

2003

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Recommended Citation

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 (2003). Available at: <https://ir.lawnet.fordham.edu/jcfl/vol8/iss3/6>

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THE MISAPPROPRIATION THEORY OF INSIDER TRADING IN THE SUPREME COURT: A (BRIEF) RESPONSE TO THE (MANY) CRITICS OF UNITED STATES V. O'HAGAN

*Randall W. Quinn*¹

INTRODUCTION

The extent that insider trading should be regulated under the antifraud provisions of the federal securities laws, although not the most urgent issue facing the securities markets in light of the corporate accounting scandals that came to light in 2001-2002 and the passage of the landmark Sarbanes-Oxley Act,² remains important.³ The proper scope of insider trading regulation also remains controversial, notwithstanding the Supreme Court's 1997 decision in *United States v. O'Hagan*,⁴ which upheld the validity of the misappropriation theory of insider trading. Under that theory, "a person commits fraud 'in connection with' a securities transaction, and thereby violates [section] 10(b) [of the Securities Exchange Act of 1934] and Rule 10b-5, when he misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information."⁵ From the

1. Assistant General Counsel, Securities and Exchange Commission; Adjunct Associate Professor, Washington College of Law, American University. The author would like to thank Michael A. Conley for his valuable comments on an earlier draft of this Comment. The Commission requires that the following disclaimer be included: "The Securities and Exchange Commission, as a matter of policy, disclaims responsibility for any private publication or statements of any SEC employee. This Comment expresses the author's views and does not necessarily reflect the views of the Commission, or other members of the staff."

2. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002).

3. See, e.g., Debora Vrana & Walter Hamilton, *Insider Trading an Issue that Won't Go Away*, L.A. TIMES, June 13, 2002, at C1.

4. *United States v. O'Hagan*, 521 U.S. 642 (1997).

5. *O'Hagan*, 521 U.S. at 652. The court also held that the Securities and

perspective of law enforcement, *O'Hagan* was a major victory that settled key issues with respect to enforcing anti-fraud insider trading prohibitions.⁶ Several commentators also expressed support for the decision.⁷ However, this trickle of published support for the *O'Hagan* decision has been swamped by a flood of critical articles.⁸

Exchange Commission did not exceed its rulemaking authority under section 14(e) of the Exchange Act, 15 U.S.C. 78n(e) (1994), when it adopted Rule 14e-3(a), 17 C.F.R. § 240.14e-3(a) (1998), which prohibits, in the context of tender offers, certain trading without requiring a breach of a fiduciary duty. *See O'Hagan*, 521 U.S. at 667-77. This Comment will not address this aspect of *O'Hagan*, which has generated relatively little critical attention. *See* Jeff Lobb, Note, *SEC Rule 14e-3 in the Wake of United States v. O'Hagan: Proper Prophylactic Scope and the Future of Warehousing*, 40 WM. & MARY L. REV. 1853, 1854 (1999); E. Livingston B. Haskell, Note, *Disclose-or-Abstain Without Restraint: The Supreme Court Misses the Mark on Rule 14e-3 in United States v. O'Hagan*, 55 WASH. & LEE L. REV. 199 (1998).

6. *See, e.g.*, Carol B. Swanson, *Reinventing Insider Trading: The Supreme Court Misappropriates The Misappropriation Theory*, 32 WAKE FOREST L. REV. 1157, 1159 (1997) (quoting SEC officials).

7. *See, e.g.*, Christopher J. Bebel, *A Detailed Analysis of United States v. O'Hagan: Onward Through The Evolution of The Federal Securities Laws*, 59 LA. L. REV. 1 (1998); Adam C. Pritchard, *U.S. v. O'Hagan: Agency Law And Justice Powell's Legacy For The Law of Insider Trading*, 78 B.U. L. REV. 13 (1998); Joel Seligman, *A Mature Synthesis: O'Hagan Resolves Insider Trading's Most Vexing Problems*, 23 DEL. J. CORP. L. 1 (1998); Elliott J. Weiss, *United States v. O'Hagan: Pragmatism Returns to the Law of Insider Trading*, 23 J. CORP. L. 395 (1998). It should also be noted that twenty law professors joined an amicus brief supporting the United States in the Supreme Court. *See* Brief of Amici North American Securities Administrators, Inc. and Law Professors in Support of Petitioner, *United States v. O'Hagan*, 1997 WL 86236, at *1a.

8. *See, e.g.*, Stephen M. Bainbridge, *Insider Trading Regulation: The Path Dependent Choice Between Property Rights and Securities Fraud*, 52 SMU L. REV. 1589 (1999); David Cowan Bayne, *Insider Trading: The Misappropriation Theory Ignored: Ginsburg's O'Hagan*, 53 U. MIAMI L. REV. 1 (1998); Mark Dallas, Note, *United States v. O'Hagan: A Failed Attempt to Protect Public Policies Underlying the Securities Laws*, 32 U.C. DAVIS L. REV. 1107 (1999); Michael H. Dessent, *Joe Six-pack, United States v. O'Hagan, and Private Securities Litigation Reform: A Line Must Be Drawn*, 40 ARIZ. L. REV. 1137 (1998); Amy E. Fahey, Note, *United States v. O'Hagan: The Supreme Court Abandons Textualism to Adopt the Misappropriation Theory*, 25 FORDHAM URB. L. J. 507 (1998); Christopher C. Faille, *Securities Fraud Prosecution: Drifting Into*

Critics have argued that the decision suffers from numerous flaws, including: misconstruing the relevant statute⁹; misreading the Supreme Court's own precedents¹⁰; lacking a coherent doctrinal basis for prohibiting insider trading¹¹; leaving too many unanswered questions¹²; creating illogical loopholes in the regulatory scheme; and extending the reach of federal securities laws too far¹³. Some representative statements from this body of criticism illustrate the lack of admiration for the decision. One author wrote that the Supreme Court "ducked, misunderstood, or mishandled virtually every issue presented by the case."¹⁴ Another stated that the *O'Hagan* decision worked a "vast, unwitting, and wholly

Dangerous Waters, 44 FED. LAW. 24 (1997); Roberta S. Karmel, *Outsider Trading on Confidential Information—a Breach in Search of a Duty*, 20 CARDOZO L. REV. 83 (1998); James L. Kelly, Note, *The Unpredictable Net: United States v. O'Hagan: The Misappropriation Theory Upsets Investor Confidence By Catching More Than the Plain Statutory Language and Established Precedent*, 49 SYRACUSE L. REV. 1067 (1999); Janet E. Kerr & Tor S. Sweeney, *Look Who's Talking: Defining the Scope of the Misappropriation Theory After United States v. O'Hagan*, 51 OKLA. L. REV. 53 (1998); Kimberly D. Krawiec, *Fiduciaries, Misappropriators and the Murky Outlines of the Den of Thieves: A Conceptual Continuum for Analyzing United States v. O'Hagan*, 33 TULSA L.J. 163 (1997); Michael J.T. McNally, Comment, *United States v. O'Hagan: The "Classic" Misuse of the "Misappropriation" Theory*, 25 NEW ENG. J. ON CRIM. & CIV. CONFINEMENT 495 (1999); Donna M. Nagy, *Reframing the Misappropriation Theory of Insider Trading Liability: A Post-O'Hagan Suggestion*, 59 OHIO ST. L.J. 1223 (1998); Richard W. Painter et al., *Don't Ask, Just Tell: Insider Trading After United States v. O'Hagan*, 84 VA. L. REV. 153 (1998); Saikrishna Prakash, *Our Dysfunctional Insider Trading Regime*, 99 COLUM. L. REV. 1491 (1999); Larry E. Ribstein, *Federalism and Insider Trading*, 6 S. CT. ECON. REV. 123 (1998); Bryan S. Schultz, Casenote, *Feigning Fidelity to Section 10(b): Insider Trading Liability After United States v. O'Hagan*, 66 U. CIN. L. REV. 1411 (1998); J. Dormer Stephen III, *United States v. O'Hagan: The Misappropriation Theory Under Section 10(b) and Rule 10b-5—Can The Judicial Oak Grow Any Higher*, 102 DICK. L. REV. 277 (1998); Swanson, *supra* note 6.

9. Dallas, *supra* note 8.

10. Bainbridge, *supra* note 8; *see also* Fahey, *supra* note 8.

11. Fahey, *supra* note 8.

12. Dessent, *supra* note 8.

13. Fahey, *supra* note 8; *see also* Kelly, *supra* note 8.

14. Bainbridge, *supra* note 8, at 1591.

unwarranted expansion of Rule 10b-5";¹⁵ while yet another held the view that the misappropriation theory is "foolish in enforcement and absurd in private actions . . . [and] underestimates the problems with the Court's acceptance of the theory."¹⁶

I do not share this assessment of *O'Hagan*. The Supreme Court's adoption of the misappropriation theory is consistent with the statute and relevant precedent, rests on a reasonable policy foundation, does not leave open too many unanswered questions or create significant loopholes in the regulatory scheme, and does not extend the reach of the federal securities laws too far. In sum, *O'Hagan's* critics have overstated their case. The purpose of this comment is to restore balance to the commentary on *O'Hagan*.

