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# Old Rule, New Theory: Revising the Personal Benefit Requirement for Tipper/Tippee Liability Under the Misappropriation Theory of Insider Trading

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# OLD RULE, NEW THEORY: REVISING THE PERSONAL BENEFIT REQUIREMENT FOR TIPPER/TIPPEE LIABILITY UNDER THE MISAPPROPRIATION THEORY OF INSIDER TRADING

**Abstract:** Under the classical theory of insider trading, tipper/tippee liability may arise only when the tipper makes the relevant disclosure to obtain a personal benefit. Courts are divided, however, as to whether this personal benefit requirement applies to the misappropriation theory of insider trading. This Note argues that because the personal benefit requirement is severely flawed, courts should not impose it in misappropriation cases. Instead, courts adjudicating misappropriation cases should require that (1) the tipper was at least reckless as to whether he or she would *either* benefit personally *or* harm the information source by tipping, and (2) the tipper was at least reckless as to whether someone in the line of tippees would use the information to trade. This standard should be subject only to the tipper's defense that the disclosure was made in a good faith attempt to prevent criminal activity reasonably certain to cause substantial physical or financial harm to others.

## INTRODUCTION

Suppose that you, the CEO of Acme Corporation, disclose to your Vice President that your company plans to make a tender offer for Zen Corporation.<sup>1</sup> You warn the Vice President that this information is sensitive and confidential and must not be discussed with anyone outside of the office. He agrees to keep the secret. Unbeknownst to you, however, the Vice President dislikes you and your company, plans to quit soon, and does not feel particularly loyal.

After work, the Vice President gets a haircut. During the haircut, the barber asks the Vice President whether Acme Corporation plans to buy any other companies soon. The Vice President knows the barber is an avid stock trader because the barber often talks about his investments. He also believes that the barber is probing for informa-

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<sup>1</sup> For a set of facts similar to those provided in this hypothetical, see *SEC v. Maxwell*, 341 F. Supp. 2d 941, 943-45 (S.D. Ohio 2004).

tion with high trading value. The barber has mentioned that he and his friends enjoy finding and then investing in acquisition targets, and every time he gives the Vice President a haircut, he goes out of his way to ask whether Acme Corporation plans to make any acquisitions in the near future.

The Vice President also knows that anyone who buys stock in Zen Corporation now would likely enjoy a large profit due to the upcoming offer. In addition, the Vice President knows that there is a substantial chance that leaking information about the tender offer would harm his company because leaking information about an upcoming acquisition may cause the acquisition to fall apart.

Nevertheless, the Vice President is tired of having to watch his words for a company he dislikes. Indifferent to the consequences, he tells the barber about the upcoming offer. He does not speak in order to bestow a gift upon the barber, who is not his friend. He also does not speak in order to obtain a better haircut, a better price, or a good reputation with the barber.<sup>2</sup> He simply does not feel like watching his words.

In fact, the barber was probing for information with high trading value. Knowing that the Vice President probably was not supposed to talk about the upcoming tender offer, the barber quickly tells his friends and they all use the information to buy stock in Zen Corporation. Zen Corporation's stock price rises.

In addition, because the barber's friends are not careful about whom they tell, rumors spread about an upcoming tender offer for Zen Corporation, eventually causing two more companies to join the bidding war. Ultimately, your company must abandon its contemplated offer because the bidding war has pushed the purchase price too high. Your company missed a perfect opportunity to expand its business. People learn that you told the Vice President about the upcoming offer and, as a result, your reputation is damaged. Meanwhile, the barber and his friends sell their stock in Zen Corporation, reaping millions in profits.

Despite the Vice President's conscious disregard of a substantial risk that the barber would trade based on the information and that his disclosure would cause you and your company tremendous harm,

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<sup>2</sup> See *id.* at 948 & n.2 (“[G]iven [the insider-tipper’s and barber-tippee’s] relative stations in life, any reputational benefit to [the insider-tipper] in the eyes of his barber is extremely unlikely to have translated into any meaningful future advantage. . . . ‘Surely it cannot be claimed that the purpose of the alleged disclosure was so [the insider-tipper] would receive a better haircut, a better appointment slot, a better price?’”).

some courts and authors would insist that he escape all federal insider trading liability.<sup>3</sup> They reason that the Vice President sought no personal benefit in disclosing the information with which you entrusted him.<sup>4</sup> This seems wrong, however. After all, your company is defrauded of the exclusive use of the information with which you entrusted the Vice President. Furthermore, the integrity of the securities markets is harmed as a result. What is the basis for the personal benefit requirement?

In 1983, in *Dirks v. SEC*, the U.S. Supreme Court held that where a corporate insider discloses material, nonpublic information to one who then uses that information to trade in the stock of the insider's corporation, the corporate insider and the trader are not liable unless the tipper personally benefited from making the tip.<sup>5</sup> The Court reasoned that where a tipper does not personally benefit, the tip does not constitute a breach of duty to the corporation's shareholders.<sup>6</sup>

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<sup>3</sup> See, e.g., *SEC v. Yun*, 327 F.3d 1263, 1275 (11th Cir. 2003); *SEC v. Gonzalez de Castilla*, 184 F. Supp. 2d 365, 374-75 (S.D.N.Y. 2002); *SEC v. Blackman*, No. 3:99-1072, 2000 WL 868770, at \*6-8 (M.D. Tenn. May 26, 2000); *Stevens v. O'Brien Envtl. Energy, Inc.*, [1999 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 90,475, at 92,242 (E.D. Pa. May 10, 1999); *SEC v. Trikalis*, Fed. Sec. L. Rep. (CCH) ¶ 97,015, at 97,462 (C.D. Cal. July 28, 1992), *vacated on other grounds*, [1992-1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,375, at 95,981 (C.D. Cal. Jan. 22, 1993); Nelson S. Ebaugh, *Insider Trading Liability for Tippees and Tippees: A Call for the Consistent Application of the Personal Benefit Test*, 39 Tex. J. Bus. L. 265, 288-93 (2003); Craig W. Davis, Comment, *Misappropriators, Tippees and the Intent-to-Benefit Rule: What Can We Learn from Cady, Roberts?*, 35 SETON HALL L. REV. 263, 291-97 (2004); Jeffrey Plotkin, *The Tippee Benefit Test Under the Misappropriation Theory*, N.Y.L.J., Aug. 15, 2003, at 4, 5.

<sup>4</sup> See *Yun*, 327 F.3d at 1275; Ebaugh, *supra* note 3, at 288-93. Although one might try to argue that the Vice President sought the "benefit" of speaking freely, this is likely too trivial to meet the personal benefit standard. See *Dirks v. SEC*, 463 U.S. 646, 663-64 (1983) (identifying personal benefits of consequence for the requirement that the tipper intend to benefit personally from the tip, such as a pecuniary gain, an enhanced reputation, or the satisfaction of making a valuable gift to a relative or friend); *Maxwell*, 341 F. Supp. 2d at 948 (holding that there was no personal benefit where the tipper-insider tipped his barber because "*Dirks* requires an intended benefit of at least some consequence" and there was no evidence that the tipper-executive sought money, a reputational gain, or the satisfaction of giving a gift to the barber); *SEC v. Switzer*, 590 F. Supp. 756, 766 (W.D. Okla. 1984) (holding that there was no personal benefit where a father-tipper made the disclosure for the purpose of making child care arrangements).

<sup>5</sup> 463 U.S. at 662. Information is material if there is a substantial likelihood that a reasonable investor would consider it important when deciding how to invest. See *Basic Inc. v. Levinson*, 485 U.S. 224, 231-32 (1988). To be nonpublic, information must be specific and more private than general rumor. *United States v. Mylett*, 97 F.3d 663, 666 (2d Cir. 1996). For purposes of this Note, a "tipper" is a person who discloses material, nonpublic information to another person. If the recipient of that information uses it by trading or passing it along to others, that recipient is a "tippee." Depending on the circumstances, both the tipper and the tippee may be held liable for insider trading. See *Dirks*, 463 U.S. at 662.

<sup>6</sup> *Dirks*, 463 U.S. at 662.

Absent such a breach, neither the tipper nor the tippee can be liable for insider trading, in part because breach of duty is an important "limiting principle" that protects tippers and tippees from unreasonable enforcement actions by the Securities and Exchange Commission (the "SEC").<sup>7</sup> The Court decided the case under the so-called "classical theory" of insider trading, which posits that a person who owes a fiduciary duty to a corporation's shareholders must not use material, nonpublic information about the corporation to trade in the corporation's stock unless the person first discloses the information to the shareholders.<sup>8</sup>

Subsequently, in 1997, in *United States v. O'Hagan*, the Supreme Court adopted an additional theory of insider trading—the misappropriation theory—under which the Vice President in the example above could be prosecuted.<sup>9</sup> Similar to the classical theory, the misappropriation theory was also designed to protect investors.<sup>10</sup> The misappropriation theory, however, differs from the classical theory in a crucial way: the fraud victim is not a shareholder of the traded corporation, but rather the source of the information used for the trade.<sup>11</sup> In other words, misappropriation liability arises when a trader or tipper breaches a fiduciary duty to the source of the information, rather than a duty to shareholders of the corporation whose stock is bought or sold.<sup>12</sup>

Since *O'Hagan*, this fundamental difference has caused confusion as to which aspects of the classical theory should apply to misappropriation cases.<sup>13</sup> For instance, it is unclear whether a misappropriation

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<sup>7</sup> *Id.* at 662, 664 & n.24 (suggesting that the SEC has sent mixed signals to the public regarding who will be subject to its enforcement actions, and that legal limitations are therefore necessary).

<sup>8</sup> *Id.* at 653–61. For the purpose of brevity, cases decided under the classical theory of insider trading will hereinafter be referred to as "classical cases."

<sup>9</sup> See *United States v. O'Hagan*, 521 U.S. 642, 650 (1997). The Vice President also could likely be prosecuted under SEC Rule 14e-3. See 17 C.F.R. § 240.14e-3(a) (2005) (prohibiting trading on the basis of material, nonpublic information regarding an upcoming tender offer that the trader knows, or has reason to know, was acquired from an insider of the offeror or issuer, or someone working on their behalf); *id.* § 240.14e-3(d) (prohibiting disclosure when it is reasonably foreseeable that the disclosure is likely to result in a trade that violates Rule 14e-3(a)).

<sup>10</sup> *O'Hagan*, 521 U.S. at 652–53.

<sup>11</sup> See *id.*

<sup>12</sup> See *id.*

<sup>13</sup> See *SEC v. Sargent*, 229 F.3d 68, 77 (1st Cir. 2000) (noting disagreement as to whether the personal benefit requirement for tipper/tippee liability should apply to misappropriation cases); Donna M. Nagy, *Reframing the Misappropriation Theory of Insider Trading Liability: A Post-O'Hagan Suggestion*, 59 OHIO ST. L.J. 1223, 1287–310 (1998) (arguing

tor's disclosure to the source of the intention to trade is sufficient to negate liability in the same way that disclosure to shareholders negates liability in classical cases.<sup>14</sup> Another unresolved issue is whether the misappropriation theory precludes tipper/tippee liability where the tipper does not seek to benefit from the tip.<sup>15</sup> *Dirks* established that such preclusion clearly exists under the classical theory, but courts are divided as to whether this is also true under the misappropriation theory.<sup>16</sup>

Part I of this Note reviews the common-law development of insider trading laws under section 10(b) of the Securities Exchange Act and SEC Rule 10b-5 promulgated thereunder.<sup>17</sup> In doing so, this Part examines the two theories of insider trading: the classical and misappropriation theories.<sup>18</sup> Part II focuses specifically on the liability of tippers and tippees for insider trading.<sup>19</sup> This Part examines the circumstances in which insider trading liability may arise when a person who holds material, nonpublic information discloses that information to one who then trades.<sup>20</sup> Part II also gives special attention to the requirement, under *Dirks*, that the tipper personally benefit by making the tip.<sup>21</sup> Part III argues that courts should not impose the personal benefit requirement in cases brought under the misappropriation

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that despite dicta in *O'Hagan* suggesting the contrary, disclosure to the source in misappropriation cases, unlike disclosure to shareholders in classical cases, does not fully negate the trader's or tipper's deception of others).

