareholder on the other side of the trade.¹¹⁴

Prosecutors quickly embraced a variant of the misappropriation theory espoused by Burger. In *United States v. Newman*,¹¹⁵ they charged that Newman, a securities trader, and two investment bankers, one from Morgan Stanley and one from Kuhn Loeb, "misappropriated confidential information concerning proposed mergers and acquisitions that was entrusted to their employers by corporate clients."¹¹⁶ Rather than alleging a breach of duty to the shareholders with whom the conspirators traded, however, the indictment alleged that the conspirators had breached their duties of trust and confidence to their employers, the investment banks, and to their employers' corporate clients.¹¹⁷

The Second Circuit agreed that this breach of duty stated a violation of § 10(b).¹¹⁸ The court brushed aside objections that the investment banks were not purchasers or sellers as being inapplicable to a government action.¹¹⁹ It found the requisite deception in the conspirators' conduct that damaged the investment banks' reputations as keepers of client confidences and in wronging the investment banks' clients.¹²⁰ The court also rejected the claim that the conspirators' fraud was not "in connection with" the purchase or sale of securities, reasoning that the defendant's sole purpose in misappropriating the takeover information was to purchase shares of the target companies.¹²¹ *Newman* illustrates that from its earliest acceptance by the courts, the misappropriation theory, unlike the classical theory, was premised upon a fraud committed on one party, and a securities transaction entered into with another.

B. *United States v. Carpenter: Misappropriation Theory in Limbo*

The Second Circuit subsequently reaffirmed the misappropriation the-

¹¹⁴ See *id.* at 240 (Burger, C.J., dissenting) (arguing that one who misappropriates non-public information has an absolute duty to disclose that information to the shareholder on the other side of the transaction or to refrain from trading). Purchasers who have inside information from their own company generally have no duty to shareholders of other corporations. See *General Time Corp. v. Talley Indus.*, 403 F.2d 159, 164 (2d Cir. 1968) ("We know of no rule of law . . . that a purchaser of stock, who was not an 'insider' and had no fiduciary relation to a prospective seller, had any obligation to reveal circumstances that might raise a seller's demands and thus abort the sale.").

¹¹⁵ 664 F.2d 12 (2d Cir. 1981).

¹¹⁶ *Id.* at 15.

¹¹⁷ See *id.* at 15-16.

¹¹⁸ See *id.* at 16.

¹¹⁹ See *id.* at 16-17 (arguing that Rule 10b-5 applies to any person, and that the court must be concerned with the scope of the Rule and not the plaintiff's standing to sue).

¹²⁰ See *id.* at 17 (noting that the clients had takeover plans that depended upon market-based prices, not inflated prices caused by the release of this information).

¹²¹ See *id.* at 18.

ory.¹²² The Supreme Court's first opportunity to consider the misappropriation theory was presented in another Second Circuit case, *United States v. Carpenter*.¹²³ *Carpenter* narrowly avoided a decision on the validity of the theory—a decision which, but for a quirk of fate, in all likelihood would have changed the course of insider trading jurisprudence.

Carpenter arose from a unique set of facts. Defendant R. Foster Winans was a reporter for the *Wall Street Journal* and one of the writers of the "Heard on the Street" column, while defendant David Carpenter was a news clerk at the *Journal*.¹²⁴ Defendant Kenneth Felis was a stockbroker at Kidder Peabody.¹²⁵ Winans would pass securities-related information scheduled to appear in the next day's column through Carpenter to Felis, who would then, depending upon the tenor of the article, buy or sell the subject securities.¹²⁶ *Wall Street Journal* policy deemed all news information to be company property and required nonpublic information to be treated as confidential.¹²⁷ Ignoring this policy, the conspirators netted nearly \$690,000 from the scheme.¹²⁸ The stress of an SEC inquiry into the scheme caused the conspirators to turn on each other,¹²⁹ and an indictment followed.

The Second Circuit affirmed the conspirators' convictions for mail fraud, wire fraud, and securities fraud.¹³⁰ With respect to the securities fraud convictions, the Second Circuit followed its earlier precedents and upheld the convictions under the misappropriation theory.¹³¹ The Second Circuit rejected the argument that the misappropriation theory did not apply because the victim of the misappropriation was the *Wall Street Journal* and not the companies whose shares were traded.¹³²

The conspirators petitioned for certiorari, which the Court initially voted to deny.¹³³ Justice Powell prepared a draft dissent from the denial of certiorari in which he made it clear that he would have rejected the misappropriation theory altogether.¹³⁴ He began his opinion by noting that "the Second Circuit has resolved an important question of securities law in a way that ap-

¹²² See *SEC v. Materia*, 745 F.2d 197, 201 (2d Cir. 1984) (holding that misappropriation of nonpublic information constitutes a violation of § 10(b)).

¹²³ 791 F.2d 1024 (2d Cir. 1986), *aff'd*, 484 U.S. 19 (1987).

¹²⁴ See *id.* at 1026.

¹²⁵ See *id.*

¹²⁶ See *id.*

¹²⁷ See *id.*

¹²⁸ See *id.* at 1027.

¹²⁹ See *id.*

¹³⁰ See *id.* at 1036.

¹³¹ See *id.* at 1034-35.

¹³² See *id.* at 1032-34.

¹³³ See Powell's Draft, *supra* note 11, at 1 (dissenting from denial of certiorari).

¹³⁴ See *id.* at 6 (arguing that the misappropriation theory has "little or no support . . . in the language or history of the Securities Act of 1934").

pears to conflict with recent opinions of this Court."¹³⁵ The first of these opinions was Powell's own work in *Chiarella*.

In *Chiarella*, the analysis of Rule 10b-5 began with the proposition that:

[P]arties to a business transaction generally do not have an affirmative duty to disclose information about the transaction. The court noted, however, that a failure to disclose material information could be fraudulent in certain circumstances. "But such liability is premised upon a duty to disclose arising from a relationship of trust and confidence *between parties to a transaction*."¹³⁶

Powell's reading of *Chiarella* is closely tied to the common law of deceit, which requires that "[o]ne party to a business transaction is under a duty to exercise reasonable care to disclose to the other before the transaction is consummated . . . matters known to him that the other is entitled to know because of a fiduciary or other similar relation of trust and confidence between them."¹³⁷ Thus, the common law of deceit requires that the duty of disclosure be owed by one party of the transaction to the other. In Powell's view, *Chiarella* had incorporated this common law requirement into § 10(b).¹³⁸

Powell then turned to *Dirks*, which "established that when outsiders have a fiduciary duty to the shareholders, they cannot purchase securities from those shareholders without first informing them of material information that might influence the decision to purchase or sell the securities."¹³⁹ Again, the disclosure duty was only between the parties to the securities transaction. By contrast, in *Carpenter* there was no fiduciary relationship between the defendants and those from whom they purchased securities.¹⁴⁰ The only fiduciary relationship at issue was Winans' duty to the *Journal*.¹⁴¹ Powell noted, however, that previous cases under Rule 10b-5 did not support the proposition that the fiduciary duty an individual owes to his employee was sufficient to support an action under Rule 10b-5.¹⁴² Rather, the inquiry under Rule 10b-5 "must focus on the petitioner's relationship with the sellers of . . . securities."¹⁴³ Because there was no such relationship in *Carpenter*, Powell concluded that the petitioners' conduct did not violate § 10(b) and Rule 10b-5.¹⁴⁴

¹³⁵ *Id.* at 1.

¹³⁶ *Id.* at 3 (citation omitted).

¹³⁷ RESTATEMENT (SECOND) OF TORTS § 551(2) (1977) (emphasis added).

¹³⁸ See Powell's Draft, *supra* note 11, at 4 (arguing that *Chiarella* found that parties to a business transaction do not necessarily owe a duty to disclose information and that liability arises only in instances where there is such a duty).

¹³⁹ *Id.*

¹⁴⁰ See *id.* (noting that the court of appeals found no fiduciary relationship between any of the parties).

¹⁴¹ See *id.* at 4-5.

¹⁴² See *id.* at 6.

¹⁴³ *Id.* (internal quotations marks and citations omitted).

¹⁴⁴ See *id.* (concluding that because there was no fiduciary duty to disclose information,

Powell's draft dissent was joined by Justice O'Connor and Chief Justice Rehnquist.¹⁴⁵ It was never published, however, because Justices Brennan and Scalia changed their votes to grant certiorari.¹⁴⁶ Before *Carpenter* was argued, Justice Powell retired.¹⁴⁷ His successor, Anthony Kennedy, was not confirmed until after the argument.¹⁴⁸ The Court split 4-4 on the misappropriation theory under the securities laws and it issued no opinion on the validity of the theory.¹⁴⁹ Given Powell's explicit rejection of the misappropriation theory in his draft dissent, it is reasonable to conclude that if Justice Powell had not retired when he did, the Supreme Court would have rejected the misappropriation theory in 1987.¹⁵⁰

C. *United States v. Bryan: The Fourth Circuit Rejects the Misappropriation Theory*

In the aftermath of *Carpenter*, Congress considered, but declined to adopt, a proposal to codify the misappropriation theory.¹⁵¹ Nevertheless, the government continued to bring misappropriation cases, and the theory was ac-

their convictions under § 10(b) and Rule 10b-5 could not be sustained). Powell reiterated the point in his conclusion. *See id.* ("There appears to be little or no support for the decision below in the language or the history of the Securities Act of 1934.")