Part 1 of this Comment presents a brief overview of the development of the misappropriation theory of insider trading prior to *O'Hagan*; Part 2 summarizes the *O'Hagan* litigation; Part 3 responds to a number of arguments advanced by *O'Hagan's* critics, focusing on three themes: the alleged lack of a coherent doctrine supporting the misappropriation theory; the questions left open by the decision, and the asserted loopholes created by the Court.¹⁷

I. HISTORY OF THE MISAPPROPRIATION THEORY OF INSIDER TRADING PRIOR TO O'HAGAN

"Theories" of insider trading exist because insider trading is not expressly prohibited in the securities statutes, except in the limited context of section 16(b) of the Exchange Act.¹⁸ Section 16(b), which is not an antifraud provision, generally requires corporate officers, directors, and 10% owners to give back to the corporation any profits made (or losses avoided) on trading in that

15. Prakash, *supra* note 8, at 1496.

16. Ribstein, *supra* note 8, at 141 (quoting ALAN R. BROMBERG & LEWIS D. LOWENFELS, BROMBERG & LOWENFELS ON SECURITIES AND COMMODITIES FRAUD 7:241-242 (1994)).

17. This Comment does not attempt to cite, much less discuss, every article addressing the *O'Hagan* decision. Rather, I have selected and grouped criticisms of *O'Hagan* thematically, with illustrations drawn from representative articles.

18. 15 U.S.C. § 78p(b) (1988).

company's securities within any six-month period.¹⁹ Proof that the person trading engaged in deception or was aware of any material non-public information is not required.²⁰ The argument has been made, but never accepted by any court, that section 16 should be the exclusive means of addressing insider trading.²¹

Two theories have been used to prosecute insider trading under section 10(b) and Rule 10b-5: the classical or traditional theory, and the misappropriation theory.²² Under the classical theory, a corporate insider violates section 10(b) and Rule 10b-5 by "trad[ing] in the securities of his corporation on the basis of material, non-public information."²³ In so doing, the insider breaches a duty of trust owed to the corporation's shareholders.²⁴ The misappropriation theory, in contrast, applies when a person "misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information."²⁵

The misappropriation theory was first advanced by the government in a criminal case brought against Vincent Chiarella.²⁶ Chiarella worked at a financial printing firm, preparing documents used in corporate takeover bids.²⁷ The identities of the acquiring and target companies were concealed from the printer until the

19. See *id.*; see also Steve Thel, *The Genius of Section 16: Regulating the Management of Publicly Held Companies*, 42 HASTINGS L.J. 391, 452-94 (1991).

20. See *Kern County Land Co. v. Occidental Petroleum Corp.*, 411 U.S. 582, 585 (1973) (noting that section 16(b) imposes strict liability upon all transactions occurring within the statutory time period, "without proof of actual abuse or insider information, and without proof of intent to profit on the basis of such information.").

21. Stephen, *supra* note 8, at 314 ("Although the Exchange Act was enacted by Congress, inter alia, to proscribe insider trading activities, section 16 of the Exchange Act, not section 10(b), was the vehicle intended to achieve such means.").

22. See generally, WILLIAM K.S. WANG & MARC I. STEINBERG, *INSIDER TRADING* 281-390 (Little, Brown and Company 1996).

23. *United States v. O'Hagan*, 521 U.S. 642, 651 (1997).

24. *Id.*

25. *Id.*

26. *Chiarella v. United States*, 445 U.S. 222, 235 (1980).

27. *Id.* at 224.

night of the final printing of the documents.²⁸ Chiarella figured out the companies' identities from other information contained in the documents, and used the information to purchase securities of the target companies.²⁹

Chiarella was tried by a jury and convicted.³⁰ On appeal, the Second Circuit affirmed the convictions, holding that "anyone—corporate insider or not—who regularly receives material nonpublic information may not use that information to trade in securities without incurring an affirmative duty to disclose."³¹

The Supreme Court reversed and held, relying on common law principles, that "there can be no fraud absent a duty to speak" and that "a duty to disclose under 10(b) does not arise from the mere possession of nonpublic market information."³² The Court also stated that the requisite duty must arise from "a relationship of trust and confidence between parties to a transaction."³³

Chiarella was not, however, a total loss for the government. The Court, in dicta, accepted the classical theory of insider trading.³⁴ Further, the Court left open the validity of the misappropriation theory, holding only that, because the theory was not presented to the jury, it could not be a basis for affirming the conviction.³⁵ Four justices, in concurring and dissenting opinions,

28. *Id.*

29. *Id.*

30. *Id.* at 225.

31. *United States v. Chiarella*, 588 F.2d 1358, 1365 (2d Cir. 1978).

32. *See Chiarella*, 445 U.S. at 235. The Court's use of common law principles to confine the scope of the federal securities laws is questionable. *See, e.g.,* Ray J. Grzebielski, *Friends, Family, Fiduciaries: Personal Relationships As a Basis for Insider Trading Violations*, 51 CATH. U. L. REV. 467, 472 (2002) ("Since the federal securities laws were primarily aimed at regulating national trading markets in securities, where those laws were intended to fill shortcomings in state securities and common law, the Court should have considered the securities market context to determine which uses of material, nonpublic information would have been improper . . .").

33. *Chiarella*, 445 U.S. at 230.

34. *See id.* at 222 ("[T]hat the relationship between a corporate insider and the stockholders of his corporation gives rise to a disclosure obligation is not a novel twist of the law.").

35. *See id.* at 236.

indicated approval of some type of misappropriation theory of liability, although they did not all agree on the proper scope of the theory.³⁶

The government had two responses to the Supreme Court's insistence that insider trading liability under section 10(b) requires breach of a fiduciary or similar duty of trust and confidence. First, pursuant to its authority under section 14(e) of the Exchange Act to "define, and prescribe means to prevent," fraudulent practices in connection with a tender offer, the SEC promulgated Rule 14e-3.³⁷ Rule 14e-3 prohibits trading securities while in possession of material non-public information acquired from either a bidder or a target company if substantial steps have been taken to commence the offer.³⁸ Breach of a duty is not required.

Second, the government brought cases pursuant to the misappropriation theory. The government asserted that if insider trading liability required a fiduciary or similar duty, such a duty could be found in the relationship between the misappropriator of information and the source or owner of the information.

The misappropriation theory was tested in court shortly after *Chiarella* in *United States v. Newman*.³⁹ *Newman* involved employees of an investment banking firm that advised companies with respect to proposed mergers and acquisitions.⁴⁰ The defendants misappropriated confidential information entrusted to their employer and conveyed it to securities traders who purchased stock, then shared the profits from the stock's sale with the defendants.⁴¹ The employees owed no duty to the target company or its shareholders and thus could not be prosecuted under the classical theory of insider trading. On appeal, the Second Circuit affirmed defendants' convictions.⁴² The court stated that "in other

36. See *id.* at 237-52.

37. See 17 C.F.R. § 240.14e (1998).

38. See *id.* § 240.14e-3; see also SEC v. Sargent, 229 F.3d 68 (1st Cir. 2000).

39. *United States v. Newman*, 664 F.2d 12 (2d Cir. 1981), *aff'd*, 722 F.2d 729 (2d Cir. 1983).

40. *Id.* at 15.

41. *Id.*

42. SEC v. Materia, 745 F.2d 197 (2d Cir. 1984) (upholding the misappropriation theory after *Newman* in a case brought by the SEC, the Second

areas of the law, deceitful misappropriation of confidential information by a fiduciary... has consistently been held to be unlawful.... Congress [did not intend] a less rigorous code of conduct under the Securities Acts.”⁴³

Following the theory's acceptance by the Second Circuit, two other circuits expressly adopted the misappropriation theory. In *SEC v. Clark*, the defendant, a senior executive of a bidder, learned of his employer's plan to make an acquisition.⁴⁴ Clark used this information to buy shares of the target. The Ninth Circuit held that the “peculiar blend of legislative, administrative, and judicial history” surrounding section 10(b) and Rule 10b-5 provides “strong evidence that the misappropriation theory is compatible with the broad language of those provisions.”⁴⁵

Clark represented a straightforward application of the principles set forth in the Second Circuit cases that first adopted the misappropriation theory.⁴⁶ *SEC v. Cherif*,⁴⁷ in which the Seventh Circuit followed suit in accepting the theory, presented somewhat unusual facts. After Cherif lost his job at First National Bank of Chicago, he kept an ID card used by employees to gain access to the building.⁴⁸ In order for his card to remain active, Cherif forged a memorandum that falsely stated that he was continuing to work part-time at the bank on special projects.⁴⁹ Using his card to get into the bank at night and on weekends, Cherif stole information from the bank's Specialized Finance Department, which provided financing for extraordinary business transactions, and used the information to trade securities.⁵⁰ In effect, Cherif impersonated a current employee to gain access to

Circuit believed that *Materia* presented the same fact pattern as *Chiarella*).

43. *Newman*, 664 F.2d at 18. *But see* *United States v. Chestman*, 947 F.2d 551, 567 (2d Cir. 1990) (sitting en banc, the Second Circuit affirmed its prior acceptance of the misappropriation theory, but noted that the court would “tread cautiously in extending the misappropriation theory to new relationships.”).

44. *SEC v. Clark*, 915 F.2d 439 (9th Cir. 1990).

45. *Id.* at 453.

46. *Id.* (describing the facts as a “garden-variety misappropriation case”).

47. *SEC v. Cherif*, 933 F.2d 403 (7th Cir. 1991).

