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## FIDUCIARIES, MISAPPROPRIATORS AND THE MURKY OUTLINES OF THE DEN OF THIEVES: A CONCEPTUAL CONTINUUM FOR ANALYZING *UNITED STATES v. O'HAGAN*\*

Kimberly D. Krawiec†

*And Jesus went into the temple of God, and cast out all them that sold  
and bought in the temple, and overthrew the tables of the moneychangers,  
and the seats of them that sold doves.*

*And said unto them, It is written, My house shall be called the house of  
prayer; but ye have made it a den of thieves.*<sup>1</sup>

In July 1988, Grand Metropolitan PLC (“Grand Met”) retained the Minneapolis law firm of Dorsey and Whitney as local counsel in connection with a proposed tender offer for the common stock of the Pillsbury Company (“Pillsbury”).<sup>2</sup> James Herman O’Hagan, a Dorsey and Whitney partner not directly involved in the Grand Met representation, allegedly learned of Grand Met’s plans from another partner in the firm and purchased 2,500 Pillsbury call options and 5000 shares of Pillsbury common stock.<sup>3</sup> When Grand Met announced its tender offer for Pillsbury common stock in October of 1988,

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\* 117 S.Ct. 2199 (1997). Based on remarks delivered at the Conference, *Practitioner’s Guide to the October 1996 Supreme Court Term*, at the University of Tulsa College of Law, October 31, 1997.

† Assistant Professor of Law, University of Tulsa; Visiting Assistant Professor of Law, University of Oregon. Much of the research for this article was undertaken in the course of preparing an *amicus* brief, Brief of *Amici Curiae* Law Professors and Lawyers in Support of Respondent, *United States v. O’Hagan*, 117 S.Ct. 2119 (1997)(No. 96-842), and an article, Richard W. Painter, Kimberly D. Krawiec & Cynthia A. Williams, *Don’t Ask, Just Tell: Insider Trading after United States v. O’Hagan*, 84 VA. L. REV. \_\_\_\_ (forthcoming 1998) (copy on file with author). I would thus like to thank my co-authors in those endeavors, Richard W. Painter and Cynthia A. Williams. I would also like to thank David Cramer and Jason Pinson for their analytical input and research assistance in connection with this article.

1. JAMES B. STEWART, *DEN OF THIEVES* 8 (1992) (quoting Matthew 21:12-13, King James).

2. See *O’Hagan*, 117 S.Ct. at 2205.

3. See *id.* O’Hagan challenged the sufficiency of the evidence that he traded on the basis of nonpublic information, citing in his defense news reports published on August 18 and 22, 1988, which disclosed that Grand Met was interested in acquiring Pillsbury, and an August 12, 1988, report that Grand Met had decided to sell its hotel chain in order to raise funds for an acquisition. O’Hagan’s challenge to the sufficiency of the evidence remains open for consideration on remand. See *id.* at 2205 n.1.

O'Hagan sold his stock and call options for a profit in excess of \$4.3 million.<sup>4</sup> A subsequent Securities and Exchange Commission (the "Commission") investigation resulted in a 57-count indictment against O'Hagan, including 20 counts of mail fraud,<sup>5</sup> 17 counts of securities fraud in violation of section 10(b) of the Securities Exchange Act of 1934 (the "Exchange Act") and Rule 10b-5 thereunder,<sup>6</sup> 17 counts of fraudulent trading in connection with a tender offer in violation of section 14(e) of the Exchange Act and Rule 14e-3(a) thereunder<sup>7</sup> and 3 counts of violating federal money laundering statutes.<sup>8</sup> O'Hagan was convicted on all 57 counts and sentenced to 41 months in prison.<sup>9</sup>

A divided panel of the Court of Appeals for the Eighth Circuit reversed all of O'Hagan's convictions.<sup>10</sup> In finding that liability under section 10(b) and rule 10b-5 cannot be grounded on the "misappropriation theory" because it requires neither a "deception" nor a "connection with the purchase or sale of a security," the Eighth Circuit became the second Court of Appeals to reject the theory, exacerbating the split among the circuits.<sup>11</sup> When the Supreme Court granted *certiorari* to resolve this split among the circuits, I, along with other securities law professors and practitioners, filed an *amicus* brief urging the Court to affirm the Eighth Circuit's rejection of the misappropriation theory.<sup>12</sup> We took this action, not because we condoned O'Hagan's conduct (in fact we strongly condemn an attorney's use of confidential information for personal profit) nor because we harbored doubts as to O'Hagan's potential guilt. Rather, we were motivated to file as *amici curiae* by our concern with the logic and predictability of case law under the misappropriation theory, our belief that Congress, not the courts, is the proper government body to fill any perceived gaps in section 10(b) and our understanding that other civil and criminal penal-

4. See *id.* at 2205. The government's indictment charged that O'Hagan used these profits to conceal earlier acts of embezzlement and conversion of client funds. See *id.*

5. See 18 U.S.C. §1341 (1995).

6. See 15 U.S.C. §78j(b) (1995); 17 CFR §240.10b-5 (1996).

7. See 15 U.S.C. §78n(e) (1995); 17 CFR §240.14e-3(a) (1996).

8. See 18 U.S.C. §§1956(a)(1)(B)(i), 1957 (1994); *O'Hagan*, 117 S.Ct. at 2205.

9. See *O'Hagan*, 117 S.Ct. at 2205. In connection with the alleged embezzlement and conversion of client funds, O'Hagan was also convicted of theft in state court, fined and sentenced to 30 months in prison. O'Hagan was also disbarred from the practice of law by the Supreme Court of Minnesota. *Id.* at 2205 n.2.