¹⁴⁵ *See* Letter from Chief Justice Rehnquist to Justice Powell, (Dec. 11, 1986) (on file with the author) (joining in dissent from denial of certiorari); Letter from Justice O'Connor to Justice Powell, (Dec. 11, 1986) (on file with the author) (joining in dissent from denial of certiorari).

¹⁴⁶ *See* Bench Memorandum, *Carpenter v. United States* (No. 86-422) (Oct. 7, 1987) (copy on file with the Library of Congress, Manuscript Division, Box 427 of Thurgood Marshall Papers). Certiorari was granted on December 15, 1986. *See United States v. Carpenter*, 479 U.S. 1016 (1986).

¹⁴⁷ *See* Al Kamen, *Justice Powell Resigns, Was Supreme Court's Pivotal Vote*, WASH. POST, June 27, 1987, at A1 (reporting that Justice Powell retired on June 26, 1987).

¹⁴⁸ *See Carpenter v. United States*, 484 U.S. 19, 19 (1987) (noting that the case was argued on October 7, 1987); Linda Greenhouse, *Reagan Nominates Anthony Kennedy to Supreme Court*, N.Y. TIMES, Nov. 12, 1987, at A1 (reporting that Justice Kennedy was nominated November 11, 1987); Stuart Taylor, Jr., *Kennedy Sworn In as 104th Justice on High Court*, N.Y. TIMES, Feb. 19, 1988, at A10 (reporting that Anthony Kennedy was sworn in as Justice on February 18, 1988).

¹⁴⁹ *See Carpenter*, 484 U.S. at 24. The Court affirmed the mail and wire fraud convictions unanimously. *See id.*

¹⁵⁰ Conversely, if Justice Kennedy had been nominated and confirmed by the time of argument, the misappropriation theory might well have been upheld, given that Justice Kennedy voted with the majority in *O'Hagan*. *See United States v. O'Hagan*, 117 S. Ct. 2199, 2204 (1997) (noting that Stevens, O'Connor, Kennedy, Souter, and Breyer joined in Ginsburg's opinion).

¹⁵¹ *See* Stuart J. Kaswell, *An Insider's View of the Insider Trading and Securities Fraud Enforcement Act of 1988*, 45 BUS. LAW. 145, 150-51 (1989) (discussing the debate over the move to define insider trading and the decision against such definition).

cepted by the Seventh¹⁵² and Ninth Circuits.¹⁵³ The government's string of victories came to an abrupt halt in 1995, when the Fourth Circuit rejected the misappropriation theory in *United States v. Bryan*.¹⁵⁴

Elton "Butch" Bryan, Lottery Director for the State of West Virginia,¹⁵⁵ was convicted of wire and securities fraud for trading in the securities of companies that were about to be awarded contracts with the lottery.¹⁵⁶ On appeal, the Fourth Circuit framed the question before it as:

[W]hether [Rule 10b-5]'s prohibition of "fraud" "in connection with the purchase or sale of any security," which can be read no more broadly than the statutory prohibition of "deception" "in connection with the purchase or sale of any security," may extend to breaches of fiduciary duty involving the misappropriation of confidential information from one who is neither a purchaser nor seller of securities, or otherwise connected with a securities transaction.¹⁵⁷

The Fourth Circuit found that the misappropriation theory failed to meet the statutory requirements on two grounds. First, the court held that the misappropriation theory imposes liability upon the mere breach of fiduciary relationship or similar relationship of trust and confidence without a showing of deception.¹⁵⁸ In the court's view, this omission conflicted with the Supreme Court's holding in *Santa Fe*, that a mere breach of fiduciary duty, absent deception, did not give rise to liability under § 10(b).¹⁵⁹ Second, the theory failed because it could not satisfy § 10(b)'s requirement that the persons deceived have some connection to the security transaction, because it "artificially divides into two discrete requirements—a fiduciary breach and a purchase or sale of securities—the single indivisible requirement of deception upon the purchaser or seller of securities, or upon some other person intimately linked with or affected by a securities transaction."¹⁶⁰ In this regard, the Fourth Circuit's analysis follows the logic of Justice Powell's draft dissent in *Carpenter*, that the fraud must be *in* the securities transaction for it to

¹⁵² See *SEC v. Cherif*, 933 F.2d 403, 410 (7th Cir. 1991) (accepting the misappropriation theory and holding that one "violates Rule 10b-5 and § 10(b) . . . by misappropriating and trading upon material information").

¹⁵³ See *SEC v. Clark*, 915 F.2d 439, 449 (9th Cir. 1990) (holding that the misappropriation theory applies to fraud under § 10(b) and Rule 10b-5).

¹⁵⁴ 58 F.3d 933, 944 (4th Cir. 1995) (rejecting the misappropriation theory because it lacked support from the language of § 10(b) and Rule 10b-5, Supreme Court decisions interpreting these provisions, or from the purposes of securities fraud provisions).

¹⁵⁵ See *id.* at 937.

¹⁵⁶ See *id.* at 939.

¹⁵⁷ *Id.* at 946 (citations omitted).

¹⁵⁸ See *id.* at 949.

¹⁵⁹ See *Santa Fe Indus., v. Green*, 430 U.S. 462, 473-74 (1977) (holding that deception is necessary to trigger § 10(b) liability).

¹⁶⁰ *Bryan*, 58 F.3d at 950.

violate § 10(b).¹⁶¹

D. United States v. O'Hagan

1. The Eighth Circuit

In *O'Hagan*, the Eighth Circuit followed the Fourth Circuit's rejection of the misappropriation theory.¹⁶² James O'Hagan was a prominent lawyer with Dorsey & Whitney in Minneapolis, the law firm Grand Met retained to represent it in connection with a possible takeover of Pillsbury.¹⁶³ Despite Grand Met's and Dorsey & Whitney's efforts to maintain confidentiality, O'Hagan learned of the transaction and began purchasing Pillsbury call options and stock.¹⁶⁴ When Grand Met announced its tender offer for Pillsbury, O'Hagan realized a profit in excess of \$4 million.¹⁶⁵ Following an SEC investigation, O'Hagan was convicted of 57 counts of mail fraud, securities fraud, and money laundering.¹⁶⁶

In reversing all of the convictions, the Eighth Circuit rejected the misappropriation theory because it does not require deception, "contrary to § 10(b)'s explicit requirements,"¹⁶⁷ and that in any event, it renders "nugatory the requirement that the 'deception' be 'in connection with the purchase or sale of any security.'"¹⁶⁸ The court adopted *Bryan's* analysis in its entirety.¹⁶⁹

¹⁶¹ See *supra* notes 138-44 and accompanying text (discussing Justice Powell's draft dissent from denial of certiorari in *Carpenter*).

¹⁶² See *United States v. O'Hagan*, 92 F.3d 612, 662 (8th Cir. 1996) (holding that criminal liability could not be imposed under § 10(b) under the misappropriation theory), *rev'd*, 117 S. Ct. 2199 (1997).

¹⁶³ See *id.* at 614.

¹⁶⁴ See *id.*

¹⁶⁵ See *id.*

¹⁶⁶ See *id.* The SEC obtained summary judgment in a parallel civil action against O'Hagan based on the collateral estoppel effect of the conviction. See *SEC v. O'Hagan*, 901 F. Supp. 1461, 1461 (D. Minn. 1995).

¹⁶⁷ *O'Hagan*, 92 F.3d at 617.

¹⁶⁸ *Id.*

¹⁶⁹ See *id.* at 620. The Eighth Circuit went further than the *Bryan* court, however, by also invalidating the SEC's Rule 14e-3, see *id.* at 627, which prohibits the use in securities trading of confidential information relating to tender offers, see 17 C.F.R. § 240.14e-3(a) (1997). The validity of the Rule had previously been upheld by the Second, see *United States v. Chestman*, 947 F.2d 551, 562-63 (2d Cir. 1991) (en banc); Seventh, see *SEC v. Maio*, 51 F.3d 623, 631 (7th Cir. 1995); and Tenth Circuits, see *SEC v. Peters*, 978 F.2d 1162, 1166-67 (10th Cir. 1992). The Eighth Circuit rejected the Rule because it does not include any requirement of misrepresentation or nondisclosure. See *O'Hagan*, 92 F.3d at 625-26 (invalidating Rule 14e-3). In the court's view, this omission conflicted with *Chiarella's* holding that nondisclosure could be fraudulent only when there was a duty to disclose, and the court found no material differences between § 10(b) and § 14(e). See *id.* at