48. *Id.* at 406.

49. *Id.*

50. *Id.*

material, non-public information.

The Seventh Circuit, agreeing with prior decisions upholding the validity of the misappropriation theory, held that Cherif's conduct fell within the scope of the theory, stating that Cherif was not a "mere thief," but rather his actions "were fraudulent in the common understanding of the word because they deprived some person of something of value by 'trick, deceit, chicane or overreaching.'"⁵¹

In addition to three circuits expressly accepting the misappropriation theory,⁵² Congress on two occasions indicated its approval of the misappropriation theory. In 1984, Congress increased sanctions for insider trading.⁵³ The House report accompanying the legislation cited with approval court decisions upholding the misappropriation theory, and stated: "in other areas of the law, deceitful misappropriation of confidential information by a fiduciary . . . has consistently been held to be unlawful, [and Congress] has not sanctioned a less rigorous code of conduct under the federal securities laws."⁵⁴

In 1988, Congress further increased sanctions for insider trading.⁵⁵ In so doing, Congress declared: "[T]he rules and regulations of the Securities and Exchange Commission . . . governing trading while in possession of material nonpublic information are, as required by such Act, necessary and appropriate in the public interest and for the protection of investors."⁵⁶ In addition, the House Report accompanying the

51. *Id.* at 412 (citations omitted).

52. The Third Circuit arguably accepted the misappropriation theory in *Rothberg v. Rosenbloom*, 771 F.2d 818 (3d Cir. 1985). The issue was not squarely addressed, but on the facts as described by the court it appears that insider trading liability was based on the misappropriation theory. See *Rothberg*, 771 F.2d at 822 (citing *United States v. Newman*, 664 F.2d 12 (2d Cir. 1981) with approval).

53. Insider Trading Sanctions Act of 1984, Pub. L. No. 98-376, 98 Stat. 1264.

54. H.R. Rep. No. 355, 98th Cong., 1st Sess. 4 (1983).

55. Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, 102 Stat. 4677.

56. See Steve Thel, *Statutory Findings and Insider Trading Regulation*, 50 VAND. L. REV. 1091, 1134 (1997) (arguing that "this Congressional finding appears extremely well-constructed to establish the validity of the

legislation stated that the misappropriation theory "fulfills appropriate regulatory objectives in determining when communicating or trading while in possession of material nonpublic information is unlawful."⁵⁷

Carpenter v. U.S. involved a scheme by a reporter for the Wall Street Journal, who was one of the writers of the Journal's Heard on the Street column, to profit from his advanced knowledge of the contents of the column by tipping brokers who traded based on their (correct) expectation that the information in the column would have an impact on the price of securities.⁵⁸ The Second Circuit affirmed the lower court's securities fraud convictions based on the misappropriation theory, as well as convictions for mail fraud.⁵⁹

The misappropriation theory reached the Supreme Court in 1988, and insider trading law might have taken a different course if the Supreme Court had not been lacking one justice when it decided *Carpenter v. United States*.⁶⁰ With respect to the securities fraud convictions, the Supreme Court split 4-4, leaving the court of appeals' decision intact.⁶¹ However, the Court affirmed, by a vote of 8-0, the mail fraud convictions. The mail fraud statute requires deception, but not fraud "in connection with" the purchase or sale of securities.⁶² The Court held there was deception because the reporter "continued in the employ of the Journal, appropriating its confidential business information for his own use, all the while pretending to perform his duty of safeguarding it."⁶³ Thus, the Court made clear the validity of a key component of the misappropriation theory—stealing information from one's

misappropriation doctrine . . .").

57. H.R. Rep. No. 910, 100th Cong., 2d Sess. 26-27 (1988).

58. *Id.* at 22-23.

59. *United States v. Carpenter*, 791 F.2d 1024 (2d Cir. 1986).

60. *Carpenter v. United States*, 484 U.S. 19 (1987).

61. *Id.* The Court had a vacancy because of the departure of Justice Powell. See Pritchard, *supra* note 7, at 16 (arguing that "[h]ad Powell remained on the court for another term, the misappropriation theory almost certainly would have been overturned in 1987.").

62. See 18 U.S.C. § 1341 (1982); see also *Post v. United States*, 407 F.2d 319, 329 (D.C. Cir. 1968).

63. *Carpenter*, 484 U.S. at 23.

employer might, under certain circumstances, constitute deception.

In sum, in early 1995, the Second, Seventh, and Ninth circuits expressly adopted the misappropriation theory, no court rejected the theory, and Congress indicated its approval of the theory. This consensus was shattered by the Fourth Circuit's surprising decision in *United States v. Bryan*.⁶⁴ Bryan, at a time when he directed the West Virginia lottery, bought securities in a company that he knew was going to be awarded a gaming contract because he had rigged the bidding.⁶⁵ Bryan was convicted of mail and securities fraud.⁶⁶

On appeal, Bryan made only a passing challenge to the application of the misappropriation theory to his conduct.⁶⁷ In a remarkable display of judicial activism, the Fourth Circuit, in a lengthy opinion addressing numerous arguments that were never made by any of the parties in the case, held that the misappropriation theory was invalid.⁶⁸ The court of appeals based its holding primarily on two grounds. First, the court held that "by its own terms, the misappropriation theory does not even require deception, but rather allows the imposition of liability upon the mere breach of a fiduciary relationship or similar relationship of

64. *United States v. Bryan*, 58 F.3d 933 (4th Cir. 1995).

65. *Id.* at 938-39.

66. *Id.* at 936.

67. See Richard H. Walker & David M. Levine, *The Limits of Central Bank's Textualist Approach—Attempts to Overdraw the Bank Prove Unsuccessful*, 26 HOFSTRA L. REV. 1, 16 n.89 (1997) (noting that "of the more than [eighty] pages of text constituting Bryan's opening and reply briefs, only four buried sentences challenged the validity of the misappropriation theory.").

68. See *id.* (indicating that Bryan argued only that the misappropriation theory was void for vagueness). *Bryan* is also noteworthy for its strident tone. For example, the court ridicules the development of the law in the Second Circuit specifically stating that: "We regard the somewhat harrowing evolution of the misappropriation theory as almost a testament to the theory's invalidity." *Bryan*, 58 F.3d at 953. The court also castigates the SEC, which was not a party and played no role in bringing the criminal prosecution against Bryan by specifically stating that: "Absent clearly defined rules, investors find themselves the targets of ad hoc decision-making or pawns in an overall litigation strategy known only to the SEC." *Id.* at 951. The *Bryan* opinion reads like a brief written by a lawyer outraged that the government brought an action against his or her client, rather than a judicial opinion.

trust and confidence.”⁶⁹ Second, the court held that deception, even if present, was not in connection with the purchase or sale of securities, because the defendant must deceive a “purchaser or seller, or . . . a person in some way connected with or having a stake in an actual or proposed purchase or sale of securities”⁷⁰ The government did not seek Supreme Court review in *Bryan*, leaving the new circuit split on the validity of the misappropriation theory to await future resolution.

II. THE *O’HAGAN* LITIGATION

The *O’Hagan* litigation has been described in detail elsewhere and need only be summarized briefly here.⁷¹ James O’Hagan was a partner at the Minnesota law firm of Dorsey & Whitney.⁷² Prior to the events giving rise to his prosecution for securities fraud, O’Hagan had embezzled funds from clients that he needed to repay.⁷³ O’Hagan used his position at Dorsey & Whitney to learn that Grand Metropolitan PLC, a Dorsey & Whitney client, was contemplating a tender offer for Pillsbury.⁷⁴ O’Hagan bought Pillsbury stock and call options, becoming the largest individual holder of Pillsbury call options in the world.⁷⁵ When the proposed tender offer was publicly announced, O’Hagan cashed in his positions and made a profit of \$4.3 million.⁷⁶

O’Hagan did not fare well at trial. After conviction on all counts of an indictment charging securities fraud under both Rule 10b-5 and Rule 14e-3, mail fraud, and money laundering, O’Hagan was sentenced to 41 months in prison.⁷⁷ Subsequent to his sentencing, however, O’Hagan’s luck seemed to turn. While his appeal to the Eighth Circuit was pending, and before the oral

69. *Bryan*, 58 F.3d at 949.

70. *Id.*

71. *See, e.g.,* Bebel, *supra* note 7, at 3–31.

72. *United States v. O’Hagan*, 521 U.S. 642, 647 (1997).

73. *Id.* at 648. O’Hagan was convicted of state fraud charges. *Id.* at 648 n.2.

74. *Id.* at 648.

75. *Id.* at 647.

76. *Id.* at 648.