10. See *United States v. O'Hagan*, 92 F.3d 612 (1996).

11. The Fourth Circuit rejected the misappropriation theory in *United States v. Bryan*, 58 F.3d 933 (4th Cir. 1995). In contrast, the theory had been explicitly adopted by the Second, Seventh and Ninth Circuits. See, e.g., *United States v. Chestman*, 947 F.2d 551, 566 (2nd Cir. 1991) (en banc), 503 U.S. 1004 (1992); *SEC v. Cherif*, 933 F.2d 403, 410 (7th Cir. 1991), 502 U.S. 1071 (1992); *SEC v. Clark*, 915 F.2d 439, 453 (9th Cir. 1990). In addition the Third Circuit, while not using the word "misappropriation," arguably adopted the theory in *Rothberg v. Rosenbloom*, 771 F.2d 818, 822 (3d Cir. 1982), *rev'd on other grounds*, 808 F.2d 252 (1986), 481 U.S. 1017 (1987) (although not an insider of the issuer, defendant could be liable for insider trading because he owed a fiduciary duty not to disclose material nonpublic information to a corporation party to the "underlying proposed transaction").

The Eighth Circuit reversed O'Hagan's Rule 14e-3 convictions on the grounds that the Rule exceeds the Commission's rulemaking authority because it does not require a breach of fiduciary duty to impose liability, and reversed the mail fraud and money laundering convictions on the grounds that these convictions rested on the securities convictions and could not be sustained once the securities convictions had been reversed. See *O'Hagan*, 117 S.Ct. at 2206.

12. See Brief of *Amici Curiae* Law Professors and Counsel in Support of Respondent, *United States v. O'Hagan*, 117 S.Ct. 2199 (1997)(No. 96-842).

ties are available against most persons charged with trading on the basis of material nonpublic information.<sup>13</sup>

The Court, however, reversed the Eighth Circuit in a 6-3 decision, holding that the misappropriation theory is consistent with both the language and the purpose of section 10(b). This article will demonstrate the error of the Court's decision. Part I of this article sets forth a conceptual continuum for analyzing *O'Hagan* and shows that the misappropriation theory is a misguided judicial attempt to steer the middle ground in the absence of legislative guidance. Part II demonstrates that the misappropriation theory is unsupported by the language and purpose of the Exchange Act and by prior Court decisions, and that application of the theory leads to inconsistent and sometimes undesirable results. Part III concludes that the Court should have affirmed the Eighth Circuit's rejection of the misappropriation theory, thus inviting Congress to amend the Exchange Act if it feels that the prohibition of trading while in possession of material nonpublic information is necessary in order to protect the integrity of the securities markets.

## I. THE CONCEPTUAL CONTINUUM

The issue at the heart of *O'Hagan* is a simple one: when will we allow individuals to play the game of securities trading when they possess information that other players do not have and cannot get, no matter how much effort they put forth? Although there are only three possible answers to this question—always, never and sometimes—settling on a satisfying and workable choice is, nonetheless, surprisingly difficult.

In analyzing the possible ways in which the law could treat those who trade while in possession of informational advantages, it may be helpful to conceptualize the possibilities as a continuum. At one end, the "free market in information" level, the law could allow all trading while in possession of material nonpublic information. At the other end, the "parity of information" level, the law could allow no trading while in possession of material nonpublic information. In between these two extremes are a multitude of possibilities, including the misappropriation theory adopted by the Court in *United States v. O'Hagan*.

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13. See *id.* Specifically, federal mail (18 U.S.C. §1341) and wire fraud (18 U.S.C. §1343 (1994)) statutes could be invoked against most persons accused of misappropriating material nonpublic information. See, e.g., *Carpenter v. United States*, 484 U.S. 19 (1987) (unanimously affirming mail fraud conviction of Wall Street Journal reporter for misappropriation of information prior to its publication in popular column); *Chestman*, 947 F.2d at 571 ("A scheme to misappropriate material nonpublic information in breach of a fiduciary duty of confidentiality may indeed constitute a fraudulent scheme sufficient to sustain a mail fraud conviction."). See also *United States v. Ruggiero*, 56 F.3d 647 (5th Cir. 1995); *United States v. Newman*, 664 F.2d 12 (2d Cir. 1981); *United States v. Willis*, 737 F.Supp. 269 (S.D.N.Y. 1990); *United States v. Grossman*, 843 F.2d 78, 86 (1988).

The mail and wire fraud statutes prohibit the use of the mails or of wire communication to further a "scheme to defraud." 18 U.S.C. §§1341, 1343. The two statutes are interpreted similarly. See, e.g., *Carpenter*, 484 U.S. at 25 n.6 ("The mail and wire fraud statutes share the same language in relevant part, and accordingly we apply the same analysis to both sets of offenses here.").