2. The Supreme Court

In the face of the widening split in the circuits over the validity of the misappropriation theory, the Supreme Court granted the government's petition for certiorari.¹⁷⁰ In arguing for the validity of the misappropriation theory, the government faced two principal challenges: (1) establishing that the theory rests on "deception" within the meaning of § 10(b); and (2) establishing that the deception required under the theory occurs "in connection with" the purchase or sale of securities. The government argued that deception occurs not merely when a misappropriator breaches a duty to a principal in using the principal's confidential information, but rather, when the misappropriator fails to disclose his intention to use the information.¹⁷¹ Drawing from agency principles, the government argued that O'Hagan's failure to disclose his trading to his law firm and Grand Met made his conduct "deceptive" under § 10(b).¹⁷² "[U]nder well settled principles, before an agent may use his principal's confidential business information for his personal benefit, he must make disclosure to the principal and obtain the principal's consent; the breach of that duty thus inherently involves deceptive nondisclosure."¹⁷³ This failure to disclose in circumstances where disclosure is required distinguishes the misappropriation theory from the fully disclosed breach of fiduciary obligation rejected as a basis for § 10(b) liability in *Santa Fe*.¹⁷⁴

The government's second challenge—establishing that the misappropriation theory satisfies the "in connection with" requirement—raised a question of pure statutory construction. The government argued that the statutory phrase should be read "in its ordinary meaning, as 'related to' or 'involving.'"¹⁷⁵ Applying this standard to the facts of *O'Hagan*, the government urged that O'Hagan's

fraud was "in connection with" his purchases of Pillsbury securities because . . . his trades were a necessary element of his fraud. The non-public information about the Pillsbury takeover had no value to [O'Hagan] personally except as it might enable him to reap windfall profits in the securities market (or enable someone else to reap such profits, through illegal tipping). Thus, . . . his deceptive fiduciary breach and his purchase of securities were connected, because the

624-27. The court also overturned O'Hagan's mail fraud convictions, holding that "the indictment was structured in such a manner as to premise the fraud for the mail fraud charges on the acts allegedly constituting the securities fraud." *Id.* at 627.

¹⁷⁰ See *United States v. O'Hagan*, 117 S. Ct. 759 (1997) (No. 96-842).

¹⁷¹ See Reply Brief for the United States at 6, *United States v. O'Hagan*, 1997 WL 174119.

¹⁷² See *id.*

¹⁷³ *Id.*

¹⁷⁴ See *id.* at 8.

¹⁷⁵ *Id.* at 11.

breach was consummated by his purchase of securities.¹⁷⁶

No alternative opportunity could have secured the windfall profits of \$4.3 million that O'Hagan made trading Pillsbury options. But until O'Hagan actually traded on the inside information, he had not actually converted it to his own use, and thus, he had not yet breached his fiduciary duty of disclosure. Only when O'Hagan used Grand Met's information for trading in the securities markets did he finally breach that duty. Consequently, the government's theory of "deception"—trading without disclosure—converged with its theory of why that fraudulent nondisclosure was "in connection with" O'Hagan's trading.

The "deception" and "in connection with" requirements were the central focus of oral argument before the Court. The first question posed by Justice O'Connor to Deputy Solicitor General Michael Dreeben concerned the deception element of the misappropriation theory:

QUESTION: [S]uppose the defendant here had instead come clean, and he told his superiors in the law firm that he was going to use this information. Then he would not be posing as a loyal employee any more, and it would have been okay?

DREEBEN: He would not have deceived his employer. He still would have breached independent fiduciary duties that he owed to that employer.

QUESTION: And you say he would still have breached the securities laws?

DREEBEN: No, I do not think he would have breached the securities laws.

QUESTION: So that's the line? He didn't tell them that he was going to go out and use it?

DREEBEN: That's absolutely correct, and the reason why that is significant is that § 10(b) prohibits deceptive devices and contrivances. It requires deception.¹⁷⁷

Thus, the government's brief and oral argument made clear that under the misappropriation theory the "deception" element of § 10(b) is satisfied by an agent's failure to disclose to his principal the agent's intention to use the principal's confidential information for the agent's benefit.

Chief Justice Rehnquist raised concerns about the "in connection with" requirement that were reminiscent of Justice Powell's draft dissent in *Carpenter*:

¹⁷⁶ *Id.*

¹⁷⁷ Transcript of Oral Argument at 4-5, *United States v. O'Hagan* (Apr. 16, 1997), 1997 WL 182584 [hereinafter Transcript of Oral Argument].

QUESTION: Well, Mr. Dreeben, . . . the thing that bothers me about the case here is, where is the connection between the deceptive device and the purchase or sale of a security?

DREEBEN: The connection, Chief Justice Rehnquist, lies in the fact that the misappropriation does not occur until the lawyer uses the information as the basis for his trades. It is that very information which drives his participation in the market and allows the profits to be . . . reaped by him.

QUESTION: But he didn't deceive anyone who sold him securities.

DREEBEN: That is true. The misappropriation theory doesn't rely on the notion that he owed a duty of disclosure to the shareholders on the other side of the transaction, but it does satisfy the requisite connection between the fraud and the securities trading, because it is only in the trading that the fraud is consummated. There could be no closer—

QUESTION: *But you think of fraud being practiced on a person who is damaged by it.*

DREEBEN: I think *under the common law view of fraud*, Chief Justice Rehnquist, *that is an accurate statement*, but the securities laws are not framed to pick up only those violations that are covered by common law fraud. Congress did not pass a statute that says, it is unlawful to commit fraud on the purchaser or seller of securities.

Congress did not pass a law even that said it is unlawful to commit fraud in a securities transaction. It passed a law with a broader phrase, in connection with a securities transaction, because the very aim of this section was to pick up unforeseen, cunning, deceptive devices that people might cleverly use in the securities markets.¹⁷⁸

The Chief Justice's questions suggest that he believed that § 10(b) was limited to the common law of deceit, and that the fraud had to be in the securities transaction. This is essentially the position taken by Justice Powell,¹⁷⁹ in which the Chief Justice and Justice O'Connor concurred at the time of *Car-*

¹⁷⁸ *Id.* at 6-7 (emphasis added).

¹⁷⁹ See *supra* notes 135-39 and accompanying text (discussing Justice Powell's view that the fraud had to occur in the securities transaction). The Chief Justice dissented in *O'Hagan*, while Justice O'Connor joined the majority opinion. See *United States v. O'Hagan*, 117 S. Ct. 2199, 2204 (1997).

penter.¹⁸⁰

O'Hagan's counsel attempted to capitalize on the issue raised by the Chief Justice's line of questioning. Relying on the Fourth Circuit's analysis in *Bryan*, he argued that deception and the securities transaction had to be "a unitary concept":

COUNSEL: The unitary concept is deception or manipulation in connection with the purchase or sale of a security. To me, that means the buyer or seller of the security deceives the person on the other side of the transaction. It's not as if you deceive someone over here and then later on you benefit from it by dealing with somebody else.

Mr. Dreeben's remark, it seems to me, fits with my theory of this case. He says . . . it has to be in connection with the purchase or sale of a security because the only way Mr. O'Hagan could profit was in the purchase or sale of a security. Not so. That assumes Mr. O'Hagan has no imagination. Mr. O'Hagan could have said, I now have a useful piece of information. I have misappropriated it. I'm going to profit on it by selling it to the trade press. I can get a good fee for this information.

So the misappropriation would have occurred, but it had been disconnected from the purchase or sale of the security.

QUESTION: It's not entirely disconnected. The trade press would only be interested in it because the people who read the trade press would be able to buy securities on the basis of this confidential information.¹⁸¹

Counsel for O'Hagan provided the Court with another hypothetical:

COUNSEL: I'll give you another hypothetical, Your Honor, because I'm firmly convinced that the statute doesn't read the way Mr. Dreeben says it does. You cannot disconnect the misappropriation from the purchase and sale of securities and say it's satisfied.

Mr. O'Hagan's office in Minneapolis is across the street from the Pillsbury Company. He could have said to himself, I have always wanted the business of the

¹⁸⁰ See *supra* note 145 and accompanying text (noting that Chief Justice Rehnquist and Justice O'Connor joined Justice Powell in dissent from denial of certiorari).

¹⁸¹ See Transcript of Oral Argument, *supra* note 177, at 35 (discussing the unitary concept).

Pillsbury Company. I will walk across the street, misappropriating this information of my law firm and its client, deliver it to the Pillsbury Company, and suggest to the Pillsbury Company that in the future they might find it very desirable to use me for legal work.

That wouldn't have had anything to do with the purchase and sale of the security, and yet it would have profited Mr. O'Hagan if it had worked.¹⁸²

Experienced appellate lawyers know that many cases are decided before oral argument, but in some cases, oral argument can be decisive. *O'Hagan* may have been such a case. The government was able to demonstrate the logical limits of its theory of deception, and show how that deception was "in connection with" a securities transaction. The misappropriation was "in connection with" O'Hagan's securities trading because he had not breached his duty of disclosure until he actually traded. O'Hagan's counsel was unable to parry that argument with a convincing response.¹⁸³

The Court's decision accepted the misappropriation theory in its entirety.¹⁸⁴ Justice Ginsburg, writing for the Court, had little difficulty in finding that the misappropriation theory satisfied § 10(b)'s deception requirement.¹⁸⁵ She distinguished *Santa Fe* on the grounds that:

Deception through nondisclosure is central to the [misappropriation] theory [F]ull disclosure forecloses liability under the misappropriation theory: Because the deception essential to the misappropriation theory involves feigning fidelity to the source of information, if the fiduciary discloses to the source that he plans to trade on the non-public information, there is no "deceptive device" and thus no § 10(b) violation—although the fiduciary-turned-trader may remain liable under state law for breach of a duty of loyalty.¹⁸⁶

Thus, nondisclosure in breach of a duty of disclosure remained the touchstone for a finding of deception under § 10(b), just as it had been in *Chiarella*. That duty of disclosure, however, was found in the common law of agency rather than the common law of deceit.¹⁸⁷

¹⁸² *Id.* at 35-37.