77. *Id.* at 647.

argument, the Fourth Circuit decided *Bryan*. The Eighth Circuit, adopting in full the reasoning of *Bryan*, held that the misappropriation theory was invalid.⁷⁸

O'Hagan's victory, however, was not permanent. The government sought, and obtained, Supreme Court review. The Court upheld the validity of the misappropriation theory, holding that "a person commits fraud 'in connection with' a securities transaction, and thereby violates section 10(b) and Rule 10b-5, when he misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information."⁷⁹ The Supreme Court rejected the two main premises of the Eighth Circuit's opinion, which, as noted, were the same arguments made by the Fourth Circuit in *Bryan*.⁸⁰ First, the Court held that there was deception because "a fiduciary who [pretends] loyalty to the principal while secretly converting the principal's information for personal gain . . . dupes or defrauds the principal."⁸¹ Second, regarding the "in connection with" requirement, the Court held that the fraud in a misappropriation case is "in connection with the purchase or sale of [a] security because the fiduciary's fraud is consummated, not when the fiduciary gains the confidential information, but when, without disclosure to his principal, he uses the information to purchase or sell securities."⁸² The Court also reversed the Eighth Circuit's

78. *United States v. O'Hagan*, 92 F.3d 612, 620 (8th Cir. 1996) (adopting *Bryan*'s "analysis in its entirety as our own"). The Eighth Circuit also reversed O'Hagan's convictions for violating Rule 14e-3, holding that "the SEC exceeded its rulemaking authority under section 14(e) when it promulgated Rule 14e-3(a) without including a requirement of a breach of a fiduciary obligation." *Id.* at 627. This was not an issue in *Bryan*, which did not involve a tender offer. *See supra* notes 65 & 66 and accompanying text. The Supreme Court held in *O'Hagan* that the SEC did not exceed its authority. *See O'Hagan*, 521 U.S. 642. The Eighth Circuit also reversed O'Hagan's convictions for mail fraud and for money laundering. *See O'Hagan*, 92 F.3d. at 628-29. The Supreme Court reversed as to mail fraud. *O'Hagan*, 521 U.S. at 678 n.24. The government did not seek review of the reversal of O'Hagan's money laundering conviction.

79. *O'Hagan*, 521 U.S. at 642, 652.

80. *See supra* text accompanying note 78.

81. *O'Hagan*, 521 U.S. at 653.

82. *Id.* at 653-54. Justice Scalia, dissenting, stated that "[w]hile the Court's

holding that Rule 14e-3 was invalid,⁸³ and remanded the case to the Eighth Circuit to address other challenges raised by O'Hagan to his convictions.⁸⁴

III. A RESPONSE TO O'HAGAN'S CRITICS

As noted in the introduction to this Comment, critics have pointed to numerous perceived flaws in the Supreme Court's *O'Hagan* decision. It is impossible to address in detail all or even most of the critical articles, many of which develop their points skillfully and at length. Rather, this part of the Comment will respond to the main themes in the commentary. First, the Comment will discuss criticisms of the court's technical legal analysis. Then, it will turn to an examination of three broader themes advanced by *O'Hagan*'s critics: the Supreme Court did not set forth a coherent doctrine in support of the misappropriation theory; the Court's decision leaves substantial questions unanswered; and the decision creates significant loopholes for the future regulation of insider trading.⁸⁵ Finally, this comment will address arguments that the decision extends federal law too far.

explanation of the scope of section 10(b) and Rule 10b-5 would be entirely reasonable in some other context, it does not seem to accord with the principle of lenity we apply to criminal statutes." *Id.* at 679. Justice Thomas, joined by Chief Justice Rehnquist, dissented on the ground that, although the undisclosed misappropriation of confidential information involves "deception," the deception in a misappropriation case is not "in connection with" a securities transaction. *Id.* at 681-82.

83. The Court upheld the Rule on the basis of the Commission's authority to adopt "means reasonably designed to prevent fraudulent trading on material, nonpublic information in the tender offer context." *Id.* at 676. The Court held that "insofar as it serves to prevent the type of misappropriation charged against O'Hagan, Rule 14e-3(a) is a proper exercise of the Commission's prophylactic power under 14(e)." *Id.*

84. On remand, the Eighth Circuit rejected O'Hagan's other challenges to his convictions. *United States v. O'Hagan*, 139 F.3d 641 (8th Cir. 1998).

85. Some overlap exists between these two topics. When exactly does an unanswered question—creating uncertainty as to whether conduct is prohibited—become a loophole—allowing conduct to escape prosecution even though it is the sort of thing the statute should cover?

1. Statutory Language and Precedent

Both before and after *O'Hagan*, commentators have argued that the misappropriation theory is contrary to the plain language of section 10(b), which requires a "deceptive device" used "in connection with" the purchase or sale of securities.⁸⁶ I do not find this a serious objection to the misappropriation theory. The conduct prohibited by the theory easily fits within the plain meaning of "deception" as well as "in connection with." Liability under the misappropriation theory exists only where there is an undisclosed breach of duty to the source or owner of the information. Remaining silent in the face of a duty to speak is deceptive.⁸⁷ Further, obtaining information about the value of securities by means of deception and then trading those securities is conduct "connected" to the purchase or sale of securities.⁸⁸

Several commentators argue that *O'Hagan* is inconsistent with the Supreme Court's decision in *Santa Fe Industries v. Green*.⁸⁹ *Santa Fe* involved a short-form merger that minority shareholders, who received full disclosure about the transaction, alleged was unfair.⁹⁰ The minority shareholders did not pursue appraisal rights available to them under state law, but instead brought an action alleging violation of Rule 10b-5.⁹¹ The Court observed that "the

86. See, e.g., Michael P. Kenny & Teresa D. Thebaut, *Misguided Statutory Construction to Cover the Corporate Universe: The Misappropriation Theory of Section 10(b)*, 59 ALB. L. REV. 139, 211 (1995) ("The misappropriation theory goes wrong because it is untethered to the words of the statute. Free of textual constraint, the theory has been applied to conduct that cannot credibly be considered fraud, much less fraud in a securities transaction."); Fahey, *supra* note 8, at 539 ("The [Supreme] Court improperly extended liability under section 10(b) to reach a culpable defendant whose conduct was not covered by the language of the statute or the rule.")

87. See *Carpenter v. United States*, 484 U.S. 19 (1987).

88. See *SEC v. Zandford*, 122 S. Ct. 1899 (2002).

89. *Santa Fe Industries v. Green*, 430 U.S. 462 (1977). See also Bainbridge, *supra* note 8, at 1643 (stating that the Court ignored the "serious federalism concerns that drove *Santa Fe*."); Stephen, *supra* note 8, at 316 ("[T]he misappropriation theory contradicts the Court's holding in *Santa Fe*.").

90. *Santa Fe*, 430 U.S. at 466-67.

91. *Id.*

complaint failed to alleged a material misrepresentation or material failure to disclose,” and held that “the transaction, if carried out as alleged in the complaint, was neither deceptive nor manipulative and therefore did not violate either section 10(b) of the Act or Rule 10b-5.”⁹² The Court also stated, as additional support for its holding, that allowing a suit under Rule 10b-5 could open the door to “bringing within the Rule a wide range of corporate conduct traditionally left to state regulation.”⁹³

Professors Painter, Krawiec, and Williams argue that, prior to *O’Hagan*, “the most significant obstacle believed to stand in the way of the misappropriation theory” was “the Court’s interpretation of section 10(b) in *Santa Fe*.”⁹⁴ They argue that *O’Hagan*:

[C]ontradicts the interpretation of [section] 10(b) underlying the Court’s holding in *Santa Fe* on three separate grounds: 1) Breach of fiduciary duty, not deception, lies at the heart of the theory; 2) The “deception” required to implicate the theory is entirely different from the “deception” described in *Santa Fe*; and 3) Misappropriation under the theory has nothing to do with the securities transaction, and thus the “deception” required by *Santa Fe*, to the extent it exists at all, is not “in connection with” the purchase or sale of a security.⁹⁵

None of these points presents a contradiction between *O’Hagan* and *Santa Fe*. First, whether or not breach of fiduciary duty is the “heart” of the misappropriation theory, the theory requires deception. The theory is thus fully consistent with *Santa Fe*’s holding that deceptive or manipulative conduct is an element of a violation of section 10(b). Painter, Krawiec, and Williams argue that “although *Santa Fe* specifically addressed only the Court’s reluctance to merge state corporation law into federal securities law, the Court’s reasoning applies to federalization of

92. *Id.* at 474.

93. *Id.* at 478.

94. Painter et al., *supra* note 8, at 174 (citing Stephen M. Bainbridge, *Incorporating State Law Fiduciary Duties into the Federal Insider Trading Prohibition*, 52 WASH. & LEE L. REV. 1189 (1995)).

95. *Id.* at 175.

other state law fiduciary duty standards as well"⁹⁶ However, *Santa Fe*'s concern was that federal law might displace state law, leading to "established state policies of corporate regulation be[ing] overridden."⁹⁷ I am not aware of any state policy allowing trading on information obtained by breaching a duty to the source of the information that would be "overridden" by adoption of the misappropriation theory.⁹⁸

Painter, Krawiec, and Williams's second and third "contradiction" are derived from one point: the deception at issue in a misappropriation case is not deception about the value of securities, but goes to the way that a person obtains information—by breaching a duty to the source of the information. Painter, Krawiec, and Williams may believe that *O'Hagan* erred in refusing to adopt a restrictive reading of "in connection with," but the meaning of "in connection with" was not an issue implicated by the facts of *Santa Fe* or addressed by the Court. It is a stretch to contend that this concern underlies the interpretation of section 10(b) at issue in *Santa Fe*.⁹⁹

In sum, Painter, Krawiec, and Williams's argument seeks to extend the holding and reasoning of *Santa Fe* well beyond the issues decided in that case. Nothing in *Santa Fe* compels rejection of the misappropriation theory.¹⁰⁰

96. *Id.* at 176.