### A. The "Free Market in Information" Theory

At one end of the conceptual continuum, the "free market in information" level, the law could allow all trading while in possession of material nonpublic information. At least at the federal level, and perhaps at the state level as well, this was the position of the law prior to the enactment of the Exchange Act.<sup>14</sup>

The debate among academicians as to the relative costs and benefits of a rule that allows all trading while in possession of material nonpublic information is both intense and long-standing.<sup>15</sup> Proponents of a free market in information rule argue that insider trading provides important incentive compensation for management,<sup>16</sup> while trading on the basis of material nonpublic information hastens the communication of information to the marketplace, thus promoting allocational efficiency.<sup>17</sup> Both of these rationales have been highly criticized.<sup>18</sup> Those opposed to a free market in information rule have argued that a legal standard permitting trading while in possession of material nonpublic information would have many harmful effects, including: harm to the stock market due to erosion of investor confidence,<sup>19</sup> harm to the issuing corporation,<sup>20</sup> harm to the trader's employer (when the employer is not the issuer)<sup>21</sup>

14. The common law "majority" rule is that officers and directors of the corporation owe a fiduciary duty to the shareholders of that corporation only when dealing "with or on behalf of the corporation." Under the majority rule, corporate insiders are thus free to trade in the stock of their corporations without any affirmative disclosure obligations, so long as they do not engage in any half-truths or affirmative misrepresentations. By contrast, the "minority" rule holds that corporate insiders are subject to a fiduciary duty of full disclosure of all material facts when dealing with the shareholders of their corporation. See LOUIS LOSS, *FUNDAMENTALS OF SECURITIES REGULATION* 818-19 (1983); WILLIAM K.S. WANG AND MARC I. STEINBERG, *INSIDER TRADING* 1108, 1111 (1996). Most states that employ the majority rule also recognize the "special facts" doctrine articulated by the Supreme Court in *Strong v. Repide*, 213 U.S. 419 (1909) (controlling shareholder and general manager of corporation guilty of fraud in purchasing securities from a minority shareholder without disclosure of the status of ongoing negotiations for profitable contract with the Philippine government due to special facts such as the controlling shareholder's insider status and consequent special knowledge of the company). See LOSS at 819. There is little debate that today the "majority" rule is not followed in a majority of states. There is, however, significant debate as to when the "minority" rule became the predominant rule. See WANG & STEINBERG at 1111 n.12 ("Commentators have disagreed over whether the 'majority rule' was, in fact, followed in the majority of states at the time of the enactment of the Securities Exchange Act of 1934."); see LOSS at 819 ("In actual results the old 'majority rule' has substantially merged into the 'special circumstances' doctrine, which in turn is scarcely distinguishable from the so-called 'minority' rule." (footnote omitted)).

15. For a summary of the debate see WANG & STEINBERG, *supra* note 14, at chapter 2. See also Charles C. Cox & Kevin S. Fogarty, *Bases of Insider Trading Law*, 49 OHIO ST. L.J. 353, 354-60 (1988); Boyd Kimball Dyer, *Economic Analysis, Insider Trading, and Game Markets*, 1992 UTAH L.REV. 1, 11-39 (1992).

16. See, e.g., H. MANNE, *INSIDER TRADING AND THE STOCK MARKET* 111-58 (1966); Dennis W. Carlton & Daniel R. Fischel, *The Regulation of Insider Trading*, 35 STAN. L. REV. 857 & n.1 (1983).

17. See Anthony T. Kronman, *Mistake, Disclosure, Information, and the Law of Contracts*, 7 J. LEGAL STUD. 1, 13 (1978).

18. See, e.g., 7 LOUIS LOSS AND JOEL SELIGMAN, *SECURITIES REGULATION* 3460-62 (3d ed. 1991); W. PAINTER, *THE FEDERAL SECURITIES CODE AND CORPORATE DISCLOSURE* §5.10 at 235-50 (1979); Lynn A. Stout, *The Unimportance of Being Efficient: An Economic Analysis of Stock Market Pricing and Securities Regulation*, 87 MICH. L. REV. 613, 637 & n.130 (1988).

19. See, e.g., PAINTER, *supra* note 18, at 235-50; 7 LOSS & SELIGMAN, *supra* note 18, at 3452-54.

20. See, e.g., Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 632-33 n.221 (1984); Robert J. Haft, *The Effect of Insider Trading Rules on the Internal Efficiency of the Large Corporation*, 80 MICH. L. REV. 1051 (1982).