¹⁸³ See Lyle Denniston, *Supreme Confidence*, AM. LAW., June 1997, at 75-76 (reviewing the *O'Hagan* oral arguments).

¹⁸⁴ See *United States v. O'Hagan*, 117 S. Ct. 2199, 2206 (1997) (upholding the convictions under the misappropriation theory).

¹⁸⁵ See *id.* at 2208 (stating that the misappropriation theory "satisfies § 10(b)'s requirement that chargeable conduct involve 'deceptive device or contrivance'").

¹⁸⁶ *Id.* at 2208-09. Justice Ginsburg reinforced the point, stating "it [was O'Hagan's] failure to disclose his personal trading to Grand Met and Dorsey, in breach of his duty to do so, that ma[de] his conduct 'deceptive' within the meaning of 10(b)." *Id.* at 2211.

¹⁸⁷ See *id.* at 2208 (discussing how a fiduciary breaches his duty of loyalty when con-

Ginsburg departed further from Justice Powell's legacy in her finding that the misappropriation theory satisfied § 10(b)'s "in connection with" requirement:

This element is satisfied because the fiduciary's fraud is consummated, not when the fiduciary gains the confidential information, but when, without disclosure to his principal, he uses the information to purchase or sell securities. The securities transaction and the breach of duty thus coincide. This is so even though the person or entity defrauded is not the other party to the trade, but is, instead, the source of the non-public information. A misappropriator who trades on the basis of material, nonpublic information, in short, gains an advantageous market position through deception; he deceives the source of the information and simultaneously harms members of the investing public.¹⁸⁸

Ginsburg gave short shrift to the alternative uses for Grand Met's confidential information hypothesized by O'Hagan's counsel;¹⁸⁹ in her view, it sufficed that the information "ordinarily" would have value only in securities trading.¹⁹⁰ Thus, the misappropriation theory was consistent with the text of § 10(b).

Justice Ginsburg's treatment of the Court's prior precedents further demonstrated O'Hagan's departure from Justice Powell's vision of insider trading law. She rebuffed the notion that *Chiarella* required that the fraud be between parties to the securities transaction.¹⁹¹ The statements in *Chiarella* that suggested such an interpretation of § 10(b) merely "rejected the notion that § 10(b) stretches so far as to impose 'a general duty between all participants in market transactions to forgo actions based on material, non-public information,' and we confine them to that context."¹⁹² She also noted that *Dirks* specifically had reserved the question of trading on misappropriated information.¹⁹³ Thus, Justice Ginsburg's treatment of *Chiarella* and *Dirks* diverged completely from Justice Powell's understanding of those cases as expressed in his draft dissent from denial of certiorari in *Carpenter*.

Ginsburg concluded that it would "make[] scant sense to hold a lawyer

verting the agent's information for personal gain).

¹⁸⁸ *Id.* at 2209.

¹⁸⁹ *See id.* at 2210 n.8 (discounting O'Hagan's counsels' hypothetical uses of the client's information, such as selling it to a trade journal or using it to seek a legal position with Pillsbury).

¹⁹⁰ *See id.* at 2210.

¹⁹¹ *See id.* at 2212 ("The Court did not hold in *Chiarella* that the *only* relationship prompting liability for trading on undisclosed information is the relationship between a corporation's insiders and shareholders.").

¹⁹² *Id.* (quoting *United States v. Chiarella*, 445 U.S. 222, 233 (1980)).

¹⁹³ *See id.* at 2213 (arguing that *Dirks* did not support that § 10(b) does not prevent those who acquire nonpublic information through misappropriation and then trade based on that information).

like O'Hagan a § 10(b) violator if he works for a law firm representing the target of a tender offer, but not if he works for a law firm representing the bidder"¹⁹⁴ in light of "the inhibiting impact on market participation of trading on misappropriated information, and the congressional purposes underlying § 10(b)."¹⁹⁵ Policy concerns and congressional intent, not the common law of deceit followed by Powell in *Chiarella* and *Dirks*, guided the Court's decision in *O'Hagan*.¹⁹⁶

These interests did not lead to a limitless prohibition against trading based on informational advantages, however, because the theory reaches only the "person who gains non-public information gained through misappropriation in breach of fiduciary duty"¹⁹⁷ and then "without alerting the source . . . trades on the information."¹⁹⁸ That duty to alert the source of the information arises from the law of agency.

E. *Puzzles in the Misappropriation Theory*

The misappropriation theory, like the classical theory, creates a series of puzzles. Most prominently, the agency law principles incorporated by the

¹⁹⁴ *Id.* at 2210-11.

¹⁹⁵ *Id.* at 2211. The Court also reversed the Eighth Circuit's ruling on Rule 14e-3, holding that the Commission had not exceeded its authority in promulgating the Rule. *See id.* at 2217 (upholding Rule 14e-3 as applied to cases like *O'Hagan*). The Court held that § 14(e) authorized the Commission to adopt rules reasonably designed to prevent fraud, even if the conduct proscribed was not itself fraudulent. *See id.* (upholding the Commission's prohibitions if "reasonably designed to prevent . . . acts and practices that are fraudulent" even if not fraudulent themselves under the common law). The Court accepted the government's argument that Rule 14e-3 serves this preventive purpose by prohibiting trading activity in a class of cases where there is likely to be a breach of fiduciary duty, but the breach is difficult to prove. *See id.* at 2219 (validating Rule 14e-3 "insofar as it serves to prevent the type of misappropriation charged against O'Hagan"). Having reversed the Eighth Circuit's judgment on the securities fraud counts, the Court also reversed the lower court's ruling on the mail fraud convictions. *See id.* at 2220.

¹⁹⁶ Justice Scalia dissented in part, stating that, "[w]hile the Court's explanation of the scope of § 10(b) and Rule 10b-5 would be entirely reasonable in some other context, it does not seem to accord with the principle of lenity we apply to criminal statutes." *Id.* at 2220 (Scalia, J., concurring in part and dissenting in part). Justice Thomas, joined by Chief Justice Rehnquist, also dissented in part. *See id.* (Thomas, J., concurring in part and dissenting in part) (arguing that the misappropriation theory failed to provide an acceptable interpretation of § 10(b)'s requirement that a deceptive device be used in connection with a securities transaction). While Thomas agreed that the undisclosed misappropriation of confidential information involves "deception," he argued that deception in a misappropriation case is not "in connection with" a securities transaction. *See id.* at 2221. (Thomas, J., concurring in part and dissenting in part) (arguing that the "in connection with" requirement needs a more "integral" connection than what the majority required).

¹⁹⁷ *Id.* at 2213.

¹⁹⁸ *Id.*

misappropriation theory apply whether or not the victim of the fraud has a connection to the securities markets.¹⁹⁹ The misappropriation theory might have more intuitive appeal if the victims were always market participants, or businesses with close connections to market participants, such as investment banks and law firms.²⁰⁰ For example, in *O'Hagan*, that connection existed because Grand Met intended to become a purchaser of Pillsbury securities, and therefore O'Hagan's trading was both in competition with, and posed a real risk of harm to, Grand Met.²⁰¹ By contrast, in *Bryan*, the West Virginia Lottery Commission did not intend to enter the securities market, and there was minimal risk that it would be harmed by Bryan's trading.²⁰² Although the Fourth Circuit's rejection of the misappropriation theory was not premised on a lack of connection to a market participant, that lack of connection may have influenced the court's decision,

Notwithstanding this concern, there is no principled way to limit the misappropriation theory to market participants. Neither the statutory language of § 10(b), nor the principles of agency law, so circumscribe the theory's reach.²⁰³ While the common law of agency only precludes agents from using their principal's confidential information "in competition with or to the injury of the principal"²⁰⁴ the disclosure requirements imposed by agency law—and incorporated by the misappropriation theory—are not so narrow: "an agent is subject to a duty to use reasonable efforts to give his principal information

¹⁹⁹ See Langevoort, *supra* note 85, at 47 ("The source of the information is not necessarily defrauded as part of any investment-related activity of its own.").

²⁰⁰ See, e.g., Jill E. Fisch, *Start Making Sense: An Analysis and Proposal for Insider Trading Regulation*, 26 GA. L. REV. 179, 202 (1991) (noting that fraud in an insider trading case is questionable when the victim is not a market participant); Mitchell, *supra* note 84, at 830 (questioning the appropriateness of using securities fraud laws against those not trading in the stock about which the misappropriated information concerns); Lawrence A. Rosenbloom, Note, *Is It Inside or Out?—A Proposal To Clarify the Misappropriation Theory of Unlawful Trading*, 18 CARDOZO L. REV. 867, 900 (1996) (proposing that misappropriation theory be limited to fiduciary breaches or similar relationships "closely tied to the securities marketplace and pos[ing] a direct and imminent danger to the market" (emphasis omitted)).