<sup>14</sup> See *O'Hagan*, 521 U.S. at 654–55. The *O'Hagan* Court stated that disclosure to the information source prior to trading undermines the claim of deception of the information source and thus also does not constitute a SEC Rule 10b-5 violation of fraud in securities trading. *Id.* at 655. This was merely dicta, however, and a compelling argument can be made that deception still remains even when such disclosure is made. See *id.* at 647–48, 654–55 (demonstrating that the Court's assertion was merely dicta because the defendant in the case did not disclose to the information source his intent to trade); Nagy, *supra* note 13, at 1287–310 (arguing that deception remains even in the face of disclosure to the source). For instance, the investors with whom the misappropriator trades are arguably still deceived. Nagy, *supra* note 13, at 1287–310 (arguing that courts faced with cases involving such disclosure could find that the investors with whom the misappropriator trades are still deceived).

<sup>15</sup> See *Sargent*, 229 F.3d at 77 (noting disagreement among courts).

<sup>16</sup> See *Dirks*, 463 U.S. at 662 (requiring a personal benefit in classical cases); *Yun*, 327 F.3d at 1275 (requiring a personal benefit in misappropriation cases); *SEC v. Willis*, 777 F. Supp. 1165, 1172 n.7 (S.D.N.Y. 1991) (requiring no personal benefit in misappropriation cases).

<sup>17</sup> See *infra* notes 25–80 and accompanying text.

<sup>18</sup> See *infra* notes 25–80 and accompanying text.

<sup>19</sup> See *infra* notes 81–150 and accompanying text.

<sup>20</sup> See *infra* notes 81–150 and accompanying text.

<sup>21</sup> See *infra* notes 81–150 and accompanying text.

theory.<sup>22</sup> Instead, this Part explains, courts should require that (1) the tipper was at least reckless as to whether he or she would *either* benefit personally *or* harm the information source by tipping, and (2) the tipper was at least reckless as to whether someone in the line of tippees would use the information to trade.<sup>23</sup> This standard should be subject *only* to the tipper's defense that the tipper made the disclosure in a good faith attempt to prevent criminal activity reasonably certain to cause substantial physical or financial harm to others.<sup>24</sup>

## I. THE DEVELOPMENT OF INSIDER TRADING PROHIBITION UNDER SECTION 10(B) AND RULE 10B-5

Section 10(b) of the Securities Exchange Act of 1934, and SEC Rule 10b-5 promulgated thereunder, provide the primary basis for courts' proscription of insider trading.<sup>25</sup> Together, they create a broad prohibition of fraud in connection with securities trades.<sup>26</sup> The scope of the prohibited conduct has evolved over decades through interpretations by the courts and the SEC, and through this evolution, two theories of insider trading have emerged: the classical and misappropriation theories.<sup>27</sup>

### A. *The Classical Theory*

Initially, insider trading was proscribed through what is now known as the classical theory.<sup>28</sup> In its early stages, its scope was unclear.<sup>29</sup> Government prosecutors attempted to require anyone in possession of material, nonpublic information about a corporation either

<sup>22</sup> See *infra* notes 151–270 and accompanying text.

<sup>23</sup> See *infra* notes 151–270 and accompanying text.

<sup>24</sup> See *infra* notes 151–270 and accompanying text.

<sup>25</sup> Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j(b) (2000); 17 C.F.R. § 240.10b-5 (2005); 3 THOMAS LEE HAZEN, *THE LAW OF SECURITIES REGULATION* § 12.17, at 492 (5th ed. 2005) (identifying Rule 10b-5 as the primary basis for the prohibition of insider trading). In the special situation where the information used for trading relates to a tender offer, the trade is also subject to Rule 14e-3, which proscribes trading on the basis of material, nonpublic information regarding an upcoming tender offer if the trader knows, or has reason to know, that the information has been acquired from an insider of the offeror or issuer, or someone working on their behalf. 17 C.F.R. § 240.14e-3(a) (2005).

<sup>26</sup> See 15 U.S.C. § 78j(b); 17 C.F.R. § 240.10b-5.

<sup>27</sup> See *United States v. O'Hagan*, 521 U.S. 642, 651–52 (1997).

<sup>28</sup> See *id.*

<sup>29</sup> See Daniel J. Bacastow, Comment, *Due Process and Criminal Penalties Under Rule 10b-5: The Unconstitutionality and Inefficiency of Criminal Prosecutions for Insider Trading*, 73 J. CRIM. L. & CRIMINOLOGY 96, 108 (1982) (noting that “the insider confronting the issue of 10b-5 liability is faced with a calculus of uncertainties”).

to disclose that information to the marketplace or refrain from trading in that corporation's stock.<sup>30</sup> Whether courts would ultimately sanction such a broad rule, however, remained to be seen.<sup>31</sup>

In 1961, the SEC laid the groundwork for this broad rule in *In re Cady, Roberts & Co.*<sup>32</sup> In *Cady, Roberts*, the directors of a public company decided to reduce the company's dividends.<sup>33</sup> Soon after the decision was made, one of the directors telephoned a broker to communicate the upcoming reduction.<sup>34</sup> The broker then sold 7000 shares of the company's stock before the company publicly announced the dividend cut to the marketplace.<sup>35</sup> The public announcement of the cut caused the stock price to fall, and therefore the broker avoided significant losses by selling prior to the announcement.<sup>36</sup>

As part of the settlement between the brokerage firm and the SEC, the SEC explained how the broker's sales violated Rule 10b-5.<sup>37</sup> The SEC stated that insider trading liability is premised on a relationship that provides access to information intended only for a corporate purpose, as well as the "inherent unfairness" involved where a party takes advantage of the information gained from the special relationship while knowing it is unavailable to those with whom he deals.<sup>38</sup> Thus, the broker violated Rule 10b-5 when he took advantage of his access to this material, nonpublic information for trading purposes knowing that the investing public remained unaware of it.<sup>39</sup>

In 1968, the U.S. Court of Appeals for the Second Circuit endorsed the SEC's broad theory.<sup>40</sup> In *SEC v. Texas Gulf Sulphur Co.*, the Second Circuit stated that *anyone* who possesses material, nonpublic information about a company must either disclose that information to

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<sup>30</sup> See *SEC v. Tex. Gulf Sulphur Co.*, 401 F.2d 833, 848 (2d Cir. 1968) (adopting this broad requirement).

<sup>31</sup> See *id.*, cert. denied, 394 U.S. 976 (1969) (demonstrating the U.S. Supreme Court's decision not yet to resolve the matter).

<sup>32</sup> See 40 S.E.C. 907, 910-18 (1961).

<sup>33</sup> *Id.* at 909.

<sup>34</sup> *Id.*

<sup>35</sup> *Id.*

<sup>36</sup> *Id.* at 909-10.

<sup>37</sup> *Cady, Roberts*, 40 S.E.C. at 907-08, 910-18.

<sup>38</sup> *Id.* at 912.

<sup>39</sup> See *id.* at 910-18.

<sup>40</sup> See *Tex. Gulf Sulphur Co.*, 401 F.2d at 848.



the investing public or abstain from trading in that company's stock.<sup>41</sup> The court reasoned that this rule protected the justifiable expectation of the marketplace that all investors enjoy relatively equal access to material information.<sup>42</sup>

In 1980, however, in *Chiarella v. United States*, the U.S. Supreme Court rejected this "equal access" rule.<sup>43</sup> In *Chiarella*, which remains the law today, the Court significantly narrowed the scope of the classical theory.<sup>44</sup> The Court held that under Rule 10b-5, a duty either to disclose information or abstain from trading arises *only* from a specific fiduciary relationship or similar relationship of trust and confidence.<sup>45</sup> In the context of the classical theory, this means that a person cannot be held liable for insider trading in a certain corporation's stock unless the person owes a fiduciary duty to that corporation's shareholders.<sup>46</sup> In other words, to be liable under the classical theory, a person must be an insider or tippee of an insider of the traded corporation.<sup>47</sup> With this principle in mind, the *Chiarella* Court reversed the conviction of an employee of a financial printer who, while on the job, learned of several upcoming mergers and subsequently bought stock in the target corporations.<sup>48</sup> Because the financial printer was hired by the acquiring corporations rather than the targets, the employee owed no derivative fiduciary duty to the shareholders of the target corporations.<sup>49</sup> There-

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<sup>41</sup> *Id.* One should note, however, that the defendants in the case were officers, directors, and employees of the traded company, and therefore this broad language was probably dicta as applied to others. *See id.* at 839.

<sup>42</sup> *Id.* at 848.

<sup>43</sup> 445 U.S. 222, 235 (1980).

<sup>44</sup> *See id.* at 228-29; *see also O'Hagan*, 521 U.S. at 652 (favorably discussing *Chiarella*); *Dirks v. SEC*, 463 U.S. 646, 654-58 (1983) (favorably citing *Chiarella*).

<sup>45</sup> *Chiarella*, 445 U.S. at 228-29.

<sup>46</sup> *See id.*

<sup>47</sup> *See id.* For example, if a CEO of a drug company learns of medical tests showing that the company's flagship product causes severe cancer as a side-effect—a revelation that would surely make the company's stock price fall upon public disclosure—the CEO must either disclose that information to the company's shareholders or refrain from selling his or her stock in the company. *See id.* But if an outsider learns the same information—for example, he sees a copy of the medical report that the CEO accidentally left on the subway—the outsider is free to sell any stock he owns in the company without penalty because he owes no fiduciary duty to the company's shareholders. *See id.* Furthermore, in this situation he is not a tippee of the CEO because the CEO only inadvertently imparted the information, without any intent to benefit from the disclosure. *See Dirks*, 463 U.S. at 662. Typical "insiders" include persons such as officers and directors, and may also include accountants, lawyers, consultants, and other people to whom the corporation divulges information solely for business purposes. *Id.* at 655 n.14.

<sup>48</sup> *Chiarella*, 445 U.S. at 224, 232-33, 237.

<sup>49</sup> *Id.* at 232-33.

fore, the employee's trading in the targets' stock without disclosure of the upcoming mergers to the targets' shareholders could not give rise to insider trading liability under Rule 10b-5.<sup>50</sup>

### B. The Misappropriation Theory

In response to the Supreme Court's restriction of the scope of the classical theory in *Chiarella*, the government began to prosecute insider trading cases under an alternate theory: the misappropriation theory.<sup>51</sup> The government posited that the specific fiduciary duty required by *Chiarella* could be one owed not only to a corporation's shareholders, but also to a source of information.<sup>52</sup> Thus, the government asserted that a person who steals information and uses it for trading purposes, in breach of a fiduciary duty to the information source, also should be liable under section 10(b).<sup>53</sup> The *Chiarella* Court had left open the issue of whether such a misappropriation theory was viable.<sup>54</sup>

On the one hand, several circuit courts agreed with the government's position and adopted the misappropriation theory.<sup>55</sup> For instance, in 1983, the Second Circuit in *United States v. Newman* affirmed the 10b-5 insider trading convictions of employees of an investment banking firm who misappropriated information from the firm for trading purposes.<sup>56</sup> The employees conveyed the information to traders and shared the profits reaped from purchasing the stock of upcoming merger targets.<sup>57</sup> The court found the employees liable because they breached a fiduciary duty to the investment bank and the bank's clients, from whom they stole the information.<sup>58</sup>

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<sup>50</sup> *Id.*

<sup>51</sup> Randall W. Quinn, *The Misappropriation Theory of Insider Trading in the Supreme Court: A (Brief) Response to the (Many) Critics of United States v. O'Hagan*, 8 FORDHAM J. CORP. & FIN. L. 865, 871 (2003).