21. See WANG & STEINBERG, *supra* note 14, at §2.3.3.

and harm to individual investors.<sup>22</sup>

### B. Early Limits on the Free Market in Information Theory

Congress placed the first limits on this free market in information in 1934 when it included § 16 as part of the Exchange Act, forcing the disclosure by certain corporate insiders of their dealings in shares of their own corporations and the disgorgement of “short swing” profits from certain such trades.<sup>23</sup> Although § 16 is very limited in scope, it represented the first Congressional attempt to proscribe the use of confidential information for profit by corporate insiders of the issuer.<sup>24</sup>

It is notable that the text of § 10(b) did not, and does not today, even mention insider trading.<sup>25</sup> Although the 1934 Congress' concern with insider trading is evidenced by the inclusion of § 16 in the Exchange Act, it seems unlikely that Congress specifically intended § 10(b) to apply to insider trading.<sup>26</sup> Commentators have, in fact, argued that Congress originally intended to regulate insider trading only through § 16 and regarded § 10(b) as a “catch all” provision designed to combat more generic forms of “manipulative or deceptive” conduct.<sup>27</sup>

For many years the federal courts addressed insider trading only through § 16's disclosure and disgorgement requirements.<sup>28</sup> Because § 16 proscribes trading only by *certain* insiders in *certain* instances, however, it was felt that a broader ban against trading while in possession of material nonpublic information was needed.<sup>29</sup> Lacking a specific legislative prohibition against such conduct, the Commission and federal courts seized on section 10(b) and rule 10b-5 thereunder, and began in the early 1940's to impose on corporate insiders an affirmative duty to disclose material nonpublic information in face-to-face transactions.<sup>30</sup> Although there was initially some doubt as to whether this rule also

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22. *See id.*

23. *See* 15 U.S.C. §78p(a)-(c) (1994). “Short swing” profits are profits from a purchase and sale or sale and purchase within any six month period. *See id.* at (b).

24. *See* WANG & STEINBERG, *supra* note 14, at 995, 997.

25. Section 10(b) reads as follows:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange . . . (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. §78j(b).

26. *See* Painter et al., *supra* note †.

27. *See id.*

28. *See id.*

29. Section 16, for example, applies only to issuers with a class of securities registered under § 12 of the Exchange Act; applies only to persons who are the beneficial owner of more than 10 % of any class of equity security of the issuer or who are officers or directors of the issuer; applies only where there is a purchase and sale, or sale and purchase, within a six-month period; imposes liability based on the profits of the insider, rather than on losses to other investors; and is enforceable only through actions brought by or on behalf of the issuer, rather than through actions brought by the Commission or other investors. *See* WANG & STEINBERG, *supra* note 14, at 997 (quoting DAVID RATNER, *SECURITIES REGULATION: MATERIALS FOR A BASIC COURSE* 363-64 (2d ed. 1980)).

30. *See, e.g.,* Kardon v. National Gypsum Co., 73 F.Supp. 798, 800 (E.D. Pa. 1947) (“Under any rea-

applied to “faceless” transactions conducted on an exchange,<sup>31</sup> the standard was explicitly extended by the Commission and the federal courts in the 1960’s to hold trading in the public markets while in possession of material nonpublic information a violation of § 10(b) of the Exchange Act.<sup>32</sup>

### C. *The Classical Theory*

Out of these cases developed what later became known as the “classical theory” of insider trading. As the Supreme Court defined the theory in *O’Hagan*:

Under the “traditional” or “classical theory” of insider trading liability, § 10(b) and Rule 10b-5 are violated when a corporate insider trades in the securities of his corporation on the basis of material, nonpublic information. Trading on such information qualifies as a “deceptive device” under § 10(b), we have affirmed, because “a relationship of trust and confidence [exists] between the shareholders of a corporation and those insiders who have obtained confidential information by reason of their position with that corporation.”<sup>33</sup>

Both *Cady, Roberts & Co.* and *Texas Gulf Sulphur* emphasized the unfairness of allowing corporate insiders to profit from their special access to material nonpublic information.<sup>34</sup> There are numerous other parties, however, who regularly come into contact with such information: employees of law firms, accountants and their staff, financial printers, taxicab drivers, etc. The classical theory gives no guidance as to how the law should deal with the trading activities of these corporate “outsiders” who, nonetheless, have frequent access to material nonpublic information.

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sonably liberal construction, these provisions [§10(b) and Rule 10b-5] apply to directors and officers who, in purchasing the stock of the corporation from others, fail to disclose a fact coming to their knowledge by reason of their position, which would materially affect the judgement of the other party to the transaction.”); *Ward LaFrance Truck Corp.*, 13 S.E.C. 373 (1943) (published report of Commission investigation finding violation of Rule 10b-5 by two controlling officers of Ward La France who purchased shares in the over-the-counter market through a broker when neither the identity of purchasers nor fact that earnings had substantially improved since last earnings statement was revealed); *Speed v. Transamerica Corp.*, 99 F.Supp. 808, 829 (D.Del. 1951) (“It is unlawful for an insider, such as a majority stockholder, to purchase the stock of minority stockholders without disclosing material facts affecting the value of the stock, known to the majority stockholder by virtue of his inside position but not known to the selling minority stockholders, which information would have affected the judgement of the sellers.”). See also LOUIS LOSS, *SECURITIES REGULATION* 827-39 (1951).

31. See LOSS, *supra* note 30, at 833.

32. See *SEC v. Cady, Roberts & Co.*, 40 S.E.C. 907 (1961); *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 848 (2d Cir. 1968); *Painter et al.*, *supra* note †.