²⁰¹ See *O'Hagan*, 117 S. Ct. at 2205.

²⁰² See *United States v. Bryan*, 58 F.3d 933, 950 (1995) (explaining that the West Virginia Lottery Commission has no connection to the securities transaction).

²⁰³ See Fisch, *supra* note 200, at 190. Fisch states:

Applying agency law principles to insider trading is problematic . . . because agency law does not generate an obligation to the trading counterparty or to the market. Rather, agency law suggests that a corporate insider is unjustly enriched by making use of corporate information for his personal benefit and that any trading profits are rightfully the property of the owner of the information—the corporation. This unjust enrichment takes place, though, whether or not the insider discloses the information prior to trading.

Id.

²⁰⁴ RESTATEMENT (SECOND) OF AGENCY § 395 (1958).

which is relevant to affairs entrusted to him and which, as the agent has notice, the principal would desire to have."²⁰⁵ This broader disclosure requirement allows the principal, whether or not he is a market participant, to decide if he would be harmed by the agent's trading. Moreover, the broad disclosure required by agency law is more consistent with the purposes of insider trading prohibitions, because trading on misappropriated information impairs the integrity of the market, whether or not it has been purloined from a market participant.²⁰⁶

The misappropriation theory also creates the oddity that the victim of the misappropriation usually does not have a cause of action against the wrongdoer under the federal securities laws. Under the rule of *Blue Chip Stamps*, only purchasers or sellers of securities have standing to sue under § 10(b).²⁰⁷ As with the classical theory, Congress has created a statutory remedy for contemporaneous traders, but that provision affords no relief to the immediate victim of misappropriation.²⁰⁸ State law, of course, may provide a remedy.²⁰⁹

Finally, the misappropriation theory is subject to contractual waiver. If the entity from whom the information has been obtained consents to the trading, there is no violation of § 10(b).²¹⁰ This aspect of the misappropriation

²⁰⁵ *Id.* § 381.

²⁰⁶ See *infra* notes 224-49 and accompanying text (discussing the effects on the market of trading on misappropriated information).

²⁰⁷ See *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 730 (1975) (holding that under § 10(b) and Rule 10b-5, only actual purchasers and sellers of securities can bring a private damages action); see also *Litton Indus. v. Lehman Bros. Kuhn Loeb, Inc.*, 967 F.2d 742, 749 (2d Cir. 1992) (holding that tender offerors who have purchased securities may have a cause of action under § 10(b) if they can establish loss causation).

²⁰⁸ See Section 20A of the Securities Exchange Act, 15 U.S.C. § 78t-1(a) (1994). Prior to Congress's passage of § 20A, the Second Circuit had ruled that contemporaneous traders had no private cause of action against misappropriators because they were not the victims of the fraud. See *Moss v. Morgan Stanley, Inc.*, 719 F.2d 5, 15-16 (2d Cir. 1983). Section 20A was specifically intended to overrule *Moss*. See Kaswell, *supra* note 151, at 167 (noting that § 20A "specifically overturns the holding in *Moss v. Morgan Stanley*"). Section 20A, of course, creates a doctrinal puzzle of its own, as the plaintiffs entitled to sue under that provision are not the victims of the fraud.

²⁰⁹ But see *infra* note 222 and accompanying text (discussing limitations of state law on insider trading).

²¹⁰ See, e.g., *Langevoort*, *supra* note 85, at 52 (noting examples that the misappropriation theory does not cover such as where "executives of a company about to award a profitable contract to another trade in the other company's stock, they are not misappropriating the information if they trade with the approval of their own company"). There would be liability, however, under Rule 14e-3 in the context of tender offers. See *supra* note 195 and accompanying text (discussing Rule 14e-3). The corporation's ability to waive its property rights in information means that market analysts will not risk misappropriation liability for trading on information given to them by the company.

tion theory has troubled some commentators,²¹¹ but it is not a serious defect in the misappropriation theory. The fact that the rule is not mandatory provides some assurance of its efficiency. If the misappropriation theory does create obstacles to useful business arrangements, corporations and their employees will simply contract around it.²¹² In any event, few corporations in the shoes of Grand Met would consent to trading by their agents.²¹³ Such trading would come at the expense of their own shareholders, who would be forced to pay more for acquisitions. Authorizing insider trading could expose the directors to lawsuit under state corporate law for waste if the corporation did not receive adequate compensation for the information.²¹⁴ For this reason, companies are not likely to compensate their officers, directors, lawyers and investment bankers by allowing them to trade on confidential business information. Furthermore, government enforcement of these contractual arrangements is appropriate because of the adverse effect on the securities markets and the difficulty that corporations would face in enforcing prohibitions on their own.

²¹¹ See, e.g., Fisch, *supra* note 200, at 224. Fisch states:

A more troubling aspect of treating inside information as property is that such treatment does not justify government intervention to allocate the property rights to information. If inside information is the property of the firm producing it, why is it different from any other firm property, which the firm may allocate, as it chooses, by contract? This view would enable a firm to authorize its officers or employees to trade on the basis of inside information. The firm would, in effect, be opting out of the government enforcement of its property rights.

Id.

²¹² See David D. Haddock & Jonathan R. Macey, *A Coasian Model of Insider Trading*, 80 Nw. U. L. REV. 1449, 1468 (1986) (arguing that corporations should be allowed to opt out of restrictions on insider trading).

²¹³ A corporation could not authorize such trading in its own shares because it would run foul of the classical theory. See *McCormick v. Fund Am. Co.*, 26 F.3d 869, 876 (9th Cir. 1994) ("Numerous authorities have held or otherwise stated that the corporate issuer in possession of material non-public information, must, like other insiders in the same situation, disclose the information to its shareholders or refrain from trading with them."). Because the duties of the classical theory are owed directly to the individual shareholders, a knowing and intelligent waiver of those duties by the shareholders would be nearly impossible. This aspect of the classical theory also conflicts with common law. See *Kors v. Carey*, 158 A.2d 136, 143 (Del. Ch. 1960) (holding that corporation has no duty of disclosure to shareholders in repurchasing shares); see also Deborah A. DeMott, *Beyond Metaphor: An Analysis of Fiduciary Obligation*, 1988 DUKE L.J. 879, 916-21 (discussing problems with treating corporation as fiduciary of shareholders and disclosure obligations in the context of share repurchase).

²¹⁴ See ERNEST L. FOLK III ET AL., *FOLK ON THE DELAWARE GENERAL CORPORATION LAW* § 141.2.11 (1992) ("The duty of directors also includes a settled prohibition against waste of corporate assets.").

III. AGENCY LAW AND THE PURPOSES OF INSIDER TRADING PROHIBITIONS

The Court's shift away from the common law of deceit in *O'Hagan* has important implications for the law of insider trading. Most importantly, the Court's endorsement of the misappropriation theory has validated an important weapon in the government's fight against insider trading. Although the misappropriation theory sweeps broadly, it is well grounded in the common law of agency. As Justice Ginsburg recognized, those agency law principles limit the misappropriation theory's reach "to those who breach a recognized duty."²¹⁵ Thus, this weapon has built-in checks on its use. The misappropriation theory is not only consistent with the common law, it is also narrowly tailored to the purposes of insider trading prohibitions.

A. *The Common Law of Agency*

The *Restatement (Second) of Agency* restricts an agent's use of confidential information that belongs to his principal either "in competition with or to the injury of the principal" without the principal's consent.²¹⁶ This requirement of consent gives rise to the agent's disclosure duties; only with full disclosure will the principal be able to determine whether the agent's use of information would be in competition with or injure the principal.²¹⁷ Specifically, the agent is required to disclose "if the agent has . . . interests adverse to the principal as to matters within the scope of the agency, or if he is competing with the principal and using information acquired during his agency."²¹⁸ An agent may act for his own benefit, but only after "he makes a full disclosure of the facts to an acquiescent principal and takes no unfair advantage of him."²¹⁹ The disclosure requirement affords the principal an opportunity to seek an injunction against the agent's trading or, more realistically, an accounting of his profits.²²⁰

The misappropriation theory incorporates this disclosure requirement of agency law into the securities laws. The securities markets provide an especially tempting venue for a faithless agent to breach his fiduciary duty to his principal and misappropriate confidential information. They afford an opportunity to breach that duty in secret and to collect enormous profits. The

²¹⁵ *United States v. O'Hagan*, 117 S. Ct. 2199, 2214 (1997).

²¹⁶ RESTATEMENT (SECOND) OF AGENCY § 395 (1958).

²¹⁷ *See id.* § 395 cmt. c ("In obtaining consent of the principal to use or disclose confidential information, the agent is under the duty of disclosure stated in § 390.").

²¹⁸ *Id.* § 381 cmt. d. This specific duty of disclosure is a part of the agent's broader duty to keep his principal informed: "Unless otherwise agreed, an agent is subject to a duty to use reasonable efforts to give his principal information which is relevant to affairs entrusted to him and which, as the agent has notice, the principal would desire to have." *Id.* § 381.