<sup>52</sup> *Id.*

<sup>53</sup> *Id.*

<sup>54</sup> *O'Hagan*, 521 U.S. at 662. In his dissent in *Chiarella*, Chief Justice Burger advocated the misappropriation theory as the proper basis for liability in that case. 445 U.S. at 240, 244-45 (Burger, J., dissenting).

<sup>55</sup> See, e.g., *SEC v. Cherif*, 933 F.2d 403, 410 (7th Cir. 1991); *SEC v. Clark*, 915 F.2d 439, 453 (9th Cir. 1990); *United States v. Newman*, 664 F.2d 12, 16-18 (2d Cir. 1981), *aff'd*, 722 F.2d 729 (2d Cir. 1983).

<sup>56</sup> *Newman*, 664 F.2d at 16.

<sup>57</sup> *Id.* at 15.

<sup>58</sup> *Id.* at 16-18.

On the other hand, in 1995 the Fourth Circuit rejected the misappropriation theory in *United States v. Bryan*.<sup>59</sup> The court reasoned that the theory would hold misappropriators liable absent deception, despite the fact that deception is a requirement for section 10(b) liability.<sup>60</sup> And even if the misappropriation theory did require deception, the court reasoned, such deception would not occur "in connection with" a purchase or sale of securities, as section 10(b) requires.<sup>61</sup> The requisite connection did not exist, the court reasoned, because the person deceived was an information source who did not necessarily have "some connection to, or some interest or stake in," a securities trade.<sup>62</sup>

In 1997, the U.S. Supreme Court in *United States v. O'Hagan* settled this circuit split by explicitly adopting the misappropriation theory.<sup>63</sup> James O'Hagan, a partner at a law firm, learned that one of his firm's clients planned to make a tender offer for another company.<sup>64</sup> Prior to the public announcement of the offer, O'Hagan bought significant quantities of the target company's stock and call options.<sup>65</sup> After the public announcement, he sold them for a profit of more than \$4.3 million.<sup>66</sup> The trial court convicted O'Hagan of insider trading, money laundering, and mail fraud.<sup>67</sup>

The Supreme Court upheld the insider trading conviction under the misappropriation theory.<sup>68</sup> Justice Ginsburg, writing for the majority, opined that a fiduciary who receives information from a principal violates Rule 10b-5 when the fiduciary deceptively breaches a duty of loyalty and confidentiality to the principal by (1) using the information, without permission, to trade in securities, while (2) pretending not to do so.<sup>69</sup>

The Court took pains to reject the criticisms raised by the Fourth Circuit in *Bryan* and the Eighth Circuit in *O'Hagan*.<sup>70</sup> The Court em-

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<sup>59</sup> 58 F.3d 933, 952 (4th Cir. 1995).

<sup>60</sup> *Id.* at 949; see *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 473-76 (1977) (requiring deception for Rule 10b-5 liability).

<sup>61</sup> *Bryan*, 58 F.3d at 949-50.

<sup>62</sup> *Id.* at 950.

<sup>63</sup> See 521 U.S. at 650.

<sup>64</sup> *Id.* at 648.

<sup>65</sup> *Id.* at 647.

<sup>66</sup> *Id.* at 648.

<sup>67</sup> *Id.* at 648-49.

<sup>68</sup> See *O'Hagan*, 521 U.S. at 650.

<sup>69</sup> *Id.* at 652, 654.

<sup>70</sup> See *id.* at 654-56; *United States v. O'Hagan*, 92 F.3d 612, 620, 622 (8th Cir. 1996) (rejecting the misappropriation theory on the grounds that it fails the deception and "in

phasized that under the misappropriation theory it was adopting, deception of the information source, not merely a breach of duty owed to the source, is required for liability.<sup>71</sup> In this way, the Court reasoned, the misappropriation theory satisfies section 10(b)'s requirement of deception.<sup>72</sup> Furthermore, the Court noted that this deception occurs "in connection with" a securities trade, as required by section 10(b), because the deception and securities trade coincide.<sup>73</sup> They coincide because the fraud occurs when, without disclosure to his or her principal, the misappropriator uses the information to trade in securities.<sup>74</sup> Thus, the Court reasoned, the theory is consistent with the text of section 10(b).<sup>75</sup>

The Court also indicated that it was deriving the scope of the misappropriation theory from common-law principles of agency.<sup>76</sup> The Court referred to the information source as a "principal" multiple times, and while discussing the requirements for misappropriator liability, the Court cited to the *Restatement (Second) of Agency*.<sup>77</sup> Thus, the Court implied that courts should look to these agency principles when clarifying gray areas in the future.<sup>78</sup>

In summary, the misappropriation theory is a viable alternative to the classical theory.<sup>79</sup> While the classical theory applies to individuals who breach a fiduciary duty to the shareholders of the traded corporation, the misappropriation theory applies to individuals who breach a duty to the source of the information.<sup>80</sup>

## II. LIABILITY OF TIPPERS AND TIPPEES UNDER SECTION 10(B) AND RULE 10B-5

A person can be held liable for insider trading under Rule 10b-5 even if that person does not personally trade in stock; courts and the

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connection with" requirements of section 10(b)), *rev'd*, 521 U.S. 642 (1997); *Bryan*, 58 F.3d at 949-50 (same).

<sup>71</sup> See *O'Hagan*, 521 U.S. at 654-55.

<sup>72</sup> *Id.*

<sup>73</sup> *Id.* at 655-56.

<sup>74</sup> *Id.* at 656.

<sup>75</sup> *Id.* at 654-56.

<sup>76</sup> See *O'Hagan*, 521 U.S. at 653-56; Brief for Appellee at 40-46, *SEC v. Yun*, 327 F.3d 1263 (11th Cir. 2003) (No. 01-14490); A.C. Pritchard, *United States v. O'Hagan: Agency Law and Justice Powell's Legacy for the Law of Insider Trading*, 8 B.U. L. Rev. 13, 47-48 (1998).

<sup>77</sup> *O'Hagan*, 521 U.S. at 653-56.

<sup>78</sup> See *id.*

<sup>79</sup> *Id.* at 650.

<sup>80</sup> *Id.* at 651-53.

SEC rules also permit liability under certain circumstances when a person communicates information to another person who then trades.<sup>81</sup> The specific scope of tipper/tippee liability depends in part on whether the case is brought under the classical or misappropriation theory.<sup>82</sup>

### A. Classical Theory

In 1983, in *Dirks v. SEC*, the U.S. Supreme Court established the modern requirements for tipper/tippee liability under the classical theory.<sup>83</sup> Ronald Secrist, a former officer of an insurance company, told Raymond Dirks, an investment analyst, that the insurance company was engaged in significant fraud.<sup>84</sup> While investigating these allegations, Dirks revealed to some of his clients information about the fraud that he obtained from the insurance company's employees.<sup>85</sup> Some of these clients then sold their stock in the insurance company based on this information.<sup>86</sup> Although Dirks's investigation induced the public exposure of the insurance company's fraud, the SEC nevertheless censured Dirks for insider trading violations under Rule 10b-5.<sup>87</sup> On appeal, the U.S. Court of Appeals for the District of Columbia Circuit upheld the judgment against Dirks.<sup>88</sup>

The Supreme Court, however, reversed the judgment against Dirks.<sup>89</sup> The Court held that where a tippee receives information from a corporate insider, the tippee inherits the insider's duty either to disclose that information to the corporation's shareholders or to abstain from trading and tipping only if two requirements are met: (1) the insider breached a fiduciary duty to the shareholders by disclosing the information to the tippee, and (2) the tippee knew, or should have

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<sup>81</sup> *Dirks v. SEC*, 463 U.S. 648, 660 (1983) (illustrating liability under the classical theory of Rule 10b-5); *SEC v. Yun*, 327 F.3d 1263, 1269-70 (11th Cir. 2003) (illustrating liability under the misappropriation theory of Rule 10b-5).

<sup>82</sup> See *United States v. O'Hagan*, 521 U.S. 642, 651-53 (1997) (explaining that the fraud victim in misappropriation cases is the source of the information, as opposed to classical cases where the fraud victim is a shareholder of the traded corporation). Compare *Dirks*, 463 U.S. at 662 (requiring a personal benefit to the tipper for tipper/tippee liability in classical cases), with *SEC v. Willis*, 777 F. Supp. 1165, 1172 n.7 (S.D.N.Y. 1991) (requiring no personal benefit for tipper/tippee liability in misappropriation cases).

<sup>83</sup> See 463 U.S. at 660, 662.

<sup>84</sup> *Id.* at 649.

<sup>85</sup> *Id.*

<sup>86</sup> *Id.*

<sup>87</sup> *Id.* at 650-52.

<sup>88</sup> *Dirks*, 463 U.S. at 652.

<sup>89</sup> *Id.*

known, that such a breach occurred.<sup>90</sup> The Court reasoned that a breach of duty requirement is necessary, in part, to provide a “guiding principle” for those market participants who wish to avoid insider trading liability.<sup>91</sup> Otherwise, the Court reasoned, potential defendants would be unfairly forced to rely on the reasonableness of the SEC’s litigation strategy.<sup>92</sup>

The Court reasoned further that an insider’s disclosure to a tippee constitutes a breach of duty only when the insider makes the disclosure for an improper purpose.<sup>93</sup> The purpose is improper, the Court emphasized, only when the insider personally benefits from the disclosure.<sup>94</sup> Such a benefit can come in the form of a pecuniary gain, reputational benefit, or benefits from making a gift to a relative or friend.<sup>95</sup> Deriving this personal benefit requirement from *In re Cady, Roberts & Co.*, the Court justified the requirement by noting that a major purpose of the Securities Exchange Act was to eliminate the idea that corporate officers may treat inside information as part of their compensation packages.<sup>96</sup> The Court acknowledged, however, that it is not always easy to determine whether a corporate insider has gained a personal benefit from the tip.<sup>97</sup>

Thus, the Court’s first step in its analysis was to determine whether Secrist and the other insurance company employees, the tippers, breached a duty to the insurance company’s shareholders by disclosing information to Dirks, the tippee.<sup>98</sup> This turned on whether Secrist and the other employees obtained a personal benefit from the disclosures.<sup>99</sup> The Court found that no such benefit existed.<sup>100</sup> The Court emphasized that the tippers merely sought to expose fraud—Secrist and the employees believed that disclosure to Dirks was the best way to uncover the corporate wrongdoing because other efforts

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<sup>90</sup> *Id.* at 659–61.

<sup>91</sup> *Id.* at 664.

<sup>92</sup> *Id.* at 664 n.24 (suggesting that the SEC has sent mixed signals to the public regarding who will be subject to its enforcement actions, and therefore legal limitations are necessary).

<sup>93</sup> *Dirks*, 463 U.S. at 662.

<sup>94</sup> *Id.*

<sup>95</sup> *Id.* at 663–64.

<sup>96</sup> *Id.* at 653 n.10, 662 (citing *In re Cady, Roberts & Co.*, 40 S.E.C. 907, 912 n.15 (1961)).

<sup>97</sup> *Id.* at 664.

<sup>98</sup> *Dirks*, 463 U.S. at 665.

<sup>99</sup> *Id.* at 667.