33. *United States v. O’Hagan*, 117 S.Ct. 2199, 2207 (1997) (quoting *Chiarella v. United States*, 445 U.S. 222, 228 (1980)). For analysis of the early development of the prohibition against trading on the basis of material nonpublic information under Rule 10b-5 and section 10(b), see Donald Langevoort, *Insider Trading and the Fiduciary Principle: A Post-Chiarella Restatement*, 70 CAL. L. REV. 1 (1982); William L. Cary et al., *Insider Trading in Stocks*, 21 BUS. LAW 1009 (1965).

34. COX ET AL., *SECURITIES REGULATION* 776 (1997).

#### D. The Parity of Information Theory

Until 1980, many courts and commentators interpreted § 10(b) to extend this duty of disclosure, not only to insiders of the issuer, but to *all persons* in possession of material nonpublic information.<sup>35</sup> As the court stated in *SEC v. Texas Gulf Sulphur*: “Thus, *anyone* in possession of material inside information must either disclose it to the investing public, or . . . must abstain from trading in or recommending the securities concerned while such inside information remains undisclosed.”<sup>36</sup> This state of the law represents the other end of the conceptual continuum—the “parity of information” theory, which allows no trading while in possession of material nonpublic information.

By the time *Chiarella v. United States*<sup>37</sup> was decided in 1980, therefore, federal law had progressed from a free market in information state, imposing no limits on the ability of those in possession of material nonpublic information to profit from their advantage; to a state of regulation envisioned by § 16, imposing *certain* limits on *certain* corporate insiders; to the very early § 10(b) cases, imposing on insiders a duty to disclose material nonpublic information in face-to-face transactions; to *Cady, Roberts & Co.* and *Texas Gulf Sulphur*, imposing on all persons an affirmative duty of disclosure.

The Supreme Court, however, eliminated the parity of information theory from the continuum with its decision in *Chiarella*. *Chiarella*, the employee of a financial printer retained by hostile tender offerors, had traded in the stock of target companies whose names he had discerned during the course of his employment (despite attempts by the tender offeror to conceal the identities of the target corporations through the use of blank spaces and false names).<sup>38</sup> Although the Second Circuit had held *Chiarella* liable under a parity of information theory,<sup>39</sup> the Supreme Court reversed, holding that “[w]hen an allegation of fraud is based upon nondisclosure, there can be no fraud absent a duty to speak.”<sup>40</sup> Such a duty cannot “arise from petitioner’s relationship with the sellers of the target company’s securities, for petitioner had no prior dealings with them. He was not their agent, he was not a fiduciary, he was not a person in whom the sellers had placed their trust and confidence.”<sup>41</sup>

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35. Painter et al., *supra* note †.

36. *Texas Gulf Sulphur Co.*, 401 F.2d at 848 (emphasis added).

Analytically, the [disclose or abstain] obligation rests on two principal elements; first, the existence of a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone, and second, the inherent fairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing.

*Cady, Roberts & Co.*, 40 S.E.C. at 912.

37. 445 U.S. 222 (1980).

38. *See id.* at 224.

39. “Its [the Second Circuit’s] decision thus rested solely upon its belief that the federal securities laws have ‘created a system providing equal access to information necessary for reasoned and intelligent investment decisions.’ The use by anyone of material information not generally available is fraudulent, this theory suggests, because such information gives certain buyers or sellers an unfair advantage over less informed buyers and sellers.” *Id.* at 232 (quoting *United States v. Chiarella*, 588 F.2d 1358, 1362 (1978)).

40. *Id.* at 235.

41. *Id.* at 232.



The Court distinguished *Cady, Roberts & Co.* and *Texas Gulf Sulphur*, noting that those cases imposed a disclosure obligation on corporate insiders in their dealings with the corporation's stockholders due to the "relationship of trust and confidence" owed by a corporate insider to her shareholders.<sup>42</sup> *Chiarella* thus narrowed the potential band of the conceptual continuum, holding, in effect, that the band does not include either the parity of information theory or the free market in information theory, but does include at least the classical theory of insider trading. The Court left open, however, the question of exactly where along the continuum the prohibition against trading while in possession of material nonpublic information fell.<sup>43</sup>

The Commission responded to *Chiarella* by enacting Rule 14e-3, which prohibits trading by one in possession of material nonpublic information relating to a tender offer when the possessor knows or has reason to know the information is nonpublic and was received from the offeror, the target, any affiliate of the offeror or target, or any person acting on behalf of either the offeror or the target.<sup>44</sup> Because this broad "disclose or abstain" rule does not depend on a fiduciary or other relationship of trust and confidence between the trader and the source of the information, the Commission has, at least in the tender offer arena, restored the parity of information theory to our conceptual continuum.<sup>45</sup>

### E. The Middle Ground: Misappropriation Theory

Outside of the tender offer context, however, the Commission was seemingly left without a weapon to combat trading by corporate outsiders on the basis of material nonpublic information. Seizing on language contained in Justice Steven's concurrence in *Chiarella*, however, the Commission and the Courts forged a new level in the conceptual continuum: a middle ground between the classical theory endorsed by the Court in *Chiarella* and the parity of information theory which It had rejected. This middle ground later became known as the "misappropriation theory".