97. *Santa Fe*, 430 U.S. at 479.

98. *Id.* at 479. Further, although Painter, Krawiec, and Williams don't question the validity of the classical theory of insider trading, under their view, that theory would be equally at odds with *Santa Fe*. The duty supporting liability under the classical theory—between corporate insiders and the company's shareholders—derives from state law. Thus the classical theory should be suspect because it "federalizes" a state law duty.

99. The Supreme Court recently rejected a narrow interpretation of the "in connection with" requirement. *See SEC v. Zandford*, 122 S. Ct. 1899, 1903 (2002) ("In its role enforcing the Act, the SEC has consistently adopted a broad reading of the phrase 'in connection with' the purchase or sale of any security." This interpretation of the ambiguous text of section 10(b), in the context of formal adjudication, is entitled to deference if it is reasonable [citation omitted]. For the reasons set forth below, we think it is.").

100. Nor is *O'Hagan* inconsistent with the court's prior decisions in *Dirks v. SEC*, 463 U.S. 646 (1983) and *Central Bank of Denver v. First Interstate Bank of*

2. O'Hagan's Doctrinal Basis for Prohibiting Insider Trading

Substantial dissatisfaction exists among commentators with respect to the Court's rationale, or asserted lack thereof, for holding that the misappropriation theory is a valid basis of liability for securities fraud. Several of these criticisms are addressed below.

Professor Ribstein argues that the *O'Hagan* decision "makes sense only if federal law should protect property rights in information. State law, however, offers better-developed legal rules regarding property rights."¹⁰¹ I disagree with Ribstein's premise that the only rationale for the misappropriation theory is protecting property rights in information. I will not confront this much-debated issue at any length here, but to summarize some of the other plausible rationales advanced for prohibiting insider trading:

- insider trading makes public securities markets inefficient;¹⁰²
- insider trading has a negative effect on investor confidence, diminishing capital formation,¹⁰³ and

Denver, 511 U.S. 164 (1994), as some have argued. See, e.g., Stephen, *supra* note 8, at 318–20. *Dirks* did not involve deceitful misappropriation of information. See *Dirks*, 463 U.S. at 665. *Central Bank* did not address the issue decided in *O'Hagan*—what conduct violates section 10(b)—but rather the question of does a private right of action exist against someone alleged to have aided and abetted a violation of section 10(b). *Central Bank*, 511 U.S. at 191.

101. Ribstein, *supra* note 8, at 123; see also *United States v. Chestman*, 947 F.2d 551, 577 (2d Cir. 1991) (en banc) (Winter, J. concurring in part and dissenting in part) (a "policy rationale for prohibiting insider trading" is protecting "the property rights of a corporation in information"); Bainbridge, *supra* note 8, at 1644 ("Protection of the source of the information's property rights therein is the strongest justification for a continued prohibition of insider trading.").

102. See, e.g., Karmel, *supra* note 8, at 110–11.

A substantial body of academic literature argu[es] that insider trading makes the public securities market inefficient . . . First, allowing such trading would encourage insiders to manipulate corporate decision-making and withhold information from the market. Also, permitting insider trading would discourage research and analysis because the public information available to an analyst would not reflect all of the facts upon which trading is occurring.

Id.

103. See Pritchard, *supra* note 7, at 48 ("[T]he misappropriation theory

—insider trading is morally wrong.¹⁰⁴

In any event, even granting Ribstein's premise, and assuming that states have "better developed rules" regarding property rights, pragmatic concerns counsel against his proposal to leave this issue to the states. It is unlikely that states have the resources to investigate and prosecute major insider trading cases, which often involve conduct that crosses state boundaries.¹⁰⁵ Even more

protects more than just property rights in valuable information. It also protects the integrity of the stock markets and public confidence in those markets."); Weiss, *supra* note 7, at 434 (stating that a "substantial body of economic literature" supports the claim that "rational investors, if they fear that other participants in securities markets have access to superior information, will react by reducing the amount of capital they commit to investments in securities or the price they pay for any given security, which will increase corporations' capital cost."). It is difficult, if not impossible, to prove whether or not investors, in any significant number, would stay out of the market if the misappropriation theory had been held invalid. But let us suppose the Court had decided *O'Hagan* the other way. One can imagine press coverage along these lines: "The Supreme Court holds that insider trading laws do not prohibit stealing secret information about corporate takeovers and trading in the target company's stock." It is possible that some investors would react negatively to such a decision. (I am not claiming that the Court's interpretation of the insider trading prohibitions would outweigh, in any given case, other factors influencing investment decisions. Indeed, during the peak of the last bull market, investors probably would not have been much deterred if the press reported that "the Supreme Court encourages everyone to try to obtain non-public information by fraud and use the information to profit by trading securities.")

104. See Alan Strudler & Eric W. Orts, *Moral Principle in the Law of Insider Trading*, 78 TEX. L. REV. 375, 380, 386 (defending, on moral grounds, the result in *O'Hagan*, but criticizing the Court's rationale); see also Ian B. Lee, *Fairness and Insider Trading*, 2002 COLUM. BUS. L. REV. 119, 191 (2002) ("[A] fair market—a system of cooperative exchange between parties respectful of one another's autonomy—is one in which the parties do not withhold information relevant to their trading partners' decision."); Kim Lane Scheppele, "It's Just Not Right": *The Ethics of Insider Trading*, 56 LAW & CONTEMP. PROBS. 123, 125 (1993) (advocating an "alternative theory of the ethics of insider trading, based on a contractarian framework that focuses on the problem of unequal access to information in securities transactions.").

105. Ribstein states that "even as to misappropriation and other conduct for which there is no federal remedy [under his proposed regime], there is no reason why the SEC could not continue to perform its market surveillance function" and turn over the results of its investigation to state regulators. See Ribstein, *supra*

difficult for states to investigate and prosecute would be cases where illegal conduct takes place outside of the United States, or the proceeds of insider trading are hidden in offshore bank accounts.¹⁰⁶ Further, inefficiencies likely would result from a multiplicity of state rules governing trading in a national market.¹⁰⁷

Professor Karmel faults *O'Hagan* because the Court "did not offer any theoretical justification for banning insider trading or endorsing the misappropriation theory other than that it insures honest securities markets and promotes investor confidence."¹⁰⁸ Karmel contends that because *O'Hagan* "did not develop a broad doctrine or policy rationale," lower courts will have difficulty in "distinguishing between lawful and unlawful outsider trading."¹⁰⁹ In an attempt to clarify the scope of the insider trading prohibition, Karmel proposes that "the ban on insider trading be related to the disclosure obligations of issuers, bidders, and other market participants as a means to enforce those obligations and accelerate the release of material information."¹¹⁰

It seems to me that "insuring honest securities markets" and "promoting investor confidence" are broad policy rationales. In any event, Karmel's view that insider trading regulation should be limited to "enforc[ing] the disclosure obligations of securities

note 8, at 169. This is an idea that probably sounds better in theory than it would work in practice.

106. See DONALD C. LANGEVOORT, INSIDER TRADING REGULATION, ENFORCEMENT AND PREVENTION 14:1 (2002) ("Some of the most notorious insider trading cases that have been prosecuted in the United States . . . have involved substantial offshore activity.").

107. Ribstein acknowledges the potential problem of lack of uniformity, but dismisses it on several grounds: "as long as the law of the incorporating state determines the rights of a corporation and their insiders to corporate information, the stock price could reflect data about the applicable law. See Ribstein, *supra* note 8, at 159. If uniformity is efficient, moreover, data suggest" that states would move towards a uniform rule. See Bainbridge, *supra* note 8, at 1626 (arguing that "if the policy justification for regulation of insider trading is protection of the property rights of the source of the information, however, there is no justification for developing a uniform federal standard.").

108. Karmel, *supra* note 8, at 94.

109. *Id.* at 123 ("[W]hether a family or other non-fiduciary personal relationship will suffice for liability under *O'Hagan* remains to be seen.").

110. *Id.* at 113.

markets participants”¹¹¹ is too narrow. Persons or entities that are not market participants may obtain non-public information by breaching a duty and trading securities to profit (or avoid a loss). The source of the information, if a market participant, has not violated its disclosure obligations, yet probably will be harmed to some extent. Information useful for insider trading—that a security is either undervalued or overvalued because the market lacks certain information—will lose some of its value when the information is used for trading if such trading affects the price of the stock. Although whether this will occur is controversial,¹¹² there are other possible harms to the principal. For example, the principal may be harmed if it is a law firm or financial printer, whose ability to keep information secret has value in itself, independent of any market impact resulting from use of the information. Further, others trading in the market may be harmed as well.¹¹³

Moreover, there is no evidence yet of widespread confusion in the lower courts in dealing with issues arguably left open, or called into question, by *O'Hagan*. For example, in *United States v. Falcone*,¹¹⁴ the defendants argued that *O'Hagan* cast doubt on the Court of Appeals' prior holding in *Libera*,¹¹⁵ a pre-*O'Hagan* case, that someone who informs others of information, but does not himself trade on that information, commits fraud “in connection with” the purchase or sale of a security and therefore violates section 10(b). The court had little difficulty in rejecting this argument:

111. *Id.* at 124.