<sup>100</sup> *Id.*

had "proved fruitless."<sup>101</sup> Thus, the Court concluded that the tippers breached no duty to the shareholders and consequently, Dirks could not be held liable as a tippee.<sup>102</sup>

The Court appeared to be particularly swayed by the public service value of Secrist's and the other employees' disclosures.<sup>103</sup> As Justice Blackmun pointed out in his dissent, "[t]he Court justifies Secrist's and Dirks' action because the general benefit derived from the violation of Secrist's duty to shareholders outweighed the harm caused to those shareholders."<sup>104</sup> The Court emphasized that the tippers exposed fraud and therefore likely prevented corporate wrongdoing from victimizing many more investors.<sup>105</sup> Furthermore, the Court emphasized the need to protect tippers from liability for disclosure to analysts, given that these analysts serve the important purpose of collecting and analyzing information, as well as the fact that simultaneous disclosure to shareholders or the public is impracticable.<sup>106</sup>

The Court was unclear, however, as to whether the tipper must *intend* to benefit personally or *actually* benefit personally.<sup>107</sup> In applying the *Dirks* benefit rule, circuit courts are likewise inconsistent.<sup>108</sup> Given that the *Dirks* Court appeared to place primary importance on the tipper's motive, it seems that the Court probably intended an intent-to-benefit test.<sup>109</sup>

Although the government typically has no trouble proving the existence of a personal benefit, this is not always the case.<sup>110</sup> For instance, in 2004 in *SEC v. Maxwell*, the U.S. District Court for the Southern District of Ohio found that the SEC produced insufficient evidence to establish that a corporate insider's disclosure to his barber created a per-

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<sup>101</sup> *Id.* at 667 & n.27.

<sup>102</sup> *Id.* at 667.

<sup>103</sup> See *Dirks*, 463 U.S. at 652 n.8, 667 & n.27 (emphasizing the defendant's role in exposing fraud); *id.* at 676-77 (Blackmun, J., dissenting) (noting that the Court created the personal benefit requirement in the first place because the general benefit derived from the tips outweighed the harm caused to the corporation's shareholders).

<sup>104</sup> *Id.* at 676-77 (Blackmun, J., dissenting).

<sup>105</sup> See *id.* at 652 n.8, 667 & n.27 (majority opinion) (emphasizing the defendant's role in exposing fraud); *id.* at 676-77 (Blackmun, J., dissenting) (noting that the Court created the personal benefit requirement in the first place because the general benefit derived from the tips outweighed the harm caused to the corporation's shareholders).

<sup>106</sup> See *id.* at 658-59 (majority opinion).

<sup>107</sup> See *id.* at 662-63, 667.

<sup>108</sup> Compare *Yun*, 327 F.3d at 1274-75 (applying an intent-to-benefit test), with *SEC v. Sargent*, 229 F.3d 68, 77 (1st Cir. 2000) (applying an actual-benefit test).

<sup>109</sup> See *Dirks*, 463 U.S. at 662, 667.

<sup>110</sup> Ebaugh, *supra* note 3, at 281 (noting the general ease of proof).

sonal benefit.<sup>111</sup> Similarly, in 1984, in *SEC v. Switzer*, the U.S. District Court for the Western District of Oklahoma found that the SEC failed to prove a personal benefit.<sup>112</sup> In that case, the tipper was a corporate insider who disclosed business information to his wife while observing a track meet.<sup>113</sup> The disclosure was overheard by the tippee, Switzer, who was sunbathing behind the couple.<sup>114</sup> Because the tipper made the disclosure merely for the purpose of informing his wife of his schedule and making childcare arrangements, and thus only inadvertently imparted the information to the tippee, the court concluded that the tipper did not personally benefit from the disclosure.<sup>115</sup>

Thus, in summary, under the classical theory, a tipper and a trading tippee are both liable for insider trading when, without disclosing the information to the shareholders of the traded corporation, the tipper breaches a fiduciary duty to the shareholders by conveying the information to the tippee to obtain a personal benefit, and the tippee knows, or should know, that the breach occurred.<sup>116</sup>

### B. *Misappropriation Theory*

In addition to classical cases, courts have applied tipper/tippee liability in misappropriation cases.<sup>117</sup> In this context, the tippee inherits the tipper's duty to disclose or abstain from trading when the tipper breaches a fiduciary duty to the source of the information and the tippee knows, or has reason to know, that the tipper has breached that duty.<sup>118</sup> Unlike tipper/tippee liability in the context of the classical theory, however, courts are divided as to whether a personal benefit to the tipper is required for liability in misappropriation cases.<sup>119</sup>

The Supreme Court has not yet addressed this issue.<sup>120</sup> In *Dirks*, the Supreme Court required a personal benefit in a case brought under the classical theory, before the Supreme Court had endorsed the

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<sup>111</sup> 341 F. Supp. 2d 941, 948 (S.D. Ohio 2004).

<sup>112</sup> 590 F. Supp. 756, 766 (W.D. Okla. 1984).

<sup>113</sup> *Id.* at 761, 766.

<sup>114</sup> *Id.* at 762.

<sup>115</sup> *Id.* at 766.

<sup>116</sup> *Dirks*, 463 U.S. at 659-62.

<sup>117</sup> See *Yun*, 327 F.3d at 1269-70; *United States v. Libera*, 989 F.2d 596, 600 (2d Cir. 1993); *Willis*, 777 F. Supp. at 1169.

<sup>118</sup> See *Yun*, 327 F.3d at 1269-70; *Libera*, 989 F.2d at 600; *Willis*, 777 F. Supp. at 1169.

<sup>119</sup> Compare *Yun*, 327 F.3d at 1275 (requiring a personal benefit), with *Willis*, 777 F. Supp. at 1172 n.7 (requiring no personal benefit).

<sup>120</sup> See *Sargent*, 229 F.3d at 77 (noting disagreement among lower courts).



misappropriation theory.<sup>121</sup> Nor did the Supreme Court decide the issue when it adopted the misappropriation theory in *O'Hagan*, because *O'Hagan* was not a tipper/tippee case; the misappropriator in *O'Hagan* personally traded on the stolen information.<sup>122</sup>

On the one hand, some courts explicitly or implicitly reject the personal benefit requirement for misappropriation cases.<sup>123</sup> For instance, in 1991 in *SEC v. Willis*, the U.S. District Court for the Southern District of New York explicitly noted in dicta that the misappropriation theory does not require a showing of a benefit to the tipper.<sup>124</sup> The court reached the same conclusion in 1989 in *SEC v. Musella*.<sup>125</sup>

Similarly, in 1993 in *United States v. Libera*, the Second Circuit implied that it would not require a personal benefit in misappropriation cases.<sup>126</sup> In that case, the court affirmed the defendants' convictions for insider trading and stated:

[T]he misappropriation theory requires the establishment of two elements: (i) a breach by the tipper of a duty owed to the owner of the nonpublic information; and (ii) the tippee's knowledge that the tipper had breached the duty. We believe these two elements, without more, are sufficient for tippee liability.<sup>127</sup>

As the First Circuit observed in its 2000 decision in *SEC v. Sargent*, the Second Circuit's failure to mention a personal benefit in *Libera* strongly suggests that the Second Circuit would not require such a benefit for tipper/tippee liability.<sup>128</sup>

On the other hand, some courts do require a personal benefit for misappropriation cases, and several authors have argued in favor of this approach.<sup>129</sup> At least one author has reasoned that the personal

<sup>121</sup> See *Dirks*, 463 U.S. at 662; see also *O'Hagan*, 521 U.S. at 650 (adopting the misappropriation theory in 1997, fourteen years after *Dirks* was decided).

<sup>122</sup> See *O'Hagan*, 521 U.S. at 647-48.

<sup>123</sup> See, e.g., *Libera*, 989 F.2d at 600; *Willis*, 777 F. Supp. at 1172 n.7; *SEC v. Musella*, 748 F. Supp. 1028, 1038 n.4 (S.D.N.Y. 1989), *aff'd*, 898 F.2d 138 (2d Cir. 1990).

<sup>124</sup> See 777 F. Supp. at 1172 n.7.

<sup>125</sup> See 748 F. Supp. at 1038 n.4.

<sup>126</sup> See *Libera*, 989 F.2d at 600.

<sup>127</sup> *Id.*

<sup>128</sup> *Sargent*, 229 F.3d at 77; see *Libera*, 989 F.2d at 600.

<sup>129</sup> See, e.g., *Yun*, 327 F.3d at 1275; *SEC v. Gonzalez de Castilla*, 184 F. Supp. 2d 365, 375 (S.D.N.Y. 2002); *SEC v. Blackman*, No. 3:99-1072, 2000 WL 868770, at \*6-8 (M.D. Tenn. May 26, 2000); *Stevens v. O'Brien Envtl. Energy, Inc.*, [1999 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 90,475, at 92,242 (E.D. Pa. May 10, 1999); *SEC v. Trikilis*, Fed. Sec. L. Rep. (CCH) ¶ 97,015, at 97,462 (C.D. Cal. July 28, 1992), *vacated on other grounds*, [1992-1993

benefit requirement is needed to further the *Dirks* policy of protecting tipplers from liability in the case of inadvertent or fraud-exposing disclosures.<sup>130</sup> For instance, disclosures exposing fraud arguably promote the misappropriation theory's goal of protecting the integrity of the securities market.<sup>131</sup>

Some authors and at least one court have reasoned that a personal benefit should be required in misappropriation cases because the benefit is already required in classical cases, and courts should try to make the classical and misappropriation theories as similar as possible.<sup>132</sup> In 2003 in *SEC v. Yun*, the Eleventh Circuit employed this reasoning when it held that in misappropriation cases, the tipper and tippee are not liable unless the tipper seeks to benefit from the tip.<sup>133</sup>

In support of its opinion that a personal benefit should be required in misappropriation cases, the *Yun* court first noted the need to develop consistency in insider trading case law.<sup>134</sup> In addition, the court emphasized the similarity of the tippee's and tipper's positions under both theories.<sup>135</sup> The tippee is on notice under both theories that the tippee received confidential information through a breach of duty, and the choice of theory makes no difference as to potential liability or harm to investors if the tippee trades on the information.<sup>136</sup> In addition, the tipper breaches a duty under both theories and the resulting harm to the marketplace is the same.<sup>137</sup> Based on these similarities, the *Yun* court concluded that it would be nonsensical to treat a tipper or tippee differently under the misappropriation theory as compared to the classical theory.<sup>138</sup>

The *Yun* court also advanced a more pragmatic reason for its goal of synthesis. The *Yun* court reasoned that separating the two theories would permit the SEC, and courts hearing misappropriation cases, to

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Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,375, at 95,981 (C.D. Cal. Jan. 22, 1993); Ebaugh, *supra* note 3, at 288-93; Davis, *supra* note 3, at 291-97; Plotkin, *supra* note 3, at 5.

<sup>130</sup> See Ebaugh, *supra* note 3, at 288-93.

<sup>131</sup> See *id.* at 292.

<sup>132</sup> See *Yun*, 327 F.3d at 1275-77; Davis, *supra* note 3, at 294; Plotkin, *supra* note 3, at 5.

<sup>133</sup> 327 F.3d at 1275-77. The *Yun* court did not address whether a personal benefit is required in cases brought under Rule 14e-3 because the case before it did not involve information about a tender offer. See *id.* at 1267-68 (describing the material, nonpublic information at issue, which related to the traded corporation's unfavorable earnings); 17 C.F.R. § 240.14e-3 (2005) (applying only to information regarding a tender offer).

<sup>134</sup> *Yun*, 327 F.3d at 1276.

<sup>135</sup> *Id.* at 1276-77.

<sup>136</sup> *Id.* at 1276.

<sup>137</sup> *Id.* at 1277.