The misappropriation theory arose out of Justice Steven's concurrence in *Chiarella*:

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42. See *id.* at 230. Justice Powell emphasized repeatedly that the duty to disclose arose from a relationship of trust and confidence with the other party to the securities trade: "[A] purchaser of stock who has no duty to a prospective seller because he is neither an insider nor a fiduciary has been held to have no obligation to reveal material facts." *Id.* at 229. See also WANG & STEINBERG, *supra* note 14, at 287-88 ("In exonerating *Chiarella*, Justice Powell repeatedly emphasized that *Chiarella* had no special relationship with those who sold to him.").

43. Although liability based on the misappropriation theory had been argued by the government as an alternative basis of liability, the Court refused to address the issue on the grounds that the theory had not been presented to the jury. See *Chiarella*, 445 U.S. at 235-37.

44. See 17 C.F.R. §240.14e-3. Rule 14e-3 was enacted pursuant to the Commission's rule-making authority under §14(e) of the Exchange Act. Section 14(e) states in relevant part: "The Commission shall, for the purposes of this subsection, by rules and regulations define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive and manipulative." 15 U.S.C. §78n(e).

45. Although the validity of Rule 14e-3 was also at issue in *O'Hagan*, this article is limited to an analysis of the Court's interpretation of the misappropriation theory under Rule 10b-5 and section 10(b) and does not address that portion of the Court's opinion upholding the Commission's authority to enact Rule 14e-3.

On the one hand, if we assume that petitioner breached a duty to the acquiring companies that had entrusted confidential information to his employers, a legitimate argument could be made that his actions constituted "a fraud or a deceit" upon those companies "in connection with the purchase or sale of any security." On the other hand, inasmuch as those companies would not be able to recover damages from petitioner for violating Rule 10b-5 because they were neither purchasers nor sellers of target company securities, it could also be argued that no actionable violation of Rule 10b-5 had occurred. I think the Court wisely leaves the resolution of this issue for another day.<sup>46</sup>

The Court did, wisely or unwisely, leave the resolution of this issue for a much later day. Although the Court was again confronted with the misappropriation theory in 1987 in *Carpenter v. United States*,<sup>47</sup> the Court, without issuing a written opinion, divided evenly on the issue.<sup>48</sup> Thus it was not until *O'Hagan* was decided, seventeen years after the misappropriation theory was first presented to the Court, that the Court affirmed the theory and firmly set the line separating legal from illegal conduct at this midpoint along the conceptual continuum.

## II. CRITICISM OF THE MISAPPROPRIATION THEORY

### A. *The Misappropriation Theory Is Unsupported By The Language Of Section 10(b)*

Although one may sympathize with the Court's concern that the classical theory alone adequately protects neither investors nor the integrity of the marketplace from those who trade while in possession of material nonpublic information, as previously discussed, the theory is unsupported by the language of section 10(b).<sup>49</sup> In particular, the misappropriation required to impose liability under section 10(b) is arguably not "in connection with" the purchase or sale of a security, as required by the statute. The *O'Hagan* Court initially asserts that this requirement has been met because the purchase or sale of securities is the normal, or most common, use to which such information would be put.<sup>50</sup> The Court thus seeks to distinguish the misappropriation of information from the embezzlement of funds for the purpose of securities trading: "In other words, money can buy, if not anything, then at least many things; its misappropriation

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46. *Chiarella*, 445 U.S. at 238 (citations omitted). Justice Stevens agreed with the Court's decision, however, that the issue of misappropriation had not been presented to the jury. *See id.*

47. 484 U.S. 19 (2d Cir. 1987). In *Carpenter*, the Second Circuit had upheld the conviction under the misappropriation theory of a stockbroker, Kenneth P. Felis, and a newspaper reporter, R. Foster Winans, who wrote the popular "Heard on the Street" column for the Wall Street Journal. Winans, in violation of a known Wall Street Journal policy, provided Felis and another stockbroker with advance information of material that was to appear in the column. The Supreme Court split 4-4 on the application of the misappropriation theory to the case, thus allowing the convictions to stand. *Id.* at 22-24.

48. *See id.* at 24.

49. *See supra* notes 25-27 and accompanying text.

50. *See United States v. O'Hagan*, 117 S.Ct. 2199, 2210 (1997).

may thus be viewed as sufficiently detached from a subsequent securities transaction that § 10(b)'s 'in connection with' requirement would not be met."<sup>51</sup>

Justice Thomas easily shows the absurdity of this argument in his dissent: misappropriated information can be, and probably is, put to many uses other than securities trading.<sup>52</sup> Justice Thomas fails, however, to adequately address the majority's second argument: that misappropriation of information differs from embezzlement of funds because, in the case of embezzlement, the wrongdoing takes place at the moment the money is converted. In the case of misappropriation, however, the wrongdoing takes place only when the securities trade is made.<sup>53</sup> The same could be said, however, of a trustee who, although entrusted with the management of funds on the sole condition that the funds not be invested in securities, nonetheless uses the trust funds to purchase securities. In such a case, the trustee's misuse of the trust funds, like O'Hagan's misappropriation, is inseparable from the act of purchasing securities. Neither the majority nor the dissent, however, seek to distinguish the hypothetical trustee's conduct, which clearly is not a violation of section 10(b), from O'Hagan's conduct.<sup>54</sup>

#### *B. The Misappropriation Theory Is Unconnected With the Primary Purposes of the Exchange Act*

In addition, the misappropriation theory is unconnected with the primary purposes of the Exchange Act: investor protection and the integrity of the securities markets.<sup>55</sup> The misappropriation theory predicates liability on the breach of a duty owed to the principal in a fiduciary relationship, regardless of whether or not the principal has any interest in the securities being traded or is even a market participant at all. From the perspective of investors, the existence or nonexistence of a fiduciary duty and subsequent breach is irrelevant. If, in fact, investors are unfairly cheated when one party trades with informational advantages not available to others, the unfairness is present regardless of the breach of any fiduciary relationship owed to some third party, particularly when that

51. *Id.* at 2209.