²¹⁹ *Id.* § 390 cmt. a.

²²⁰ *See id.* § 399 (listing possible remedies for a principal against an agent who has violated her duty).

facts of *O'Hagan* demonstrate the potential harm to the principal that could result from such a breach. O'Hagan's trading posed a risk that Grand Met's plans to take over Pillsbury would be prematurely discovered by others in the market. Such a discovery could have raised the price that Grand Met was forced to pay by many millions of dollars, as the market would have revalued Pillsbury's shares in light of the impending takeover.²²¹ O'Hagan was secretly competing with his principal by purchasing the shares that Grand Met intended to purchase, thereby threatening enormous harm to his principal's interests. State fiduciary law alone is unlikely to deter such breaches because they are so difficult to detect.²²² The misappropriation theory brings the enforcement authority—and subpoena power—of the federal government to bear on the problem, thus greatly enhancing the probability of detection, punitive sanctions, and as a result, compliance.²²³ The *O'Hagan* case provides a concrete example of the advantages of government enforcement—Dorsey & Whitney first learned of O'Hagan's malfeasance when the firm was subpoenaed by the SEC.

B. *Misappropriation Theory's Close Connection to the Goals of Insider Trading Prohibitions*

The misappropriation theory protects more than just property rights in valuable information. It also protects the integrity of the stock markets and public confidence in those markets.²²⁴ Insider trading impairs investor confidence, thereby discouraging capital formation and reducing liquidity.²²⁵

²²¹ See Bradford Cornell & Erik R. Sirri, *The Reaction of Investors and Stock Prices to Insider Trading*, 47 J. FIN. 1031, 1032-33, 1045-46 (1992) (presenting empirical evidence that price increases result from insider trading); Lisa Meulbroek & Carolyn Hart, *The Effect of Illegal Insider Trading on Takeover Premia*, 1 EUROPEAN FIN. REV. 51, 51 (1997) (finding that insider trading results in bidding companies paying larger takeover premia).

²²² See Dooley, *supra* note 88, at 28 (stating that "the typical offense is so furtive in nature that it can be detected only through the use of the broad investigative powers of the federal government").

²²³ See Easterbrook, *supra* note 98, at 334 (discussing advantages of public enforcement of insider trading prohibitions); see also RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 393 (3d ed. 1986) (hypothesizing that because of the low probability of detection, it may not be cost effective for companies to stop insider trading because they cannot impose penalties); Cox & Fogarty, *supra* note 73, at 356 n.12 (arguing that corporate efforts to discourage insider trading may be deterred by "the practical difficulty of undertaking policing efforts whose effectiveness would justify their cost, by the willingness of public authorities to assume some of this burden, and by the imperfect identity of interests between managers and the corporation").

²²⁴ There is clearly a strong federal interest in the integrity of the national stock markets. See Hamermesh, *supra* note 58, at 1175 (describing "the regulation of disclosure in the interest of facilitating interstate markets for securities" as "historically and far more properly a federal matter").

²²⁵ Liquidity means that there is an active market for shares—that is, at any given time

Because insider trading reduces the returns from investing in the stock market, investors will discount the amount that they are willing to pay for shares to reflect the risk of insider trading, thus impairing capital formation.²²⁶ Investors are reluctant to play in what they perceive to be a rigged game.²²⁷ At a minimum, they must be compensated for bearing the risk that the game is fixed.²²⁸ Corporations pay the price for this discounting because they receive less when they sell shares to the public. Insider trading prohibitions reduce this discounting by investors.²²⁹

Insider trading reduces liquidity because outsiders will be reluctant to trade with insider traders. Outsiders do not know whether the share price accurately reflects the company's future prospects, but they do know that they are going to be net losers in transactions with insiders.²³⁰ Insider traders will only buy when they know that the stock price is too low, and they will only sell when they know the stock price is too high.²³¹ Therefore, anytime an outsider trades with an insider, the outsider knows that the insider trader is taking advantage of her.²³² But in an impersonal market, outsiders

there are plenty of willing buyers and sellers. See JOHN DOWNES & JORDAN ELLIOT GOODMAN, *DICTIONARY OF FINANCE AND INVESTMENT TERMS* 305 (4th ed. 1995).

²²⁶ See Easterbrook, *supra* note 96, at 325 (arguing that shareholders will pay less for stock when insider trading is expected); Michael Manove, *The Harm from Insider Trading and Informed Speculation*, 104 Q.J. ECON. 823, 823-24 (1989) (observing that "sophisticated outsiders" will pay less for shares if they are aware of insider trading).

²²⁷ See 134 CONG. REC. S17,278 (daily ed. Oct. 21, 1988) (statement of Sen. Proxmire) (discussing the view held by small investors that they are cheated by the stock market when corrupted by insider trading).

²²⁸ See James D. Cox, *Insider Trading and Contracting: A Critical Response to the "Chicago School,"* 1986 DUKE L.J. 628, 638 (arguing that because investors can discount stocks by the average risk of insider trading for all firms, insider trading does not harm investors who hold diversified portfolios).

²²⁹ See Lawrence M. Ausubel, *Insider Trading in a Rational Expectations Economy*, 80 AM. ECON. REV. 1022, 1036 (1990) (proposing that regulations of insider trading are Pareto improvements, creating greater investment and greater returns).

²³⁰ See Marcel Kahan, *Securities Laws and the Social Costs of "Inaccurate" Stock Prices*, 41 DUKE L.J. 977, 1021 (1992) ("If stock prices are inaccurate because they do not reflect some non-public information, but no person who possesses that information trades, uninformed investors would have no reason to anticipate a loss by trading."). Although uninformed investors trading with each other will have gains and losses from individual trades, those gains and losses are random and will balance out over a large number of trades. See Boyd Kimball Dyer, *Economic Analysis, Insider Trading, and Game Markets*, 1992 UTAH L. REV. 1, 59 (observing that some investors who buy when a company is concealing information will gain and some investors will lose, but gains and losses "will be distributed at random among investors and will be equal and offsetting").

²³¹ See Manove, *supra* note 226, at 823 (arguing that where there is insider trading, "shares are more likely to be available to outsiders when, unbeknownst to them, the economic value of the corporation is low than when it is high").

²³² See William S. Wang, *Trading on Material Non-public Information on Impersonal*

do not know when they are trading with an insider, so insider trading simply becomes a transaction cost of *all* trading.²³³ This discourages outsiders from trading, thus reducing liquidity.

The transaction cost of insider trading is directly incorporated in the price of trading. Market makers also know that they are at a disadvantage when trading with insiders, and like outsiders, they cannot know when they are trading with an insider. In order to compensate for the losses suffered by trading with an insider, market makers increase the bid-ask spread. For example, instead of buying at \$10 and selling at \$10.25, market makers buy at \$10 and sell at \$10.50.²³⁴ This increase in the bid-ask spread also increases transaction costs for investors, who are therefore less likely to buy and sell.²³⁵ This risk of dealing with insider traders is magnified in the options market, a favorite haven for insider traders because of the leverage it provides to the value of their information.²³⁶ Insider trading makes options more expensive to buy and sell, thereby further impairing liquidity.

The impairment of capital formation and liquidity caused by insider trading is not limited to situations involving the classical theory in which insiders are trading with their own shareholders, but rather it implicates all cases involving disparities in information.²³⁷ The misappropriation theory's broader

Stock Markets: Who is Harmed, and Who Can Sue Whom Under SEC Rule 10b-5?, 54 S. CAL. L. REV. 1217, 1235 (1981) (arguing that the "Law of Conservation of Securities" mandates that profits gained by an insider must be directly offset by losses to other investors).

²³³ See Nicholas L. Georgakopoulos, *Insider Trading as a Transactional Cost: A Market Microstructure Justification and Optimization of Insider Trading Regulation*, 26 CONN. L. REV. 1, 19 (1993) (describing the transaction cost of trading without information as the amount of insiders' profits divided by the total number of outsider trades); cf. Cox, *supra* note 228, at 638 ("[T]he risk of abusive insider-trading practices, even though random for the individual firm, becomes systematic due to the informational asymmetries that characterize public corporations. Because it is systematic, this risk cannot be reduced by diversification . . .").

²³⁴ See Lawrence R. Glosten & Lawrence E. Harris, *Estimating the Components of the Bid/Ask Spread*, 21 J. FIN. ECON. 123, 141 (1988) (presenting evidence that insider trading increases the bid/ask spread); Lawrence R. Glosten & Paul R. Milgrom, *Bid, Ask and Transaction Prices in a Specialist Market with Heterogeneously Informed Traders*, 14 J. FIN. ECON. 71, 98 (1985) (finding that inside information is one of several factors that widens the bid/ask spread).

²³⁵ See Lawrence R. Glosten, *Insider Trading, Liquidity and the Role of the Monopolist Specialist*, 62 J. BUS. L. 211, 228 (1989) ("Trading on private information . . . leads to less than optimal risk sharing. This occurs because the response of market makers to the existence of traders with private information is to reduce the liquidity of the market . . . [which] reduces the amount of trade and hence the amount of risk sharing.").