<sup>138</sup> *Id.* at 1276-77.

ignore precedent under the classical theory whenever they saw fit.<sup>139</sup> Because virtually all violations under the classical theory would also be violations under the misappropriation theory, the court reasoned, failing to synthesize the theories would provide the government with ample opportunity to exploit the looser misappropriation standards by trying all cases under the misappropriation theory.<sup>140</sup> In the context of the personal benefit requirement, the court opined, such a tactic would unacceptably render the Supreme Court's decision in *Dirks* a "dead letter."<sup>141</sup>

Aside from its synthesis rationale, the *Yun* court also advanced more technical reasons for imposing the personal benefit requirement in misappropriation cases.<sup>142</sup> For instance, the court reasoned that requiring a personal benefit is necessary to ensure that liability arises only if the tipper engages in deception in connection with a securities trade, not merely a breach of duty.<sup>143</sup> Without the personal benefit test, the court reasoned, a tipper could be liable even where the tipper does not intend that the disclosure will result in a trade.<sup>144</sup>

Furthermore, the *Yun* court reasoned, requiring a personal benefit is supported by language in *O'Hagan*, because in that case the Supreme Court either "explicitly state[d] or implicitly assume[d]" a personal benefit requirement for misappropriation cases.<sup>145</sup> For instance, the *Yun* court noted *O'Hagan's* assertion that in misappropriation cases, a breach of duty occurs through a fiduciary's "'self-serving use of a principal's information to *purchase or sell securities*,'" and that one who "'pretends loyalty to the principal while secretly converting the principal's information for *personal gain* dupes or defrauds the principal."<sup>146</sup> The *Yun* court reasoned that, because a personal benefit is required for liability of misappropriators who personally trade, as evidenced by this language in *O'Hagan*, it would be "absurd" not to require it for tippers as well, since omitting the requirement would have the effect of holding tippers liable more readily than the traders.<sup>147</sup>

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<sup>139</sup> *Yun*, 327 F.3d at 1275-76, 1279.

<sup>140</sup> *Id.* at 1279.

<sup>141</sup> *Id.*

<sup>142</sup> *See id.* at 1278-79.

<sup>143</sup> *Id.* at 1278 & n.33.

<sup>144</sup> *Yun*, 327 F.3d at 1278 & n.34.

<sup>145</sup> *Id.* at 1279.

<sup>146</sup> *Id.* (quoting *O'Hagan*, 521 U.S. at 652-54).

<sup>147</sup> *Id.*

Finally, some courts have merely applied the personal benefit test, but failed to explain why the requirement should apply to misappropriation cases.<sup>148</sup> For instance, in 2000 in *SEC v. Blackman*, the U.S. District Court for the Middle District of Tennessee stated in a misappropriation case that *Dirks* required the tipper to receive some benefit to hold the tippee liable.<sup>149</sup> The court did not expound, however, on why the *Dirks* personal benefit test necessarily applies to misappropriation cases.<sup>150</sup>

### III. REVISING THE PERSONAL BENEFIT REQUIREMENT IN MISAPPROPRIATION CASES

The personal benefit requirement for insider trading violations is flawed because it protects tippers to a much greater extent than is supported by its underlying policy rationale.<sup>151</sup> For this reason, courts should decline to extend the requirement to the misappropriation theory, and should instead apply a revised requirement that better promotes the policies underlying the theory.<sup>152</sup> To do this, courts facing tipper/tippee misappropriation cases should require that (1) the tipper was at least reckless as to whether he or she would *either* benefit personally *or* harm the information source by tipping, and (2) the tipper was at least reckless as to whether someone in the line of tippees would use the information to trade.<sup>153</sup> This standard should be subject *only* to the tipper's defense that the tipper made the disclosure in a good faith attempt to prevent criminal activity reasonably certain to cause substantial physical or financial harm to others.<sup>154</sup>

#### A. Quarantining the Personal Benefit Requirement

The personal benefit requirement is flawed because it protects tippers from liability to a much greater extent than its underlying policy rationale can support.<sup>155</sup> Because of this flaw, and because courts

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<sup>148</sup> See, e.g., *Gonzalez de Castilla*, 184 F. Supp. 2d at 375; *Blackman*, 2000 WL 868770, at \*6-8.

<sup>149</sup> *Blackman*, 2000 WL 868770, at \*6.

<sup>150</sup> See *id.*

<sup>151</sup> See *infra* notes 155-183 and accompanying text.

<sup>152</sup> See *infra* notes 155-183 and accompanying text.

<sup>153</sup> See *infra* notes 184-270 and accompanying text.

<sup>154</sup> See *infra* notes 184-270 and accompanying text.

<sup>155</sup> See *SEC v. Maxwell*, 341 F. Supp. 2d 941, 944-50 (S.D. Ohio 2004) (exculpating a tipper and tippee where the tippee used the information selfishly, thus demonstrating how the personal benefit requirement can protect tippers and tippees who produce no social

are not bound to extend the requirement to the misappropriation theory under existing Supreme Court precedent, courts should confine the requirement to the classical theory of insider trading.<sup>156</sup>

The Court articulated the underlying policy rationales in 1983 in *Dirks v. SEC*, when the Supreme Court held that tipper/tippee liability cannot arise unless the tipper intends to benefit personally from the tip.<sup>157</sup> The Court appeared to be particularly swayed by the public service value of the insider-tippers' disclosures to the analyst-tippee, who subsequently exposed the corporation's wrongdoing and also induced his clients to sell their stock.<sup>158</sup> Instead of placing importance on the fact that the tippers' selective disclosures resulted in sales that caused harm to the oblivious purchasers whose share values subsequently plummeted, the Court emphasized the tippers' efforts to expose fraud and the important role analysts play in the marketplace.<sup>159</sup> With these concerns in mind, the Court created a blanket requirement under the classical theory that the tipper intend to benefit personally in providing the tip.<sup>160</sup>

Unfortunately, it seems that these policy concerns do not justify a blanket personal benefit requirement.<sup>161</sup> It is first important to note

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benefit to offset the harm they cause to investor confidence); Regulation FD, 17 C.F.R. § 243.100–103 (2005) (forbidding selective disclosure to analysts); Selective Disclosure and Insider Trading, 65 Fed. Reg. 51,716, 51,716–18 (Aug. 24, 2000) (adopting Regulation FD and discussing the need for prohibition of selective disclosure to analysts); Selective Disclosure and Insider Trading, 64 Fed. Reg. 72,590, 72,592–93 (proposed Dec. 28, 1999) (discussing the need for prohibition of selective disclosure to analysts); Donald C. Langevoort, *Investment Analysts and the Law of Insider Trading*, 76 VA. L. REV. 1023, 1044–45 (1990) (critiquing arguments in favor of selective disclosure to analysts).

<sup>156</sup> See *United States v. O'Hagan*, 521 U.S. 642, 650 (1997) (adopting the misappropriation theory without addressing tipper/tippee liability); *Dirks v. SEC*, 463 U.S. 646, 662 (1983) (adopting a personal benefit requirement in cases brought under the classical theory).

<sup>157</sup> See *Dirks*, 463 U.S. at 652 n.8, 658–59, 667 & n.27.

<sup>158</sup> See *id.*

<sup>159</sup> See *id.* at 667 n.27 (asserting that the harm to shareholders from the ultimate tippees' trades is of little legal significance and noting that the tippers' disclosures prevented the victimization of many more investors).

<sup>160</sup> See *id.* at 652 n.8, 658–59, 662, 667 & n.27.

<sup>161</sup> See *Maxwell*, 341 F. Supp. 2d at 944–50 (exculpating a tipper for disclosure to a self-serving non-analyst tippee due to a lack of a personal benefit to the tipper, thus demonstrating how the personal benefit requirement can protect tippers and tippees who produce no societal benefit to offset the harm caused to investor confidence); Regulation FD, 17 C.F.R. § 243.100–103 (2005) (forbidding selective disclosure to analysts, thus demonstrating that selective disclosures such as tips, especially those made to analysts, harm investor confidence); Selective Disclosure and Insider Trading, 65 Fed. Reg. 51,716, 51,716–18 (Aug. 24, 2000) (adopting Regulation FD and discussing the need for prohibition of selective disclosure to analysts); Selective Disclosure and Insider Trading, 64 Fed. Reg. 72,590,

that tipping gives a distinct informational advantage to a few investors—in the case of disclosures to analysts, the analysts' clients—who are likely to use the information to trade.<sup>162</sup> This trading is in turn likely to affect adversely the confidence of investors who lack such preferential access to information from corporate insiders.<sup>163</sup> For this reason, tipping that is likely to result in trading should only be permitted when other important legal or policy considerations are strong enough to outweigh this resulting harm.<sup>164</sup>

With this point in mind, the personal benefit requirement is overly broad because it protects tippers and tippees in several instances where the benefits of the disclosure do not outweigh the harm.<sup>165</sup> For instance, selective disclosures to analysts in particular do more harm than good.<sup>166</sup> Such disclosures can create an incentive for analysts to skew their recommendations in favor of the issuer, in hopes of continued preferential access to information.<sup>167</sup> Corporate insiders might even delay public announcements in order to improve their relationships with analysts through selective disclosure.<sup>168</sup> For these very reasons, in 2000 the SEC promulgated Regulation FD, which provides that when an issuer discloses material, nonpublic information to an analyst, it must also disclose that information to the public.<sup>169</sup>

In addition, even if the personal benefit requirement could be justified in the case of disclosures to analysts in particular, the personal benefit requirement would still be overly broad because it also

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72,592-93 (proposed Dec. 28, 1999) (discussing the need for prohibition of selective disclosure to analysts); Langevoort, *supra* note 155, at 1044-45 (critiquing arguments for selective disclosure to analysts).

<sup>162</sup> See Selective Disclosure and Insider Trading, 64 Fed. Reg. at 72,592 n.15 (citing Richard Frankel et al., *An Empirical Examination of Conference Calls as a Voluntary Disclosure Medium*, 37 J. ACCT. RES. 133 (1999) (indicating that selective disclosure to analysts allows certain individuals to profit from trading before the information is announced publicly)).

<sup>163</sup> See Selective Disclosure and Insider Trading, 65 Fed. Reg. at 51,716 (adopting Regulation FD).

<sup>164</sup> See *id.*

<sup>165</sup> See Maxwell, 341 F. Supp. 2d at 944-50; 17 C.F.R. § 243.100-.103; Selective Disclosure and Insider Trading, 65 Fed. Reg. at 51,716-18 (adopting Regulation FD); Selective Disclosure and Insider Trading, 64 Fed. Reg. at 72,592-93; Langevoort, *supra* note 155, at 1044-45.

<sup>166</sup> See Selective Disclosure and Insider Trading, 64 Fed. Reg. at 72,592-93; Langevoort, *supra* note 155, at 1044-45.

<sup>167</sup> Selective Disclosure and Insider Trading, 64 Fed. Reg. 72,590, 72,592-93 (proposed Dec. 28, 1999); Langevoort, *supra* note 155, at 1041-42.

<sup>168</sup> Selective Disclosure and Insider Trading, 64 Fed. Reg. at 72,592.

<sup>169</sup> 17 C.F.R. § 243.100-.103 (2005).

protects disclosures to self-serving non-analysts.<sup>170</sup> Arguably, disclosures to analysts could be justified because analysts serve the commendable purpose of gathering and analyzing information for others' benefit.<sup>171</sup> The personal benefit requirement, however, also protects disclosures to self-serving tippees who will use the information solely for their own benefit by trading.<sup>172</sup> For instance, in 2004 in *SEC v. Maxwell*, the U.S. District Court for the Southern District of Ohio found that the SEC produced insufficient evidence to establish that a corporate insider's disclosure to his barber, who personally traded, created a personal benefit.<sup>173</sup> Rather than gathering and analyzing information for the benefit of the marketplace, the barber-tippee self-servingly used the information to trade, reaping almost \$200,000 in profits.<sup>174</sup> Yet, because the tipper did not benefit personally, the barber-tippee escaped liability.<sup>175</sup> Thus, even if the personal benefit requirement could be justified in the narrow situation of analysts, the *Dirks* Court launched "a missile to kill a mouse" by creating a blanket personal benefit requirement.<sup>176</sup>

The personal benefit requirement also protects many tippers who purposefully, knowingly, or recklessly harm others through their disclosures.<sup>177</sup> For instance, the requirement appears to protect tippers who tip in order to cause harm to someone.<sup>178</sup> Furthermore, even if the personal benefit requirement held liable those whose *purpose* is to cause harm, by treating the satisfaction of causing harm as a type of personal benefit, the requirement would still fail to hold liable those who cause the harm merely knowingly or recklessly, such as a corporate insider who becomes drunk at a bar and begins to disclose in-

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<sup>170</sup> See *Dirks*, 463 U.S. at 662.