52. *See id.* at 2223 (Thomas, J., dissenting) (information may be sold to the press or competitors, or used in a fantasy trading game).

53. "This element is satisfied because the fiduciary's fraud is consummated, not when the fiduciary gains the confidential information, but when, without disclosure to his principal, he uses the information to purchase or sell securities. The securities transaction and the breach of duty thus coincide." *Id.* at 2209. Justice Thomas's failure to adequately address this argument stems from his inability to recognize the unique character of information as an intangible public good, a shortcoming shared with the majority. *See Painter et al., supra* note †.

54. *See Painter et al., supra* note †.

55. "The basic goals of the Exchange Act remain salutary and unchallenged: to provide fair and honest mechanisms for the pricing of securities, to assure that dealing in securities is fair and without undue preferences or advantages among investors, to ensure that securities can be purchased and sold at economically efficient transaction costs, and to provide, to the maximum degree practicable, markets that are open and orderly." H.R. Conf. Rep. No. 94-229, p.91 (1975); *See also Painter et al., supra* note † ("[T]here was . . . little evidence that §10(b) was ever intended to regulate relationships formed outside the securities markets and protect newspapers from their columnists, patients from their psychiatrists, spouses from each other, parents from their children, and state lotteries from their commissioners.") (citations omitted).

party has little or no connection to the trading transaction.

### C. *The Misappropriation Theory is Unsupported by Prior Case Law*

The misappropriation theory is also unsupported by the Court's prior case law. In *Santa Fe Industries v. Green*,<sup>56</sup> the Supreme Court held that for conduct to be "manipulative" or "deceptive" under section 10(b), there must be a material misstatement or omission and not merely a breach of fiduciary duty.<sup>57</sup> According to the *O'Hagan* Court, this requirement was met because it was the failure by O'Hagan to disclose his trading to his employers, rather than the trading itself, that caused liability:

[F]ull disclosure forecloses liability under the misappropriation theory: Because the deception essential to the misappropriation theory involves feigning fidelity to the source of information, if the fiduciary discloses to the source that he plans to trade on the nonpublic information, there is no "deceptive device" and thus no § 10(b) violation.<sup>58</sup>

The implications of this potential loophole are huge: fiduciaries are allowed to trade on nonpublic information misappropriated from the principal, so long as the intent to trade is disclosed to the principal.<sup>59</sup> This is true regardless of whether or not the principal objects to the fiduciary's use of the information for trading purposes. Presumably then, if Chiarella, a print-shop employee (who most likely stood to gain much more through elicited trades based on material nonpublic information than through his printer's salary) had merely disclosed to his employer his intended use of the misappropriated information, his trades would have been legal.<sup>60</sup>

*O'Hagan's* focus on a breach of fiduciary duty as the linchpin of insider trading liability also arguably runs afoul of *Santa Fe's* caution against the "federalization" of state law.<sup>61</sup> As the Court stated in *Santa Fe*:

Federal courts applying a "federal fiduciary principal" under Rule 10b-5 could be expected to depart from state fiduciary standards at least to the extent necessary to ensure uniformity within the federal system. Absent a clear indication of congressional intent, we are reluctant to federalize the substantial portion of the law of corporations that deals with transactions

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56. 430 U.S. 462 (1977).

57. See *id.* at 474.

58. *United States v. O'Hagan*, 117 S.Ct. 2199, 2209 (1997); see also, Painter et al., *supra* note †.

59. See *O'Hagan*, 117 S.Ct. at 2208 & n. 6 ("To satisfy the requirement of the Securities Act [sic] that there be no deception, there would only have to be disclosure.") (quoting Tr. Of Oral Arg. at 12). The logical extension of the Court's ruling is that parties are also allowed to privately contract around the legal prohibition against insider trading. Thus in *Carpenter*, if the Wall Street Journal had adopted a policy which permitted its employees to trade on the basis of material nonpublic information gained in the course of employment, Winans's trades presumably would have been legal. See also *supra* note 47 (discussion of *Carpenter*); Painter et al., *supra* note †.

60. One can easily imagine other situations in which, presented with the opportunity of reasonably certain profits at the expense of workplace disgrace, the fiduciary would opt for disgrace and profits. See, e.g., Painter et al., *supra* note † (resignation letter from hypothetical associate at large law firm who resigns to open ski resort in Vail with profits to be made from trades based on material nonpublic information concerning tender offer for which firm was retained as counsel).