²³⁶ See Harvey L. Pitt & Karl Groskaufmanis, *A Tale of Two Instruments: Insider Trading in Non-Equity Securities*, 49 BUS. LAW. 187, 196 (1993) (explaining advantages that option markets provide to insider traders).

²³⁷ See Salbu, *supra* note 97, at 233 (explaining that prohibiting insider trading when

scope allows enforcement authorities to combat those disparities created as a result of wrongdoing in the many situations not reached by the classical theory.²³⁸ At the same time, however, the misappropriation theory has natural limits, implicit in the common law of agency, that make its application predictable and prevent it from becoming the "parity of information" theory that Powell feared.²³⁹

By limiting the misappropriation theory to information obtained in breach of a duty, the common law of agency protects individuals who have gained their informational advantage through superior insight or hard work.²⁴⁰ These efforts are essential to the informational efficiency²⁴¹ of the stock market.²⁴² Accordingly, the misappropriation theory does not interfere with the legitimate processes that lead to efficient pricing of securities in the way that a broader parity of information theory might.²⁴³

The misappropriation theory also puts tippee and tipper liability on a more solid footing. Disclosures that would be a breach of duty to the corporation—absent prior disclosure to the board—are proscribed; disclosures that

trades are made on misappropriated nonpublic information does not ensure market integrity because any disparity in information, even those legitimately obtained, may result in market failure); *cf.* Fisch, *supra* note 200, at 223 ("[F]or the investor-victim, it is irrelevant whether the trader has acquired inside information through the breach of a duty or not; anyone who trades based on superior information not available to the investing public has obtained a trading advantage that is arguably unfair.").

²³⁸ See *supra* notes 199-213 and accompanying text (discussing the broader sweep of the securities laws under the misappropriation theory compared with the classical theory).

²³⁹ See *supra* notes 203-06 and accompanying text (describing the limits that agency law places on the misappropriation theory).

²⁴⁰ See Fisch, *supra* note 200, at 222-23 ("Market professionals expend a great deal of effort trying to obtain information that does not duplicate what everyone else has, through discussions with corporate insiders, following the progress of important litigation, or monitoring news reports and the Dow Jones tape constantly.").

²⁴¹ Efficiency means that at any given time prices reflect *all available* information about the company and its future prospects. See DOWNES & GOODMAN, *supra* note 225, at 160 (defining the efficient market hypothesis). In other words, the stock price is the best—not perfect—estimate of the net present value of future dividends and the company's growth. Therefore, the more quickly a given market incorporates information into a stock price, the more efficient it is.

²⁴² See Jonathan Macey & Hideki Kanda, *The Stock Exchange as a Firm: The Emergence of Close Substitutes for the New York and Tokyo Stock Exchanges*, 75 CORNELL L. REV. 1007, 1013 (1990) ("Competition among market professionals in a liquid market assures even the more ignorant investors that these market prices reflect all the publicly available information about the firms behind the securities." (internal quotation marks omitted)).

²⁴³ See John F. Barry III, *The Economics of Outside Information and Rule 10b-5*, 129 U. PA. L. REV. 1307, 1318 (1981) ("[T]he securities laws should preserve incentives to market research by recognizing in the collector of outside information a right of trade without disclosure, and to earn profits at the expense of the less informed.").

do not breach any legitimate confidentiality interest possessed by the corporation are legal. Duties to shareholders are irrelevant to this inquiry.

Insider traders, knowing that they have a monopoly over the relevant information, trade strategically, because extracting the full monopoly benefit from their information depends upon concealing their trading.²⁴⁴ Insider traders split their trades between the equity and options markets, break their trades into small blocks, trade through off-shore accounts, and use multiple brokers to execute the trades, all in an attempt to prevent other traders in the market from discovering that they are trading on inside information. Because insiders can and do conceal their trading, insider trading does little to enhance the efficiency of stock market pricing.²⁴⁵

By prohibiting trading by individuals with a monopoly over inside information, insider trading law encourages market analysts, professional investors, and others to compete for the information that drives efficiency in pricing.²⁴⁶ These informed investors will not make the same profits as insiders because they have to compete with other market analysts; that competition dissipates monopoly profits.²⁴⁷ The forces of competition discourage attempts to conceal trading, because an investor who believes that a stock is mispriced knows that other investors are also likely to be trading. If the investor delays, others will beat him to the punch and the profitable opportunity will be gone. Trading under competition will send stocks to their efficient prices at a lower cost to investors than insider trading based on an

²⁴⁴ See generally Jean-Jacques Laffont & Eric S. Maskin, *The Efficient Market Hypothesis and Insider Trading on the Stock Market*, 98 J. POL. ECON. 70 (1990) (modeling trading strategies by insider traders that do not lead to revealing the insiders' information). See also Manove, *supra* note 226, at 828 (explaining that if insider traders do not exercise restraint but rather trade excessively in a short period of time, the insider traders' knowledge becomes reflected in the share's price and thus the public becomes informed).

²⁴⁵ See Bainbridge, *supra* note 87, at 44-45 (observing that insider trading does little to convey inside information to the market); Dyer, *supra* note 230, at 31 (same); Kahan, *supra* note 230, at 1004 (concluding that insider trading activities do not necessarily convey the presence of insider information to the market because investors may not be able to distinguish between trades motivated by inside information and other motivations because insiders may try to conceal their trading activities). Of course, incompetent or greedy insider traders may be unable to conceal their trading, and they consequently have a greater effect on prices. See Lisa K. Meulbroek, *An Empirical Analysis of Illegal Insider Trading*, 47 J. FIN. 1661, 1696 (1992) (finding, based on a sample of detected insider trading, that 40 to 50% of the run-up in price before public announcement of takeovers occurs on days with known insider trading).

²⁴⁶ See Mark Klock, *Mainstream Economics and the Case for Prohibiting Inside Trading*, 10 GA. ST. U. L. REV. 297, 311-12 (1994) (arguing that insider trading reduces competition and has the effect of a monopoly).

²⁴⁷ See Georgakopoulos, *supra* note 233, at 21 ("A monopolist trader can expect to be able to trade repeatedly on the same piece of information. By contrast, . . . [c]ompetition decreases the number of trades that can be made on the information.").

informational monopoly.²⁴⁸ Thus, the misappropriation theory strikes an appropriate balance between the purposes of insider trading law and the mechanisms of market efficiency.²⁴⁹

CONCLUSION

The Supreme Court's decision in *O'Hagan* shifts the foundations of insider trading jurisprudence. The decision's focus on the common law of agency as the basis for analyzing whether an individual's trading is a deceptive misappropriation frees insider trading law of the classical theory's limitations. At the same time, the misappropriation theory provides a rational and principled basis for prohibiting conduct that has no social utility and impairs the integrity of the securities markets.

Despite the misappropriation theory's firm foundation in the common law and its utility in promoting the goals of the federal securities laws, Justice Powell likely would have voted to reject the theory. Based on his draft dissent to the denial of certiorari in *Carpenter*, we know that Powell believed the misappropriation theory was inconsistent with his prior decisions for the Court in *Chiarella* and *Dirks*. The flaw in the theory, according to Powell's draft dissent, was that it broadly extends to any victim of a deceptive misappropriation, regardless of whether the victim is a party to a securities transaction. Powell apparently believed that premising liability on breaches of a fiduciary duty to persons other than securities traders would impermissibly expand the scope of the federal securities laws beyond the common law of deceit, the foundation of the classical theory.

Justice Powell's concerns about the scope of the misappropriation theory have been laid to rest by the logic of Justice Ginsburg's majority opinion in *O'Hagan*. As Justice Ginsburg explained, a breach of duty by an agent to his principal crystallizes at the moment the agent engages in a securities transaction without disclosure to his principal: the agent does not commit fraud on his principal unless and until the agent engages in a securities transaction without disclosure. Possessing confidential information, but not using it, does not breach the agent's disclosure duty. The securities transaction completes the agent's deception of his principal and simultaneously injures the integrity of the securities markets, the harm that insider trading prohibitions are intended to prevent. The nexus between the agent's breach of duty to his principal and transactions in the securities markets supplies the connection to the purchase or sale of a security that Justice Powell believed was

²⁴⁸ See Macey & Kanda, *supra* note 242, at 1015 ("[R]ivalrous competition among well-informed market professionals causes rapid assimilation of information accessible to the community of investment analysts into share prices at low cost to investors.").

²⁴⁹ See Manove, *supra* note 226, at 826 (arguing that the economic value of the release of information through informed trading by market professionals may more than offset the losses attributable to adverse selection and inefficiency and the costs of acquiring the information).

missing in the misappropriation theory. That nexus satisfies § 10(b)'s "in connection with" requirement, even if it does not satisfy the elements of the common law of deceit.

Justice Powell's legacy for the law of insider trading is the recognition of the need to anchor § 10(b) in common law principles. The common law defines and limits the law of insider trading, both under the classical theory and the misappropriation theory. Powell drew upon the common law of deceit for such guidance and found there a requirement that silence, in order to be fraudulent, had to be in breach of a duty to disclose to the shareholder on the other side of the transaction. But the law of deceit left gaps in the analytical framework. The Court in *O'Hagan* filled those gaps by relying on the common law of agency, rather than the common law of deceit.