<sup>171</sup> See *id.* at 658–59 (discussing analysts' useful public purpose).

<sup>172</sup> See *id.* at 662; *Maxwell*, 341 F. Supp. 2d at 944–50 (employing the personal benefit requirement to exculpate tipper of tippee who merely used the information to trade personally).

<sup>173</sup> 341 F. Supp. 2d at 948.

<sup>174</sup> *Id.* at 944–45.

<sup>175</sup> *Id.* at 950.

<sup>176</sup> Cf. *Lucas v. S.C. Coastal Council*, 505 U.S. 1003, 1036 (1992) (Blackmun, J., dissenting) (stating in a takings case that "today the Court launches a missile to kill a mouse" by improperly "issuing sweeping new rules to decide such a narrow case").

<sup>177</sup> See *Dirks*, 463 U.S. at 662; *SEC v. Yun*, 327 F.3d 1263, 1278 n.34 (11th Cir. 2003); Richard W. Painter et al., *Don't Ask, Just Tell: Insider Trading After United States v. O'Hagan*, 84 VA. L. REV. 153, 194 (1998).

<sup>178</sup> See *Yun*, 327 F.3d at 1278 n.34 (stating that if a CEO's wife disclosed information solely to humiliate her husband, she would not intend "that anyone would . . . benefit" but rather would "merely" want to harm her husband, thus implying that a personal benefit requirement would protect such a wife from tipper liability).

formation inappropriately without expecting anything in return, or the Vice President in the opening hypothetical of this Note who indifferently discusses a confidential tender offer with his barber.<sup>179</sup> Unlike whistleblowers or analysts, these tippers produce no public benefit to counteract the harm they cause to investors.<sup>180</sup> Thus, in protecting these tippers, the personal benefit requirement is far broader than can be justified by its motivating policy concerns.<sup>181</sup>

The aforementioned flaws in the blanket personal benefit requirement suggest that although lower courts unfortunately must apply the requirement in classical cases, they should decline to extend the requirement to the misappropriation theory.<sup>182</sup> Instead, courts should examine the misappropriation theory to determine what standard would best promote the text and purposes of section 10(b) of the Securities Exchange Act and Rule 10b-5 as interpreted by Supreme Court precedent, as well as the policies underlying our federal securities laws.<sup>183</sup>

#### B. A Revised Personal Benefit Requirement for Misappropriation Cases

Instead of requiring a personal benefit in misappropriation cases, courts should require that (1) the tipper was at least reckless as to whether he or she would *either* benefit personally *or* harm the information source by tipping, and (2) the tipper was at least reckless as to whether someone in the line of tpees would use the information to trade.<sup>184</sup> This standard should be subject *only* to the tipper's defense that the tipper made the disclosure in a good faith attempt to prevent criminal activity reasonably certain to cause substantial physical or

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<sup>179</sup> See *Dirks*, 463 U.S. at 662 (focusing on the purpose of the disclosure in creating the personal benefit requirement); Painter et al., *supra* note 177, at 194 (noting that under the *Dirks* personal benefit test, a tipper who becomes drunk at a bar and discusses confidential information without expecting anything in return would escape section 10(b) liability); *supra* notes 1-3 and accompanying text.

<sup>180</sup> See *Dirks*, 463 U.S. at 676-77 (Blackmun, J., dissenting) (noting that the Court created the personal benefit requirement because the "general benefit" derived from the tips outweighed the harm caused to the corporation's shareholders); Selective Disclosure and Insider Trading, 65 Fed. Reg. 51,716, 51,716 (Aug. 24, 2000) (adopting Regulation FD and noting that trades flowing from selective disclosure cause harm to investor confidence).

<sup>181</sup> See *Dirks*, 463 U.S. at 676-77 (Blackmun, J., dissenting); Selective Disclosure and Insider Trading, 65 Fed. Reg. at 51,716 (adopting Regulation FD).

<sup>182</sup> See *supra* notes 158-181 and accompanying text.

<sup>183</sup> See *supra* notes 158-181 and accompanying text.

<sup>184</sup> See *O'Hagan*, 521 U.S. at 653, 658-59; *Dirks*, 463 U.S. at 652 n.8, 667 & n.27; Espionage Act, 18 U.S.C. § 794(a) (2000); Brief for Appellee, *supra* note 76, at 40-46; RESTATEMENT (THIRD) OF UNFAIR COMPETITION § 40 cmt. c (1995); RESTATEMENT (SECOND) OF AGENCY § 395 cmt. a (1958).



financial harm to others.<sup>185</sup> This approach not only comports with Supreme Court precedent in a technical sense, but also best promotes the important Court-identified policies of promoting investor confidence while, at the same time, protecting tippers who seek to expose criminal and harmful activity.<sup>186</sup>

### 1. The Proposed Standard Expounded

First, the proposed standard establishes recklessness as the minimum mental state the tipper must possess regarding the resulting personal benefit or harm to the information source, as well as the ultimate securities trade.<sup>187</sup> Courts should adopt the Model Penal Code's definition of recklessness, which has become widely accepted by courts today.<sup>188</sup> Under the Model Penal Code, a person acts recklessly if he "consciously disregards a substantial and unjustifiable risk that the material element exists or will result from his conduct."<sup>189</sup> Thus, under the proposed standard, the relevant inquiry would be whether the tipper consciously disregarded a substantial and unjustifiable risk that he or she would benefit personally or harm the information source, as well as a risk that he would cause a securities trade.<sup>190</sup>

Courts should look to all relevant circumstances in determining whether these elements of the proposed standard are met.<sup>191</sup> In the case of a personal benefit, courts should look for the types of personal benefits that *Dirks* suggested: pecuniary gain, reputational benefit, or benefits from making a gift to a relative or friend.<sup>192</sup> As *Dirks* suggested, a tipper's expectation that these will result could be inferred from a

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<sup>185</sup> See 18 U.S.C. § 794(a); *O'Hagan*, 521 U.S. at 653, 658–59; *Dirks*, 463 U.S. at 652 n.8, 667 & n.27; Brief for Appellee, *supra* note 76, at 40–46; RESTATEMENT (THIRD) OF UNFAIR COMPETITION § 40 cmt. c (1995); RESTATEMENT (SECOND) OF AGENCY § 395 cmt. a (1958).

<sup>186</sup> See *O'Hagan*, 521 U.S. at 653, 658–59 (emphasizing investor confidence); *Dirks*, 463 U.S. at 652 n.8, 667 & n.27 (emphasizing the defendant's role in exposing fraud).

<sup>187</sup> See *supra* note 184 and accompanying text.

<sup>188</sup> See JOSHUA DRESSLER, UNDERSTANDING CRIMINAL LAW § 10.07[B][3][a], at 140 (3d ed. 2001).

<sup>189</sup> MODEL PENAL CODE § 2.02(2)(c) (1985). A risk is "substantial and unjustifiable" when "considering the nature and purpose of the actor's conduct and the circumstances known to him, its disregard involves a gross deviation from the standard of conduct that a law-abiding person would observe in the actor's situation." *Id.*

<sup>190</sup> *Id.*

<sup>191</sup> Cf. *Herman & MacLean v. Huddleston*, 459 U.S. 375, 390–91 n.30 (1983) (noting that scienter in fraud cases can be inferred from circumstantial evidence).

<sup>192</sup> See *Dirks*, 463 U.S. at 663–64.

relationship between the insider and the recipient that suggests a quid pro quo, or an intention to benefit the recipient of the information.<sup>193</sup>

With regard to harming the information source, courts should consider whether there is evidence that the tipper possessed negative feelings towards the source of the information, as well as whether the information source had expressed to the tipper a strong desire for the information to remain confidential.<sup>194</sup> Such facts would suggest that the tipper disclosed the information with some expectation that it would cause harm.<sup>195</sup> Finally, regarding the question of whether someone in the line of tippees would trade, courts should consider whether the tipper knew about the tippee's interest in trading in the type of stock to which the disclosure pertained, any seemingly reliable assurances made by the tippee about trading or tipping others, and the tipper's knowledge of the trading value of the information.<sup>196</sup>

Under the proposed standard, the tipper and tippee would not be liable, however, if the tipper made the disclosure in a good faith attempt to prevent criminal activity reasonably certain to cause substantial physical or financial harm to others.<sup>197</sup> Thus, tippers who make disclosures to expose a corporation's criminal fraud that is reasonably certain to cause substantial harm to investors or any other person or entity doing business with the company in the future, as the tippers in *Dirks* did, would not be liable for insider trading.<sup>198</sup> This would be true even if the disclosures were also likely to produce a personal benefit, such as an enhanced reputation, or harm the information source by exposing it to criminal liability or bankruptcy.<sup>199</sup>

Thus, in the hypothetical in the Introduction of this Note, the Vice President-tipper and the barber-tippee would both be liable for insider trading.<sup>200</sup> First, the Vice President consciously disregarded a substantial and unjustifiable risk that his disclosure would harm Acme

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<sup>193</sup> *Id.* at 664.

<sup>194</sup> See *Yun*, 327 F.3d at 1278 n.34 (describing a wife who discloses information to a newspaper editor in order to humiliate her husband).

<sup>195</sup> See *id.*

<sup>196</sup> See *Maxwell*, 341 F. Supp. 2d at 944 (exculpating a tipper and tippee and describing facts that, under the proposed standard, would likely give rise to an inference that the insider-tipper disregarded a substantial and unjustifiable risk that the barber-tippee would trade).

<sup>197</sup> See *Dirks*, 463 U.S. at 667 (exculpating the defendant-tippee and emphasizing that the tippers' purpose was to expose corporate fraud).

<sup>198</sup> See *id.*

<sup>199</sup> See *id.* at 650 (exculpating defendants despite the fact that their exposure of the corporation's fraud caused the corrupt corporation to plummet into receivership).

<sup>200</sup> See MODEL PENAL CODE § 2.02(2)(c) (1985); *supra* notes 1-3 and accompanying text.

Corporation, the source of the information.<sup>201</sup> He knew that leaking information about an upcoming acquisition would create a substantial risk that the acquisition would fall apart.<sup>202</sup> In addition, he had sufficient notice that the barber would tip his friends and that their group would collectively buy stock in Zen Corporation and even tip others, all of which would likely alert the public to the upcoming acquisition and consequently frustrate Acme Corporation's attempt to expand its business.<sup>203</sup> Thus, he was reckless as to whether his disclosure would harm the information source.<sup>204</sup> For this reason, under the proposed standard it would not matter that the Vice President sought no personal benefit in making the disclosure.<sup>205</sup>

In addition, the Vice President-tipper disregarded a substantial and unjustifiable risk that his disclosure would cause the barber-tippee to trade.<sup>206</sup> He knew that the barber and the barber's friends enjoyed finding and investing in acquisition targets.<sup>207</sup> He also believed the barber was probing for information because every time he visited the barber previously, the barber had suspiciously asked whether Acme Corporation would acquire other companies soon.<sup>208</sup> The Vice President also knew the high trading value of the information.<sup>209</sup> Yet, the Vice President still made the disclosure.<sup>210</sup> Thus, the Vice President was also reckless as to whether someone in the line of tippees would use the information provided by him to trade.<sup>211</sup>

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<sup>201</sup> See MODEL PENAL CODE § 2.02(2)(c) (1985); *supra* notes 1-3 and accompanying text.

<sup>202</sup> *Supra* notes 1-3 and accompanying text.