61. See Painter et al., *supra* note †.

in securities.<sup>62</sup>

Although the *O'Hagan* Court referred repeatedly to a "fiduciary relationship," absent from the Court's opinion is any attempt to define this concept.<sup>63</sup> Will the definition come from state or federal law? If federal, it appears that the Court is ignoring *Santa Fe's* warning as to the proper spheres of state and federal law in the regulation of corporations and their stakeholders. If the answer is to be derived from state law, then the Court has opened the door to inconsistent rulings across the various states and circuits, defeating the goal of consistency and predictability in the interpretation of federal statutes, particularly a criminal statute.<sup>64</sup> Complicating the issue further, the Court wisely appeared to narrow the scope of the inquiry to include only a "fiduciary" relationship and not a "similar relationship of trust and confidence" as the standard has sometimes been articulated by lower courts.<sup>65</sup> It is unclear, however, whether the Court in fact intended to set forth a new standard.<sup>66</sup>

#### D. The Misappropriation Theory Leads to Conflicting and Undesirable Results

Perhaps the biggest problem with the misappropriation theory is that the theoretical underpinning of the prohibition, breach of a fiduciary duty owed to the source of the information, is unrelated to the reasons for which the prohibition exists to begin with, namely, the protection of investors and the integrity of the marketplace. As a consequence, the theory's application can lead to conflicting and even undesirable results.<sup>67</sup> Many of these inconsistent results have already been noted. For example, *O'Hagan's* conduct itself would be legal under the misappropriation theory if disclosed to Dorsey and Whitney or if Dorsey and Whitney had a policy permitting such conduct.<sup>68</sup> Furthermore, as the government conceded at oral argument, the misappropriation theory does not prohibit trading by thieves, industrial spies and other nonfiduciaries who improperly obtain material nonpublic information.<sup>69</sup> Finally, because the definition of

62. *Santa Fe Industries v. Green*, 430 U.S. 462, 479 (1977).

63. Outside the traditional context of the duties owed by corporate insiders to their corporation and its shareholders, which are fairly well established, there is little agreement as to what constitutes a fiduciary relationship. See, e.g., Coffee, *From Tort to Crime: Some Reflections on The Criminalization of Fiduciary Breaches and the Problematic Line Between Law and Ethics*, 19 AM. CRIM. L. REV. 117, 150 (1981) ("[T]he common law has in fact always defined the term [fiduciary] with deliberate imprecision."); *United States v. Chestman*, 947 F.2d 551, 567 (2nd Cir. 1991) ("[F]iduciary duties are circumscribed with some clarity in the context of shareholder relations but lack definition in other contexts."). See also Painter et al., *supra* note †.

64. See Painter et al., *supra* note † (discussing the conflicting state approaches to the fiduciary character of marriage).

65. See, e.g., *Chiarella v. United States*, 445 U.S. 222, 228 (1980); *United States v. Willis*, 737 F.Supp. 269, 274 (S.D.N.Y. 1990); *Chestman*, 947 F.2d at 564; *United States v. Reed*, 601 F.Supp. 685, 696 (S.D.N.Y. 1985).

66. See Painter et al., *supra* note † (discussing the historical and current definitions of "fiduciary" and "confidential" relationships).

67. See *id.* (list of ten real and hypothetical examples demonstrating vagueness and/or inconsistency of misappropriation theory).

68. See *supra* notes 57-59 and accompanying text.

69. See Painter et al., *supra* note † (quoting *United States v. O'Hagan* (No. 96-842) 1997 WL 182584, \*5) ("QUESTION: Well, Mr. Dreeben, then if someone stole the lawyer's briefcase and discovered the information and traded on it, no violation? MR DREEBEN: That's correct, Justice O'Connor.").

“fiduciary” is unclear and varies among courts, the misappropriation theory is incredibly vague, particularly as a standard for criminal liability. Often the alleged misappropriator will not know until after the fact whether her trading was illegal, raising serious due process concerns.<sup>70</sup>

### III. CONCLUSION

Although the misappropriation theory is appealing due to the overwhelming public perception that trading on the basis of material nonpublic information unjustly enriches the misappropriator and simultaneously harms other investors and the market generally, the misappropriation theory is, in fact, a misguided judicial attempt to steer the middle ground between a free market in information and parity of information in the absence of legislative guidance. Because the theoretical underpinning of the theory, breach of a fiduciary duty owed to the source of the information, is unrelated to the reasons for which the prohibition exists, investor protection and the integrity of the marketplace, the misappropriation theory leads to inconsistent and even undesirable results. Furthermore, as may be inevitable with judge-made law, the standard has not been clearly defined nor consistently applied by courts, leading to a vagueness and unpredictability that is undesirable in the civil context and unacceptable in the criminal context. The Court should have affirmed the Eighth Circuit’s rejection of the misappropriation theory, inviting Congress, if it feels that trading by outsiders based on material nonpublic information undermines investor confidence in the public markets, to join the other industrialized nations of the world in enacting a clear statutory prohibition defining the scope of illegal conduct.<sup>71</sup>

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70. See Painter et al., *supra* note †.

71. See *id.* (discussing insider trading legislation adopted by the United Kingdom, Italy and Germany: “The United States stands alone in allowing judges to develop a common law prohibition on insider trading from a general anti-fraud statute that does not even mention insiders, inside information or insider trading.”).