112. Compare Lee, *supra* note 104, at 164 (persons who base trades on price signals are “harmed by insider trading because they may be misled by the price movements caused by insiders’ trades into perceiving that the securities are misvalued.”), with William J. Carney, *Signaling and Causation in Insider Trading*, 36 CATH. L. REV. 863, 888 (1987) (“[I]nsider trading generally provides only weak signals to traders.”).

113. See William K.S. Wang, *Stock Market Insider Trading Victims, Violators and Remedies—Including an Analogy to Fraud in the Sale of Used Car With a Generic Defect*, 45 VILL. L. REV. 27, 29 (2000) (“[E]ach act of stock market trading has specific victims.”).

114. *United States v. Falcone*, 57 F.3d 226 (2d Cir. 2001).

115. See *United States v. Libera*, 989 F.2d 596 (2d Cir. 1993).

The Supreme Court in *O'Hagan* did not purport to set forth the sole combination of factors necessary to establish the requisite connection in all contexts. Accordingly, this Circuit after *O'Hagan* has applied the misappropriation theory to schemes involving nontrading tipplers, albeit without discussion of the "in connection with" requirement.¹¹⁶ Application of *Libera* to the instant case is therefore not undermined by the lack of a trading tipper here, notwithstanding the intervening decision in *O'Hagan*.¹¹⁷

Other post-*O'Hagan* cases in the courts of appeals, for example *Larrabee*¹¹⁸ and *Sargent*,¹¹⁹ do not reflect confusion in applying the misappropriation theory.

However, one recent District Court decision goes astray as to the proper reach of the misappropriation theory. In *United States v. Kim*,¹²⁰ the government alleged that Defendant Kim belonged to the Young Presidents Organization, an organization of CEOs that required members, as a condition of membership, to agree to keep information obtained through the club confidential.¹²¹ One of the club members, whose company was involved in merger negotiations, could not attend the club's mandatory annual meeting.¹²² He told the retreat moderator the reason for his

116. See *Falcone*, 257 F.3d at 233 (citing *United States v. McDermott*, 245 F.3d 133 (2d Cir. 2001) and applying the theory to hold that sufficient evidence supported insider trading conviction of non-trading tipper—the president, CEO and chairman of an investment bank specializing in mergers and acquisitions—who gave material, non-public information for trading purposes to a woman with whom he was having an affair).

117. See *id.* The court went on to hold that:

O'Hagan's requirement that the misappropriated information "ordinarily" be valuable due to "its utility in securities trading," *O'Hagan*, 521 U.S. at 657, appears to be a more generally applicable factor in determining whether section 10(b)'s "in connection with" requirement is satisfied. That requirement is met in a case where, as here, the misappropriated information is a magazine column that has a known effect on the prices of the securities of the companies it discusses.

Falcone, 257 F.3d at 233–34.

118. *United States v. Larrabee*, 240 F.3d 18 (1st Cir. 2001).

119. *SEC v. Sargent*, 229 F.3d 68 (1st Cir. 2000).

120. *United States v. Kim*, 184 F. Supp. 2d 1006 (N.D. Cal. 2002).

121. *Id.* at 1008.

122. *Id.*

absence, and the moderator informed Kim.¹²³ Kim traded in the company's stock based on this information and tipped others who also traded.¹²⁴

The district court dismissed insider trading charges brought against Kim because it concluded, as a matter of law, that Kim did not owe any fiduciary or similar duty to the other club members.¹²⁵ The court reasoned that a fiduciary or functionally equivalent relationship requires that some measure of "superiority, dominance, or control" on the part of the fiduciary over the other party to the relationship.¹²⁶ The court held that the relationship between the club members was "best characterized as an equal relationship between peers" rather than "a relationship involving a degree of dominance."¹²⁷ The court also rejected the government's contention that the explicit confidentiality agreement gave rise to a fiduciary-type relationship, concluding that the agreement "may memorialize a moral and ethical duty that members undertake, but it does not create a legal one."¹²⁸

The court's reasoning is not persuasive. The "duty" issue in misappropriation cases turns on whether the misappropriator obtained access to confidential information by exploiting the information source's reasonable expectation that information would be kept in confidence. The Second Circuit in *United States v. Chestman* stated that such reliance is justifiable in relationships which are "inherently fiduciary" (e.g., attorney-client, doctor-patient, employer-employee).¹²⁹ These relationships do not

123. *Id.*

124. *Id.* at 1008-09.

125. *Id.*

126. *Id.* at 1011.

127. *Id.* at 1013.

128. *Id.* at 1013.

129. *United States v. Chestman*, 947 F.2d 551, 568 (2d Cir. 1991). Since *O'Hagan* did not address the issue of what types of personal relationships suffice to establish a duty for purposes of the misappropriation theory, the leading case on this issue remains *Chestman*. *Chestman* held that there was insufficient evidence to establish criminal liability based on disclosures between spouses, where there was no express agreement to keep the information confidential nor a past pattern or practice of keeping business information secret. See *Chestman*, 947 F.2d at 567-68.

necessarily involve unequal parties. Further, although the district court claimed to be following *Chestman*,¹³⁰ the court's holding is contrary to *Chestman*'s recognition that an "express agreement of confidentiality" could "itself establish fiduciary status."¹³¹

The district court's decision cannot be "blamed" (assuming one agrees it is incorrect) on anything the Supreme Court said in *O'Hagan*, although it does illustrate that *O'Hagan* could usefully have provided more guidance as to the type of duties sufficient to establish liability under the misappropriation theory. However, there is not yet widespread confusion over applying the misappropriation theory after *O'Hagan*.

Painter, Krawiec, and Williams launch an attack on *O'Hagan*'s rationale from a different perspective. They argue that "a conceptual dilemma stems from the misappropriation theory's failure to address two characteristics" of information "which distinguish it from most other forms of property."¹³² First, "because information is intangible, it is difficult to protect from discovery by others unless the possessor keeps the information to herself, sharing it with no one"; second, "information is a public good. Like many public goods, its use by one or more persons does not reduce the amount remaining for use by others."¹³³ They fault *O'Hagan* because the Court "treats information as tangible and finite."¹³⁴

Both points seem unpersuasive to me. The fact that insider trading is often successful—that is, persons make a profit trading securities based on an informational advantage with respect to others in the market—even though information about proposed corporate transactions almost always will be known by more than

130. See *Kim*, 184 F. Supp. 2d at 1110–12.

131. *Chestman*, 947 F.2d at 571; see also *SEC v. Sargent*, 229 F.3d 68, 75 (1st Cir. 2000) ("In the context of section 10(b) and Rule 10b-5 liability premised on the misappropriation theory, the existence of a fiduciary relationship turns on whether the source of the misappropriated information granted the misappropriator access to the confidential information in reliance on a promise by the misappropriator that the information would be safeguarded.").

132. Painter et al., *supra* note 8, at 182.

133. *Id.*

134. *Id.*

one person, indicates that information often is shared within a limited group and protected. Second, the use of material non-public information may reduce its value, since it is at least possible that unauthorized trading by someone having material non-public information about a company may signal the market and affect the company's stock price, thereby diminishing the future value of the information.¹³⁵

3. O'Hagan's "Unanswered Questions"

Although *O'Hagan* does not provide answers to all of the questions posed by its critics, or even by its supporters,¹³⁶ *O'Hagan's* critics overstate the extent and importance of these unanswered questions. The main "unanswered question" commentators point to is the Supreme Court's failure to specify what types of relationships suffice to establish the duty required by the misappropriation theory.¹³⁷ *O'Hagan* presented easy facts on

135. See *supra* notes 111, 112; see also Stephanie F. Barkholz, Comment, *Insider Trading, the Contemporaneous Trader, and the Corporate Acquirer: Entitlement to Profits Disgorged By the SEC*, 40 EMORY L.J. 537, 559 (1991) ("Studies of takeovers also show that when information is released before the takeover occurs (as in insider trading), the acquirer pays a higher price."); *Litton Indus., Inc. v. Lehman Brothers Kuhn Loeb, Inc.*, 967 F.2d 742, 745 (2d Cir. 1992) (stating that factual issues exist as to whether insider trading in target company stock caused price to rise and therefore injured bidder). But see Lynn A. Stout, *Are Takeover Premiums Really Premiums? Market Price, Fair Value, and Corporate Law*, 99 YALE L.J. 1235, 1277-78 (1990) (finding that it seems unlikely that "investors can decode much information from transactions that may, or may not, be illegal insider trading."); LANGEVOORT, *supra* note 106, at 1:3 ("[T]here is no reason to believe that insider trading will automatically move the market price in any significant fashion. That will occur only where other marketplace participants can 'decode' the trading as involving an insider with a significant informational advantage.").

136. See, e.g., Pritchard, *supra* note 7, at 43-46 (discussing "puzzles in the Misappropriation Theory").

137. See, e.g., Bainbridge, *supra* note 8, at 1634 ("Does a duty to disclose to the information's source arise before trading in all fiduciary relationships?"); Painter et al., *supra* note 8, at 191 ("Unfortunately, the scope of fiduciary duties, particularly outside the traditional corporate insider context, is far from clear."); Swanson, *supra* note 6, at 1209 ("[T]he Court did not explain the scope of

this issue. A lawyer owes well-recognized duties to his or her client.¹³⁸ Similarly, no difficulties are presented with respect to cases involving other employer-employee relationships.¹³⁹ Uncertainty may exist, however, with respect to which personal relationships create a duty of confidentiality.¹⁴⁰

This criticism of *O'Hagan* has some force, as illustrated by the *Kim* decision. However, any uncertainty that exists likely will affect only a relatively small number of cases.¹⁴¹ Moreover, new Commission Rule 10b-5(2) reduces further any potential uncertainty. The rule identifies three situations involving personal relationships in which a duty exists to keep information confidential, for purposes of the misappropriation theory: an express agreement, prior conduct from which an agreement can be inferred, and sharing of information among family members (subject to certain defenses).¹⁴²

Painter, Krawiec, and Williams assert, as an example of the

fiduciary relationships or the nature of the applicable law.”).