<sup>203</sup> See *supra* notes 1-3 and accompanying text.

<sup>204</sup> See MODEL PENAL CODE § 2.02(2)(c) (1985); *supra* notes 1-3 and accompanying text.

<sup>205</sup> See *supra* notes 184-199 and accompanying text. Although one might try to argue that the Vice President sought the "benefit" of speaking freely, this benefit is likely too trivial to give rise to liability. See *Dirks*, 463 U.S. at 663-64 (identifying personal benefits of consequence, such as a pecuniary gain, enhanced reputation, or satisfaction of making a valuable gift to a relative or friend); *Maxwell*, 341 F. Supp. 2d at 948 (holding that there was no personal benefit where the tipper-insider tipped his barber because "*Dirks* requires an intended benefit of at least some consequence" and there was no evidence that the tipper-executive sought money, a reputational gain, or the satisfaction of giving a gift to the barber); *SEC v. Switzer*, 590 F. Supp. 756, 766 (W.D. Okla. 1984) (holding that there was no personal benefit where a father-tipper made the disclosure for the purpose of making child care arrangements).

<sup>206</sup> See MODEL PENAL CODE § 2.02(2)(c) (1985); *supra* notes 1-3 and accompanying text.

<sup>207</sup> *Supra* notes 1-3 and accompanying text.

<sup>208</sup> *Supra* notes 1-3 and accompanying text.

<sup>209</sup> *Supra* notes 1-3 and accompanying text.

<sup>210</sup> *Supra* notes 1-3 and accompanying text.

<sup>211</sup> See MODEL PENAL CODE § 2.02(2)(c) (1985); *supra* notes 1-3 and accompanying text.

Moreover, the Vice President did not make the disclosure in a good faith attempt to prevent criminal activity reasonably certain to cause substantial physical or financial harm to others.<sup>212</sup> Rather, he made his disclosure because of his indifference to the disclosure's consequences.<sup>213</sup> In fact, Acme Corporation was not engaged in any wrongdoing that would prompt the Vice President to disclose.<sup>214</sup>

Finally, the barber would be liable as a trading tippee because he knew, or should have known, that the Vice President passed on information in breach of a duty to Acme Corporation.<sup>215</sup> The barber knew that the Vice President worked for Acme Corporation and therefore, in all likelihood, was forbidden to discuss the upcoming tender offer.<sup>216</sup>

## 2. Fully Protecting Investors from Trades Based on Misappropriated Information

When the U.S. Supreme Court adopted the misappropriation theory in 1997 in *United States v. O'Hagan*, it made clear that the purpose of the theory is to ensure honest securities markets and thereby promote investor confidence.<sup>217</sup> Investors will lose confidence in a market where many trades are the fruit of misuse of information.<sup>218</sup> For that reason, the proposed standard reaches both possible misuses of information in connection with securities trades: conversion for a personal benefit, and use to the detriment of the information source.<sup>219</sup> For the same reason, the proposed standard also holds liable tippers who cause such trades recklessly, albeit not purposefully or knowingly.<sup>220</sup>

### a. *Reaching Both Types of Misuse*

An examination of other areas of law involving misuse of information reveals that improperly using information for one's own benefit is only one type of misuse; harming the source of the informa-

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<sup>212</sup> See *supra* notes 1–3 and accompanying text.

<sup>213</sup> *Supra* notes 1–3 and accompanying text.

<sup>214</sup> See *supra* notes 1–3 and accompanying text.

<sup>215</sup> See *United States v. Libera*, 989 F.2d 596, 600 (2d Cir. 1993); *SEC v. Willis*, 777 F. Supp. 1165, 1169 (S.D.N.Y. 1991); *supra* notes 1–3 and accompanying text.

<sup>216</sup> See *Libera*, 989 F.2d at 600; *Willis*, 777 F. Supp. at 1169; *supra* notes 1–3 and accompanying text.

<sup>217</sup> *O'Hagan*, 521 U.S. at 653.

<sup>218</sup> *Id.* at 658–59.

<sup>219</sup> See *id.*

<sup>220</sup> See *id.*

tion is another.<sup>221</sup> Perhaps the most important area of law in this regard is the law of agency because in *O'Hagan* the Supreme Court itself implied that agency principles were at the misappropriation theory's core.<sup>222</sup> The Court not only cited to the *Restatement (Second) of Agency*, but also employed standard agency language when describing the participants in misappropriation.<sup>223</sup> For instance, the Court referred to the information source as a "principal" multiple times.<sup>224</sup> Under these agency principles, an agent is legally obligated not to communicate information to the detriment of the principal.<sup>225</sup> Thus, it seems that *O'Hagan* strongly implied that harming the information source constitutes the type of misuse that, when connected to securities trading, the misappropriation theory ought to proscribe.<sup>226</sup>

One need not rely solely on agency law, however, because other areas of law also demonstrate the gravity of misappropriation, through disclosure, of information to the detriment of the owner.<sup>227</sup> For instance, under the *Restatement (Third) of Unfair Competition*, one may be liable in some circumstances for disclosing a trade secret not only when disclosure is made for purposes of personal commercial exploitation, but also when disclosure is made for the purpose of causing harm to the trade secret owner.<sup>228</sup> The same idea applies in the law of espionage; a spy violates the Espionage Act when he discloses national defense secrets with intent or reason to believe that

<sup>221</sup> See Espionage Act, 18 U.S.C. § 794(a) (2000); Brief for Appellee, *supra* note 76, at 45; RESTATEMENT (THIRD) OF UNFAIR COMPETITION § 40 cmt. c (1995); RESTATEMENT (SECOND) OF AGENCY § 395 cmt. a (1958).

<sup>222</sup> See *O'Hagan*, 521 U.S. at 652-54 (employing agency terminology and citing to the RESTATEMENT (SECOND) OF AGENCY); Brief for Appellee, *supra* note 76, at 42-43 (arguing that agency principles instruct the scope of the misappropriation theory); Pritchard, *supra* note 76, at 47 (stating that the misappropriation theory is "well grounded" in the common law of agency).

<sup>223</sup> *O'Hagan*, 521 U.S. at 652-54.

<sup>224</sup> *Id.*

<sup>225</sup> RESTATEMENT (SECOND) OF AGENCY § 395 cmt. a (1958).

<sup>226</sup> See *O'Hagan*, 521 U.S. at 652-54, 658-59; RESTATEMENT (SECOND) OF AGENCY § 395 cmt. a (1958). The SEC made this very agency argument, unsuccessfully, in *Yun*. See 327 F.3d 1263, 1275 (rejecting SEC's attempt to avoid a personal benefit requirement); Brief for Appellee, *supra* note 76, at 40-46 (arguing that no personal benefit should be required because, under the agency principles to which *O'Hagan* alluded, a tipper breaches a duty to the information source not only when the tipper benefits from the disclosure, but also when the disclosure harms the source).

<sup>227</sup> See Espionage Act, 18 U.S.C. § 794(a) (2000); RESTATEMENT (THIRD) OF UNFAIR COMPETITION § 40 cmt. c (1995).

<sup>228</sup> RESTATEMENT (THIRD) OF UNFAIR COMPETITION § 40 cmt. c (1995).

the information will be used to the detriment of the United States.<sup>229</sup> The Espionage Act does not require a personal benefit to the thief.<sup>230</sup>

Together, these areas of law indicate that disclosure of information to the detriment of the information owner is equally as grave as disclosure of information for the misappropriator's own benefit.<sup>231</sup> When this misuse of information results in securities trades, the harm to investors is the same in either case; as the Supreme Court in *O'Hagan* made clear, investors will hesitate to invest because they will suspect that those with whom they trade may have gained their informational advantages by means the investor cannot legally match through skill or diligence.<sup>232</sup>

For this reason, the Eleventh Circuit's assertion in *SEC v. Yun* that *O'Hagan* "explicitly states or implicitly assumes" that a misappropriator must obtain a personal benefit is mistaken.<sup>233</sup> Rather, *O'Hagan*'s emphasis on the harm caused by trades that result from misappropriation demonstrates that the Court's occasional descriptions of a misappropriator seeking personal gain are more properly seen as reflections of the facts before the Court in which the misappropriator did trade for personal benefit.<sup>234</sup>

The proposed standard's adherence to the misappropriation theory's underlying policy rationale justifies its modest departure from the requirements of tipper/tippee liability under the classical theory.<sup>235</sup> For this reason, the *Yun* court's assertion that a personal benefit requirement is proper in order to synthesize the misappropriation theory with the classical theory is also mistaken.<sup>236</sup> The *Yun* court failed to consider that the flaws of the personal benefit requirement themselves are good reason not to impose it on the misap-

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<sup>229</sup> 18 U.S.C. § 794(a). A person also violates the Act when he discloses the information with intent or reason to believe that it will be used to the advantage of a foreign nation. *Id.*

<sup>230</sup> *See id.*

<sup>231</sup> *See id.*; *O'Hagan*, 521 U.S. at 652-54, 658-59; RESTATEMENT (THIRD) OF UNFAIR COMPETITION § 40 cmt. c (1995); RESTATEMENT (SECOND) OF AGENCY § 395 cmt. a (1958).

<sup>232</sup> *See O'Hagan*, 521 U.S. at 652-54.

<sup>233</sup> *See* Espionage Act, 18 U.S.C. § 794(a) (2000); *O'Hagan*, 521 U.S. at 652-54, 658-59; *Yun*, 327 F.3d at 1279; RESTATEMENT (THIRD) OF UNFAIR COMPETITION § 40 cmt. c (1995); RESTATEMENT (SECOND) OF AGENCY § 395 cmt. a (1958).

<sup>234</sup> *See* 18 U.S.C. § 794(a); *O'Hagan*, 521 U.S. at 647-48, 652-54, 658-59; Brief for Appellee, *supra* note 76, at 44; RESTATEMENT (THIRD) OF UNFAIR COMPETITION § 40 cmt. c (1995); RESTATEMENT (SECOND) OF AGENCY § 395 cmt. a (1958).

<sup>235</sup> *See* 18 U.S.C. § 794(a); *O'Hagan*, 521 U.S. at 652-54, 658-59; RESTATEMENT (THIRD) OF UNFAIR COMPETITION § 40 cmt. c (1995); RESTATEMENT (SECOND) OF AGENCY § 395 cmt. a (1958).

<sup>236</sup> *See Yun*, 327 F.3d at 1275-77.

propriation theory.<sup>237</sup> In addition, the *Yun* court displayed unwarranted concern about the possibility that failing to require a personal benefit would render *Dirks* a "dead letter" by inducing government prosecutors to try more cases under the misappropriation theory.<sup>238</sup> It is unclear why it would be objectionable for government prosecutors to pursue a valid theory that is harmonized with law and policy merely because there happens to be an alternate theory the government cannot satisfy in that particular case.<sup>239</sup> Where a defendant has violated *either* theory, he or she has violated Rule 10b-5, and therefore should be subject to an enforcement action.<sup>240</sup> Thus, in summary, requiring either a personal benefit *or* harm to the information source best promotes the policies emphasized by *O'Hagan*.<sup>241</sup>

### b. *Reaching Reckless Tippers*

*O'Hagan's* emphasis on protecting investors also suggests that tippers with a reckless state of mind should not escape liability merely because they did not hope, or know for certain, that their conduct would cause the resulting harm.<sup>242</sup> This is especially true given that recklessness is no stranger to either insider trading law or other areas of criminal law; it is a common standard for liability.<sup>243</sup>

Insider trading law already embraces the recklessness standard.<sup>244</sup> For instance, recklessness is sufficient to establish the requisite scienter, or intent to deceive.<sup>245</sup> Criminal law in general also embraces recklessness.<sup>246</sup> For instance, the influential Model Penal Code states that if the legislature fails to specify what state of mind is required for

<sup>237</sup> See *id.*

<sup>238</sup> See *id.* at 1279.