The disclosure duties imposed by the common law of agency provide a rational, comprehensible basis for determining whether an agent's breach of duty constitutes a deception within the meaning of § 10(b). While Justice Powell's draft in *Carpenter* indicates that he viewed the misappropriation theory as a departure from the principles underlying the classical theory, Justice Ginsburg and a majority of the current Court saw the misappropriation theory as essential to the protection of the integrity of the securities markets. Their rejection of the common law of deceit as the outer limit of insider trading law circumscribes Justice Powell's legacy to the narrow reach of the classical theory. The Court's acceptance of the misappropriation theory based on agency law principles establishes a lasting foundation for the law of insider trading.

APPENDIX

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To: The Chief Justice
Justice Brennan
Justice White
Justice Marshall
Justice Blackmun
Justice Stevens
Justice O'Connor
Justice Scalia

From: Justice Powell

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SUPREME COURT OF THE UNITED STATES

**DAVID CARPENTER, KENNETH P. FELIS, AND
R. FOSTER WINANS v. UNITED STATES**

**ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED
STATES COURT OF APPEALS FOR THE SECOND CIRCUIT**

No. 86-422. Decided December —, 1986

JUSTICE POWELL, dissenting from denial of certiorari.

A divided panel of the Court of Appeals for the Second Circuit has resolved an important question of securities law in a way that appears to conflict with recent opinions of this Court. As this decision—particularly by this Court of Appeals—could have substantial precedential effect, I would grant the petition for certiorari with respect to question 1.

I

In this case, the Court of Appeals affirmed petitioners' convictions for wire fraud, mail fraud, and securities fraud. Question 1 of the petition chal-

lenges the securities fraud convictions. The convictions rest on a conspiracy involving petitioner Winans, a reporter for the Wall Street Journal, and petitioners Felis and Brant, stockbrokers with the firm of Kidder Peabody. The final party to the conspiracy was petitioner Carpenter, an employee of the Wall Street Journal who carried messages from Winans to Felis and Brant. Winans informed Brant and Felis of the dates on which the Wall Street Journal would publish columns discussing particular securities. Advance knowledge of the dates on which certain columns would appear enabled Brant and Felis to profit by trading in anticipation of price changes that would follow publication of the columns. The columns themselves consisted of public information. The only nonpublic information provided by Winans was the publication schedule for the columns.

The petitioners were charged with wire fraud, mail fraud, and securities fraud. After a bench trial, the District Court convicted petitioners. *United States v. Winans*, 612 F. Supp. 827 (S.D.N. Y. 1985). On appeal, the Court of Appeals for the Second Circuit affirmed. *United States v. Carpenter*, 791 F.2d 1024 (1986). In the Court of Appeals' view, petitioners were guilty of criminal securities fraud under the "misappropriation" theory of securities fraud under § 10(b) of the Securities Exchange Act of 1934, 15 U. S. C. § 78j(b), and Rule 10b-5, 17 CFR § 240.10b-5. Under this theory, a person is liable under Rule 10b-5 if he misappropriates material nonpublic information and then uses the information in connection with the purchase or sale of securities. *Id.*, at 1031-1032. The Court of Appeals noted that we left open the question of the legitimacy of the misappropriation theory in *Chiarella*. But the court noted that its Circuit has adopted that theory since our decision in *Chiarella*. See *SEC v. Materia*, 745 F. 2d 197 (CA2 1984), cert. denied, 471 U. S. 1053 (1985); *United States v. Newman*, 664 F. 2d 12 (CA2 1981), affirmed after remand, 722 F. 2d 729 (CA2), cert. denied, 464 U. S. 863 (1983).

The Court of Appeals rejected petitioners' argument that the misappropriation theory could not be applied in this case because the information was misappropriated not from the corporations whose securities were traded, but from the Wall Street Journal. The court believed that our recent opinion in *Dirks v. SEC*, 463 U. S. 646 (1983), offered substantial support to petitioners' contention, but concluded that "[i]t is not accurate to say that *Dirks* wrote the book on insider or outsider trading; it wrote one chapter with respect to one type of fraudulent trading." 791 F. 2d, at 1029 (quoting the District Court's opinion, *United States v. Winans*, 612 F. Supp. 827, 842 (S. D.N. Y. 1985)). The Court of Appeals concluded that Winans' appropriation of the Wall Street Journal's publication schedules was a fraud condemned by the securities laws. "Congress apparently has sought to proscribe . . . trading on material, nonpublic information obtained not through skill but through a variety of "deceptive" practices, unlawful acts which we term 'misappropriation.'" *Id.*, at 1031. Judge Miner dissented from the panel's judgment. In his view:

"[Section 10(b)] never was intended to protect the reputation, or enforce the ethical standards, of a financial newspaper. . . . [T]he securities fraud provisions were [not] designed to prohibit the type of fraudulent conduct engaged in by these defendants. Such conduct is addressed adequately by the statutes establishing the mail and mire fraud offenses of which the defendants stand convicted." *Id.*, at 1037.

II

A comparison of the Court of Appeals' opinion in this case with our recent precedents demonstrates the need for examination by this Court of the misappropriation theory. In *Chiarella*, we began our analysis of Rule 10b-5 with the proposition that parties to a business transaction generally do not have an affirmative duty to disclose information about the transaction. The Court noted, however, that a failure to disclose material information could be fraudulent in certain circumstances. "But such liability is premised upon a duty to disclose arising from a relationship of trust and confidence *between parties to a transaction*." 445 U. S., at 230 (emphasis added). Such a duty applied when corporate insiders traded in the securities of their corporation. In such a case, "the duty arose from (1) the existence of a relationship affording access to inside information intended to be available only for a corporate purpose, and (2) the unfairness of allowing a corporate insider to take advantage of that information by trading without disclosure." *Id.*, at 227 (citing *Cady, Roberts & Co.*, 40 S. E. C. 907, 912, and n. 15 (1961)).

In *Dirks v. SEC*, 463 U. S. 646 (1983), we examined the circumstances under which outsiders could be held liable under Rule 10b-5. We noted:

"[U]nder certain circumstances, such as where corporate information is revealed legitimately to an underwriter, accountant, lawyer, or consultant working for the corporation, these outsiders may become fiduciaries of the shareholders. The basis for recognizing this fiduciary duty is not simply that such persons acquired nonpublic corporate information, but that they have entered into a special confidential relationship in the conduct of the business of the enterprise and are given access to information solely for corporate purposes." *Id.*, at 655, n. 14.

Thus, *Dirks* established that when outsiders have a fiduciary duty to the shareholders, they cannot purchase securities from those shareholders without first informing them of material information that might influence the decision to purchase or sell the securities.

The Court also noted that even if a particular outsider were not under a fiduciary duty to the corporation's shareholders, he could not trade on information that corporate insiders had disclosed to him improperly. See *id.*, at 659-660. As the Court explained, "[T]ippee responsibility must be related back to insider responsibility by a necessary, finding that the tippee knew the information was given to him in breach of a duty by a *person having a special relationship to the issuer* not to disclose the information . . ." *Id.*, at 661

(emphasis added) (quoting *In re Investors Management Co.*, 44 S. E. C. 633 (1971)).

Applying these principles to this case, it is difficult to understand how any of the petitioners were guilty of criminal securities fraud. The Court of Appeals found no fiduciary relationship between any of the petitioners and the parties from whom they purchased securities. The only fiduciary duty discussed by the court is petitioner Winans' duty to the Wall Street Journal. But our previous decisions establish that the duty of an individual to his employer, alone, is insufficient to support an action under Rule 10b-5. The inquiry under that section must focus on "petitioner's relationship with the sellers of the . . . securities. . . ." What we said in *Chiarella* is true here: "[Petitioner] was not their agent, he was not a fiduciary, he was not a person in whom the sellers had placed their trust and confidence. He was, in fact, a complete stranger who dealt with the sellers only through impersonal market transactions." 445 U. S., at 232-233. As the petitioners in this case had no fiduciary obligation to disclose the information before dealing in the securities, their convictions under § 10(b) and Rule 10b-5 are without support in any prior decision of this Court.

III

In *Chiarella*, the Court had no occasion to address the merits of the misappropriation theory. 445 U. S., at 236-237 and n. 21; *id.*, at 237-238 (STEVENS, J., concurring); *id.*, at 238-239 (BRENNAN, J., concurring in the judgment). The question is important, because the theory broadens substantially the ambit of criminal liability under the securities laws. There appears to be little or no support for the decision below in the language or history of the Securities Act of 1934.

The Court of Appeals has had three occasions to address the misappropriation theory since we left this question open in *Chiarella*. On each occasion, it has embraced the theory. Because the Second Circuit includes New York, the court's decision in this case is of special importance. In my view, this case presents "an important question of federal law which has not been, but should be, settled by this Court." S. Ct. R. 17.1(c). The time has come for this Court to resolve that question. I dissent from the Court's denial of certiorari in this case.