138. See, e.g., *United States v. Chestman*, 947 F.2d 551, 568 (2d Cir. 1991).

139. See, e.g., *SEC v. Clark*, 915 F.2d 439 (9th Cir. 1990).

140. See Grzebielski, *supra* note 32, at 488 (“[T]he unsettled question is whether a personal or family relationship can provide a basis for Rule 10b-5 violations.”).

141. See John J. Falvey, Jr., *The New SEC Rules on Insider Trading: The Criminal Implications*, 13 SEC. LITIG. AND REG. REP. 14 (2001) (“*O'Hagan*, like most misappropriation cases, involved a confidential business relationship . . .”).

142. See 17 C.F.R. § 240.10b5-2 (2000). A duty exists:

- (1) Whenever a person agrees to maintain information in confidence;
- (2) Whenever the person communicating the material nonpublic information and the person to whom it is communicated have a history, pattern, or practice of sharing confidences, such that the recipient of the information knows or reasonably should know that the person communicating the material nonpublic information expects that the recipient will maintain its confidentiality; or
- (3) Whenever a person receives or obtains material nonpublic information from his or her spouse, parent, child, or sibling; provided, however, that the person receiving or obtaining the information may demonstrate that no duty of trust or confidence existed with respect to the information, by establishing that he or she neither knew nor reasonably should have known that the person who was the source of the information expected that the person would keep the information confidential, because of the parties' history, pattern, or practice of sharing and maintaining confidences, and because there was no agreement or understanding to maintain the confidentiality of the information.

Id.

"uncertain duties" facing even an attorney possessing confidential information, that "if O'Hagan, instead of trading, had become drunk at a bar and had then, without expecting anything in return for his loose lips, breached his duty to Grand Met by talking about the impending takeover of Pillsbury with a group of lawyers, all of whom trade on the information, nobody—neither O'Hagan nor the other lawyers who traded—would be liable under section 10(b)."¹⁴³

This greatly understates the risk to anyone who traded securities in such circumstances. The SEC has taken the position that, in a misappropriation case, a person who tips others with material non-public information need not obtain any personal benefit to be liable.¹⁴⁴ If, in their hypothetical, O'Hagan acted recklessly, he could face prosecution for breaching a duty to the source of the information, whether or not he got anything in return. Further, if the tippees in this hypothetical knew or should have known that O'Hagan was breaching a duty, they could also be liable. Painter, Krawiec, and Williams mistakenly invoke the district court's decision in *SEC v. Switzer* to support their analysis.¹⁴⁵ *Switzer* involved trading (and tipping) by defendant Switzer after overhearing a conversation between a corporate insider and his spouse. The *Switzer* court determined that the tipper—the corporate insider—was not aware of anyone who might overhear his conversation, and therefore was not reckless.¹⁴⁶ Since tippee liability is derivative of tipper liability, this finding meant that the tippee, Switzer, escaped liability.¹⁴⁷ *Switzer* does not

143. Painter et al., *supra* note 8, at 194.

144. See Brief for the SEC at 40–46, *SEC v. Yun* (11th Cir. 2001) (No. 01-14490HH). In contrast, the Supreme Court held in *Dirks* that, in a case brought under the classical theory, someone who tips is not liable under section 10(b) unless he or she obtains a personal benefit from the tip. *Dirks v. SEC*, 463 U.S. 646, 662 (1983).

145. Painter et al., *supra* note 8, at 194 n.164 (citing *SEC v. Switzer*, 590 F. Supp 756 (W.D. Okla. 1984)).

146. *Switzer*, 590 F. Supp. at 762.

147. *Id.* at 765–66. Liability for insider trading, like liability for any violation of section 10(b) and Rule 10b-5, requires scienter—the intent to manipulate, deceive, or defraud—which includes reckless conduct, but not negligence. See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 n.12 (1976) (requiring scienter); Allan Horwich, *The Neglected Relationship of Materiality and Recklessness in*

stand for the proposition that there can never be liability for an overheard conversation.

Ribstein provides a catalogue of O'Hagan's "unanswered questions,"¹⁴⁸ and at times appears to be stretching to find uncertainties in the Court's decision. For example, Ribstein states that "the Court left unclear whether O'Hagan had to disclose both to his firm and the client."¹⁴⁹ However, the Court stated that where a person trading securities "owes duties of loyalty to two entities or persons—for example, a law firm and its client— but makes disclosure to only one, the trader may still be liable under the misappropriation theory."¹⁵⁰ Ribstein also asks, "Must the misappropriation involve a market participant? The Court suggested that it did but did not clearly so hold."¹⁵¹ Ribstein's support for this contention is that the Supreme Court quoted an article by Aldave "describing *Carpenter [v. United States]* as involving fraud on a non-market participant."¹⁵² However, nothing in the Court's quotation of Aldave suggests that the Court intended this comment to limit the scope of the misappropriation theory.¹⁵³

Actions Under Rule 10b-5, 55 BUS. L. 1023, 1024 (2000) ("Virtually every court that has considered the question has held that scienter includes recklessness.").

148. Ribstein, *supra* note 8, at 136–39.

149. *See id.* at 136.

150. *United States v. O'Hagan*, 521 U.S. 642, 665 n.7 (1997).

151. Ribstein, *supra* note 8, at 137.

152. *Id.* at 137 n.63 (citing Barbara Aldave, *Misappropriation, A General Theory of Liability for Trading on Non Public Information*, 13 HOFSTRA L. REV. 101 (1984)).

153. The Court was simply describing its prior decisions by noting that:

Twice before we have been presented with the question whether criminal liability for violation of section 10(b) may be based on a misappropriation theory. In *Chiarella* . . . the jury had received no misappropriation theory instructions, so we declined to address the question. In *Carpenter v. United States*, . . . the Court divided evenly on whether, under the circumstances of that case, convictions resting on the misappropriation theory should be affirmed.

Barbara Aldave, *The Misappropriation Theory: Carpenter and Its Aftermath*, 49 OHIO ST. L.J. 373, 375 (1988) (observing that "*Carpenter* was, by any reckoning, an unusual case," for the information there misappropriated belonged not to a company preparing to engage in securities transactions, e.g., a bidder in a corporate acquisition, but to the Wall Street Journal).

4. Loopholes in the Regulatory Scheme

A number of critics argue that *O'Hagan* creates gaps in the coverage of the federal securities laws governing insider trading. Some use this criticism as a further basis to challenge the correctness or coherence of the decision; others argue that the Court reached the correct result in *O'Hagan*, but did not extend the law far enough.

Professor Nagy criticizes *O'Hagan* for not reaching the conduct of "the brazen fiduciary"—"fiduciaries who disclose to their principals the fact that they intend to use confidential information in a subsequent securities transaction."¹⁵⁴ Similarly, Karmel points out that "the Court stated that if a fiduciary discloses to his source his plans to trade on nonpublic information, there is no deception and, therefore, no Rule 10b-5 violation."¹⁵⁵ Karmel argues that "this is the weakest part of the Court's opinion simply because it fails to tie the ban against insider trading to the overarching disclosure policies of the securities laws that mandate disclosure to public investors."¹⁵⁶ A related criticism is that *O'Hagan* creates another loophole by allowing authorized trading—trading where the source of information explicitly consents to the use of the information by a person owing a duty to the source. Painter, Krawiec, and Williams consider it a "startling concession" that "the *O'Hagan* decision permits a fiduciary to trade on material non-public information with the consent of the principal."¹⁵⁷

I agree that a gap exists in the reach of the misappropriation theory. Assuming one accepts that insider trading causes harm to market efficiency or capital formation, this harm exists whether or not non-public information is obtained by deception. However, this gap in the theory's coverage is compelled by section 10(b)'s deception requirement. Deception cannot exist if there is full

154. Nagy, *supra* note 8, at 1256–58.

155. Karmel, *supra* note 8, at 95.

156. *Id.*; see also Bainbridge, *supra* note 8, at 1649 (arguing that allowing trading if there is disclosure to the source is inconsistent with both investor protection rationale and property rights).

157. Painter et al., *supra* note 8, at 179.

disclosure by the misappropriator or consent by the source or owner of the information. This gap, however, probably has little practical significance in the corporate setting. The "brazen fiduciary" likely would be fired immediately, and the source or owner of the information could also seek an injunction to prohibit use of the information. Nor does the consent scenario seem likely to occur. Bainbridge asserts that "Suppose, for example, a takeover bidder authorized an arbitrageur to trade in the target company's stock on the basis of material nonpublic information" With respect to liability under 10b-5, *O'Hagan* "at least implicitly validated authorized trading of this sort."¹⁵⁸ There would, however, in the tender offer context, still be potential liability under Rule 14e-3.