<sup>239</sup> See *O'Hagan*, 521 U.S. at 665 (validating the misappropriation theory as consistent with section 10(b) and Supreme Court precedent).

<sup>240</sup> See *id.*

<sup>241</sup> See Espionage Act, 18 U.S.C. § 794(a) (2000); *O'Hagan*, 521 U.S. at 652-54, 658-59, 665; RESTATEMENT (THIRD) OF UNFAIR COMPETITION § 40 cmt. c (1995); RESTATEMENT (SECOND) OF AGENCY § 395 cmt. a (1958).

<sup>242</sup> See *O'Hagan*, 521 U.S. at 658-59.

<sup>243</sup> See MODEL PENAL CODE § 2.02(3) (1985) (setting recklessness as the default where the legislature fails to specify a mens rea, or level of intent, for an element of an offense); Quinn, *supra* note 51, at 891 n.147 (stating that in insider trading law, recklessness is a sufficient state of mind for scienter, or the intent to deceive).

<sup>244</sup> See Quinn, *supra* note 51, at 891 n.147 (stating that in insider trading law, recklessness is a sufficient state of mind for scienter, or the intent to deceive).

<sup>245</sup> *Id.*

<sup>246</sup> See MODEL PENAL CODE § 2.02(3) (1985) (setting recklessness as the default where the legislature fails to specify a mens rea, or level of intent, for an offense).

a particular element of an offense, the default state of mind is recklessness.<sup>247</sup> Applying this Model Penal Code principle to section 10(b) and Rule 10b-5 would result in a recklessness standard, since neither Congress nor the SEC specified the necessary state of mind.<sup>248</sup> Thus, given *O'Hagan's* emphasis on protecting investors and the general acceptance of recklessness as a minimum mental state for liability, tippees should be held liable when they recklessly cause the harmful results contained in the proposed standard.<sup>249</sup>

### 3. Protecting Tippees Who Expose Criminal and Harmful Activity

A primary justification posited for the personal benefit requirement is that it protects tippees whose sole motive is to expose criminal and harmful activity, as was the case with the tippees in *Dirks*.<sup>250</sup> As discussed, however, the personal benefit requirement is overly broad because it protects tippees without this commendable purpose.<sup>251</sup> Thus, to protect *only* those tippees who commendably seek to expose criminal and harmful activity, the proposed standard allows a tippee to present the defense that he made the disclosure in a good faith attempt to prevent criminal activity reasonably certain to cause substantial physical or financial harm to others.<sup>252</sup>

That this narrow defense is an appropriate balance of competing policies finds support in the analogous confidentiality exceptions of Rule 1.6 of the Model Rules of Professional Conduct.<sup>253</sup> These exceptions allow a lawyer, in limited situations, to disclose confidential information about a client to prevent physical or proprietary harm.<sup>254</sup> Recognizing the need to minimize the harm to client confidence that such disclosures create, the drafters of the Model Rules of Professional Conduct did not permit disclosure whenever a lawyer merely does not

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<sup>247</sup> *Id.*

<sup>248</sup> See Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j(b) (2000); 17 C.F.R. § 240.10b-5 (2005); MODEL PENAL CODE § 2.02(3) (1985).

<sup>249</sup> See 15 U.S.C. § 78j(b); *O'Hagan*, 521 U.S. at 658-59; 17 C.F.R. § 240.10b-5; MODEL PENAL CODE § 2.02(3) (1985).

<sup>250</sup> See *Dirks*, 463 U.S. at 652 n.8, 667 & n.27 (emphasizing the defendant's role in exposing fraud); *id.* at 676-77 (Blackmun, J., dissenting) (noting that the Court created the personal benefit requirement in the first place because the general benefit derived from the tips outweighed the harm caused to the corporation's shareholders); Ebaugh, *supra* note 3, at 291-92 (arguing for a personal benefit requirement under the misappropriation theory partly in order to protect tippees who expose fraud).

<sup>251</sup> See *supra* notes 170-181 and accompanying text.

<sup>252</sup> See *supra* notes 170-181, 184-185 and accompanying text.

<sup>253</sup> See MODEL RULES OF PROF'L CONDUCT R. 1.6(b)(1)-(3) (2003).

<sup>254</sup> *Id.*



intend to benefit personally from making it.<sup>255</sup> Similarly, recognizing the harm to investor confidence that misuse of information through disclosure creates when that information is used to trade, the proposed standard does not permit a tipper to disclose information used for trading merely because no personal benefit is sought in making the tip.<sup>256</sup>

#### 4. Reconciling the Standard with the Scope of Rule 10b-5 Liability as Defined by the Supreme Court

For several reasons, the proposed standard would not threaten the established elements of Rule 10b-5 misappropriation liability. First, the tipper, as a misappropriator, would still have to engage in deception, as required by *O'Hagan*.<sup>257</sup> In addition, the possibility of liability absent a personal benefit does not undermine the requirement that the tipper breach a duty arising from a fiduciary relationship or similar relationship of trust and confidence, as required by the U.S. Supreme Court in *Chiarella v. United States* and *O'Hagan*.<sup>258</sup> Although *Dirks* held that in classical cases there is no breach of duty absent a personal benefit, lower courts have suggested the contrary in misappropriation cases.<sup>259</sup> Furthermore, in *O'Hagan*, the Supreme Court implicitly agreed with these lower courts when it alluded to agency principles, which provide that using information to the detriment of the information owner constitutes a breach of duty.<sup>260</sup> Thus, the proposed standard would satisfy the breach of duty requirement despite its lack of a personal benefit requirement.<sup>261</sup> By requiring this breach of duty, the proposed standard

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<sup>255</sup> See *id.* at R. 1.6 cmt. 2 (emphasizing that trust is the "hallmark" of the attorney-client relationship because it encourages clients to seek legal assistance and to communicate fully).

<sup>256</sup> See *O'Hagan*, 521 U.S. at 658-59 (discussing the harm that trading on misappropriated information causes to investor confidence).

<sup>257</sup> See *id.* at 654-55.

<sup>258</sup> See *id.* at 652 (requiring a duty); *Chiarella v. United States*, 445 U.S. 222, 228 (1980) (requiring a duty). The proposed standard would also leave intact the requirement that the tippee know, or should know, that the tipper breached the duty. See *SEC v. Musella*, 748 F. Supp. 1028, 1038 (S.D.N.Y. 1989) (imposing the requirement).

<sup>259</sup> See *SEC v. Sargent*, 229 F.3d 68, 77 (1st Cir. 2000) (suggesting that requiring a breach of duty, without more, probably means that a personal benefit is not required); *SEC v. Gonzalez de Castilla*, 184 F. Supp. 2d 365, 375 (S.D.N.Y. 2002) (treating breach of duty and personal benefit as two separate and distinct elements of tipper/tippee liability).

<sup>260</sup> See *O'Hagan*, 521 U.S. at 653-55; Brief for Appellee, *supra* note 76, at 42-43; RESTATEMENT (SECOND) OF AGENCY § 395 cmt. a (1958).

<sup>261</sup> See *O'Hagan*, 521 U.S. at 653-55; *Sargent*, 229 F.3d at 77; *Gonzalez de Castilla*, 184 F. Supp. 2d at 375; RESTATEMENT (SECOND) OF AGENCY § 395 cmt. a (1958).

would protect those market participants who gain information through lawful skill and diligence.<sup>262</sup>

Finally, this standard would preserve the statutory requirement that the tipper's deception occur "in connection with" a securities trade.<sup>263</sup> As *O'Hagan* made clear, the "in connection with" requirement is satisfied when the misappropriator's deceptive breach of duty and his or her own securities trade coincide.<sup>264</sup> In addition, the federal securities laws tend not to distinguish between acts committed personally and acts done indirectly through other persons.<sup>265</sup> Thus, it reasonably follows that the "in connection with" requirement may properly be satisfied where a tipper deceptively breaches a duty by recklessly causing another to trade.<sup>266</sup>

The flexible nature of this interpretation of "in connection with" is appropriate because it serves the purposes of section 10(b).<sup>267</sup> Although the proposed standard's compliance with the "in connection with" requirement is more attenuated than the factual scenario addressed by *O'Hagan*, in which the trading misappropriator's deceptive breach of duty and his securities trade occurred simultaneously, the Supreme Court recently and unanimously indicated that the "in connection with" requirement may be construed flexibly, rather than technically and restrictively, in order to effectuate the purposes of section 10(b) in a reasonable manner.<sup>268</sup> As *O'Hagan* made clear, one of these purposes is to promote investor confidence, a confidence that is threatened by trades that result from informational misuse.<sup>269</sup> Thus, the proposed standard's heightened prevention of trades based on

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<sup>262</sup> See Pritchard, *supra* note 76, at 51 (stating that requiring a breach of duty protects individuals who have gained their informational advantage through superior insight or hard work).

<sup>263</sup> See Securities Exchange Act § 10(b), 15 U.S.C. § 78j(b) (2000) (requiring the fraud to be "in connection with" a securities trade).

<sup>264</sup> *O'Hagan*, 521 U.S. at 655-56.

<sup>265</sup> *Cf. Dirks*, 463 U.S. at 659 (citing 15 U.S.C. § 78t(b)) ("[N]ot only are insiders forbidden by their fiduciary relationship from personally using undisclosed corporate information to their advantage, but they may not give such information to an outsider for the same improper purpose of exploiting the information for their personal gain."); 17 C.F.R. § 240.14e-3(d) (2005) (providing that "it shall be unlawful . . . to communicate material, nonpublic information relating to a tender offer to any other person under circumstances in which it is reasonably foreseeable that such communication is likely to result in" trading that violates rule 14e-3).

<sup>266</sup> See *O'Hagan*, 521 U.S. at 655-56; *cf. Dirks*, 463 U.S. at 659; 17 C.F.R. § 240.14e-3(d).

<sup>267</sup> See *SEC v. Zanford*, 535 U.S. 813, 819-20 (2002); *O'Hagan*, 521 U.S. at 658-59.

<sup>268</sup> See *Zanford*, 535 U.S. at 819-20.

<sup>269</sup> *O'Hagan*, 521 U.S. at 658-59.

informational misuse, through a flexible interpretation of the "in connection with" requirement, is appropriate.<sup>270</sup>

### CONCLUSION

In misappropriation cases involving tippers and tippees, courts should not impose a requirement that the tipper intended to benefit personally from the tip. Instead, courts should require that (1) the tipper was at least reckless as to whether he or she would *either* benefit personally *or* harm the information source by tipping, and (2) the tipper was at least reckless as to whether someone in the line of tippees would use the information to trade. This standard should be subject *only* to the tipper's defense that the tipper made the disclosure in a good faith attempt to prevent criminal activity reasonably certain to cause substantial physical or financial harm to others.

This standard not only comports with section 10(b), Rule 10b-5, and Supreme Court precedent, but also best promotes the important policies emphasized by the Supreme Court's decisions: promoting investor confidence, while at the same time protecting tippers who seek to expose criminal and harmful activity. Thus, unless Congress passes a long-overdue insider trading statute, the Supreme Court should replace the personal benefit requirement with the proposed standard in tipper/tippee misappropriation cases. Lower courts, however, should not wait for Supreme Court action. While adhering to the personal benefit requirement in classical cases as they must under our system of binding precedent, lower courts should apply the proposed standard in misappropriation cases. Doing so is not only permitted, but also preferable in light of the principles and policies advanced by the Supreme Court in *O'Hagan*.

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<sup>270</sup> See *Zanford*, 535 U.S. at 819-20; *O'Hagan*, 521 U.S. at 658-59. By requiring the tipper to be reckless as to the resulting trade, therefore, the proposed standard also addresses the concerns raised by *Yun* that eliminating a personal benefit requirement might permit tipper liability absent the tipper having "even the slightest" intent for someone else to trade. See 327 F.3d at 1278.