On the other hand, *O'Hagan* has been criticized on the ground that, although it reached the correct result on the facts, the Court failed to go far enough in protecting investors. Nagy posits that, with respect to a number of scenarios, the decision is too restrictive.¹⁵⁹ For example, Nagy argues that, under *O'Hagan*, the "non-fiduciary thief" would escape liability.¹⁶⁰ Nagy asserts that *O'Hagan* would allow the computer hacker "who unlawfully gains access to a corporation's internal network and subsequently manages to uncover confidential information" that is "sure to send its stock price soaring" to trade without any potential insider trading liability, assuming that the hacker has "no pre-existing relationship with the corporation."¹⁶¹

Although a "non-fiduciary thief" may be beyond the scope of the section 10(b) insider trading prohibition, Nagy's hypothetical does not admit of a simple answer. Computer hackers, even if they had no pre-existing relationship to a company, may be engaging in deception if they pretend to be someone else in order to gain access to non-public information. That is, suppose a hacker gains access by using a password that the hacker is not authorized to possess. The hacker could be viewed as impersonating the rightful

158. Bainbridge, *supra* note 8, at 1634.

159. Nagy, *supra* note 8, at 1252-59.

160. *Id.* at 1252.

161. *Id.* at 1253.

possessor of the password, and therefore engaging in deception. On the other hand, it might be argued that this conduct is more akin to stealing the key to someone's locked file, in order to get information. That conduct, in itself, is not deceptive. Perhaps the analogy should be to getting several thousand keys made, and trying each in the door of a locked office until access is obtained. But that, again, would not be deceptive.

Nagy is mistaken, however, in arguing that "even if the thief had been a former employee of the company, rather than a stranger," the thief's conduct would not constitute deception because "the former employee would have been a 'non-fiduciary' both at the time he stole the information and at the time he used the information."¹⁶² First, if the "mere thief" is an impostor, as discussed above, the thief engages in deception, whether or not the thief owes a duty to anyone. Second, a former employee owes common law duties to his or her former employer not to steal information obtained during the course of employment.¹⁶³

5. The Decision Reaches Too Far

Many commentators argue that *O'Hagan* reaches too far. Professor Prakash, for example, argues that *O'Hagan* "underscores" the "astonishingly dysfunctional nature" of the federal insider trading regime.¹⁶⁴ Prakash contends that, under the misappropriation theory, "liability should result any time a securities trade deceptively breaches a duty."¹⁶⁵ He asks us to "consider a state government employee who knowingly and secretly violates her state's policy against using government property for personal use by making a securities trade with a

162. *Id.* at 1253-54.

163. *See* SEC v. Cherif, 933 F.2d 403, 411 (7th Cir. 1991). As Nagy points out, breaking into a locked corporate office and stealing information is burglary, but not fraud. *See* Nagy, *supra* note 8, at 1254. This conduct is not actionable under the misappropriation theory, but, it "very rarely" arises that "someone trades on the basis of material information that he has stolen from a person to whom the trader owes no fiduciary duty." Weiss, *supra* note 7, at 438.

164. Prakash, *supra* note 8, at 1491.

165. *Id.* at 1496.

government computer. *O'Hagan* perversely suggests" that this conduct violates Rule 10b-5.¹⁶⁶ According to Prakash, the Supreme Court "unintentionally endorsed a broader theory of liability that completely eclipses the misappropriation theory. Although *O'Hagan* involved material, nonpublic information, *O'Hagan's* reasoning demonstrates that the presence of such information was irrelevant."¹⁶⁷

If this were the law after *O'Hagan*, the wisdom of the decision would be questionable. However, nothing in *O'Hagan* suggests that materiality is no longer relevant.¹⁶⁸ Although the Court did not discuss the issue of materiality, it did describe the misappropriation theory as involving trading based on "material, non-public information."¹⁶⁹ *O'Hagan* provides no basis for concluding that the Supreme Court intended to implicitly abolish this well-established element of liability under section 10(b) and Rule 10b-5.¹⁷⁰

Professors Kerr and Sweeney argue that *O'Hagan's* "test for liability is too broad," because "virtually any relationship can be a basis for liability." They argue that "individuals with no connection or duty to the companies in which they trade are not the corporate insiders Congress intended to target with section 10(b)."¹⁷¹ Kerr and Sweeney do not make a convincing case for this limited reading of Congressional intent with respect to section 10(b). Indeed, they acknowledge that "the purpose of the securities laws is to protect the integrity of the market."¹⁷² Why isn't integrity of the market compromised by trading on secret information, even if the source of the information is not a

166. *Id.*

167. *Id.* at 1532.

168. Material information is information that a reasonable investor would likely consider important. *See Basic v. Levinson*, 485 U.S. 224, 240 (1988).

169. *See, e.g., United States v. O'Hagan*, 521 U.S. 642, 647, 656 (1997).

170. *See, e.g., SEC v. Research Automation Corp.*, 585 F.2d 31, 35 n.8 (2d Cir. 1978) ("One element of a securities fraud action is the materiality of the misleading factual statement or omission.").

171. Kerr & Sweeney, *supra* note 8, at 82.

172. *Id.* at 55.

corporate insider?¹⁷³ Moreover, although corporate insiders trading on information may have been the focus of Congress when it enacted the securities laws, to the extent it considered the issue, nothing in the statute or legislative history demonstrates that Congress would have intended to limit the reach of federal law enforcement to such persons.¹⁷⁴

Several critics argue that the potentially broad reach of *O'Hagan* creates issues of fair notice.¹⁷⁵ This is not a problem on the facts of *O'Hagan*. O'Hagan owed well-established duties to his client and to his employer, and, at the time of his trades (in August and September 1988), the misappropriation theory had been adopted by Second Circuit. Thus, "the statute, either standing alone or as construed, made it reasonably clear at the relevant time that the defendant's conduct was criminal."¹⁷⁶

What about the question of notice going forward, especially in cases not necessarily involving obvious duties such as those existing between lawyers and clients or employees and employers? The Supreme Court, in my view, did give a sufficient answer to this, stating:

173. See *supra* note 102.

174. See Steve Thel, *The Original Conception of Section 10(b) of the Securities Exchange Act*, 42 STANFORD L. REV. 386 (1990) (stating that Congress, in enacting section 10(b), intended to confer "open-ended rulemaking authority on the SEC.").

175. See, e.g., Bainbridge, *supra* note 8, at 1644 n.242 ("The uncertainty created as to Rule 10b-5's parameters fairly raises vagueness and related due process issues, despite the majority's rather glib dismissal of such concerns."); Dessent, *supra* note 8, at 1192 ("[T]o the extent that the pro-prosecutorial language of the majority can be read as encouraging the SEC to fashion new theories of criminal culpability without federal legislation, the court raises . . . issues of fair notice of criminal sanctions.").

176. *United States v. Lanier*, 520 U.S. 259, 267 (1997). Dessent's assertion that "O'Hagan surely believed that he was complying with the *Dirks* and *Chiarella* rationale when he traded on the information he attained regarding Grand Met's desire to take over Pillsbury" is not plausible, and even if true, is irrelevant. Dessent, *supra* note 8, at 1202. O'Hagan, as an experienced securities lawyer, must have known that the Second Circuit had held that section 10(b) and Rule 10b-5 prohibit misappropriating information from a bidder and trading securities of a target company.

To establish a criminal violation of Rule 10b-5, the Government must prove that a person "willfully" violated the provision Furthermore, a defendant may not be imprisoned for violating Rule 10b-5 if he proves that he had no knowledge of the Rule. O'Hagan's charge that the misappropriation theory is too indefinite to permit the imposition of criminal liability . . . thus fails not only because the theory is limited to those who breach a recognized duty. In addition, the statute's "requirement of the presence of culpable intent as a necessary element of the offense does much to destroy any force in the argument that application of the [statute]" in circumstances such as O'Hagan's is unjust.¹⁷⁷

In addition, the issue of when personal relationships create a duty for purposes of the misappropriation theory has now been addressed by Rule 10b-5(2). Although the Rule has been criticized,¹⁷⁸ it does provide notice of conduct that may expose persons to criminal prosecution.

CONCLUSION

The Supreme Court in *O'Hagan* correctly resolved an important issue as to the scope of the insider trading prohibition under the antifraud provisions of the federal securities laws. The disparaging view of *O'Hagan* advanced by most of the commentators is not warranted. Although commentators have identified some uncertainties as to the scope of the *O'Hagan* decision, as well as an arguable lack of depth in some parts of the Court's analysis, they have not undermined the central points of *O'Hagan's* legal analysis and policy rationale. Based on my survey of the literature, I think that commentators, taken as a whole, would give the Supreme Court a grade of D, at best. I would give the Court an A-.

177. *United States v. O'Hagan*, 521 U.S. 642, 666 (1997) (footnotes and citations omitted); *see also, e.g., SEC v. Willis*, 777 F. Supp. 1165, 1173 (S.D.N.Y. 1991) (rejecting "lack of notice" defense in a case involving a psychiatrist's misappropriation of confidential information disclosed to him by a patient).

178. *See* Bach Hang, Note, *The SEC's Criminal Rulemaking in Rule 10b5-2: Incarceration Should Be Made of Sterner Stuff*, 41 WASHBURN L. J. 629 (2002).