

Spring 1998

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Recommended Citation

Keith Adam Simon, The Misappropriation Theory: A Valid Application of 10(B) to Protect Property Rights in Information, 88 J. Crim. L. & Criminology 1049 (Spring 1998)

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THE MISAPPROPRIATION THEORY: A VALID APPLICATION OF § 10(B) TO PROTECT PROPERTY RIGHTS IN INFORMATION

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

I. INTRODUCTION

In *United States v. O'Hagan*,¹ the United States Supreme Court held that the misappropriation theory is a valid basis upon which to impose § 10(b) and Rule 10b-5 liability for securities fraud.² The Court found that the misappropriation theory satisfies the statutory requirement of § 10(b) that a deceptive device be used "in connection with" a securities transaction.³ The Court reasoned that the misappropriation theory, by proscribing trading based on misappropriated confidential information, promotes market integrity and investor confidence.⁴ This, in turn, advances the underlying purposes of § 10(b) and Rule 10b-5.⁵

In addition, the Supreme Court held that Rule 14e-3(a), which prohibits trading while in possession of material nonpublic information regarding a tender offer, is a valid exercise of the Securities and Exchange Commission's (SEC) rulemaking authority under § 14(e).⁶ The majority did not rule on the authority of the SEC to define fraud.⁷ Rather, the Court found Rule 14e-3(a), "as applied to cases of this genre," to be a means reasonably designed to prevent fraud in tender offers under § 14(e).⁸

This Note agrees with the Court's assessment that the misappropriation theory is a valid basis upon which to impose §

¹ 117 S. Ct. 2199 (1997).

² *Id.* at 2205.

³ *Id.* at 2209.

⁴ *Id.* at 2210.

⁵ *Id.*

⁶ *Id.*

⁷ *Id.* at 2217.

⁸ *Id.*

10(b) and Rule 10b-5 liability.⁹ First, this Note asserts that the misappropriation theory is consistent with Supreme Court precedent¹⁰ interpreting the statutory language of § 10(b).¹¹ Second, this Note argues that the misappropriation theory protects property rights in information and promotes investor confidence in the securities market, thereby increasing market efficiency and integrity.¹² Finally, this Note advances a solution to the “in connection with” dissent¹³ of Justice Thomas.¹⁴ This Note argues that the correct approach is to consider the gathering of information itself as part of the gatheror’s securities transaction.¹⁵

II. BACKGROUND

A. INTRODUCTION

It is axiomatic that the operations of and the information used by the securities market is an area in “special need of regulation for the protection of investors.”¹⁶ Without such regulation, investors may worry that they are being deprived of the fair market value of their investments if others illegally use confidential information.¹⁷ As a result, those same investors might choose alternatives to the stock market, thereby making it more difficult for corporate issuers to raise capital.¹⁸ This, in turn, would adversely affect this nation’s economic growth and stability.¹⁹ As part of the inquiry regarding this potentially disastrous situation, courts have dealt with the following issue: When must

⁹ See *infra* Part V. This Note does not express any opinion regarding the Court’s holding on § 14(e) or Rule 14e-3(a).

¹⁰ See *Dirks v. SEC*, 463 U.S. 646 (1983); *Chiarella v. United States*, 445 U.S. 222 (1980).

¹¹ See *infra* Part V.A.

¹² See *infra* Part V.B.

¹³ *O’Hagan*, 117 S. Ct. at 2220-25 (Thomas, J., concurring in part and dissenting in part).

¹⁴ See *infra* Part V.C.

¹⁵ See *infra id.*

¹⁶ *In re Cady, Roberts & Co.*, 40 S.E.C. 907, 910 (1961).

¹⁷ Barbara J. Finigan, *To Catch a Thief: The Misappropriation Theory and Securities Fraud*, 70 MARQ. L. REV. 692, 723 (1987).

¹⁸ *Id.*

¹⁹ *Id.*

a person who knows material nonpublic information²⁰ disclose such information before trading on it?²¹ The answer to that question has changed significantly over the years.²² Consequently, to gain an adequate understanding of the issue, this Note examines three distinct time periods: (1) the years prior to the passage of § 10(b)²³ and Rule 10b-5²⁴ of the Securities Exchange Act of 1934;²⁵ (2) the years after the passage of § 10(b)

²⁰ Technically, there are two types of material nonpublic information: corporate information and market information. See *Dirks v. SEC*, 463 U.S. 646, 656 n.15 (1983); *Chiarella v. United States*, 445 U.S. 222, 241 n.1 (1980) (Burger, C.J., dissenting). The former refers to information generated within the corporation, such as expected earnings of the corporation, while the latter entails information generated from outside the corporation, for example, advance news of an impending tender offer. John F. Olson et al., *Part I: Regulation Under the Antifraud Provisions of the Securities Exchange Act of 1934*, 41 BUS. LAW. 223, 228 (1985); Victor Brudney, *Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws*, 93 HARV. L. REV. 322, 329-33 (1979). In practice and in this Note, however, the generic term "inside" information is used interchangeably with the phrase "material, nonpublic" information. See *Dirks*, 463 U.S. at 648, 655 (initially describing information received by defendant as material nonpublic, then subsequently as inside information).

²¹ See Diana L. Hegarty, *Rule 10b-5 and the Evolution of Common-Law Fraud—The Need for an Effective Statutory Proscription of Insider Trading by Outsiders*, 22 SUFFOLK U. L. REV. 813, 820-21 (1988). A violation of the securities laws based on the failure to disclose material nonpublic information is known as a "material omission." *Id.* The issue of when a material misrepresentation is unlawful is beyond the scope of this Note.

²² See *infra* Part II.B to Part II.E.

²³ Section 10(b) of the Securities Exchange Act of 1934 provides in pertinent part: It shall be unlawful for any person, directly or indirectly, by 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 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) (1996) (emphasis added).

²⁴ In 1942, Rule 10b-5 was adopted pursuant to the Commission's § 10(b) rulemaking authority and states:

It shall be unlawful for any person, directly or indirectly, by use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5 (1996) (emphasis added).

²⁵ 15 U.S.C. §§ 78a-78ll (1996).

and Rule 10b-5 but before *Chiarella v. United States*²⁶ and *Dirks v. SEC*,²⁷ and (3) the years since the *Chiarella* and *Dirks* decisions.

B. BEFORE § 10(B) AND RULE 10B-5: THE COMMON LAW ERA

Under the common law, a failure to disclose material information is fraudulent only when there is a duty to speak.²⁸ This duty to speak is created "when one party has information that the other [party] is entitled to know because of a fiduciary or other similar relation of trust and confidence between them."²⁹

In most jurisdictions, an insider³⁰ of a corporation has no duty to disclose material information before trading.³¹ For example, in *Goodwin v. Agassiz*³² the court ruled that the defendants,³³ both insiders of Cliff Mining Company (Cliff), did not defraud Goodwin, a shareholder of Cliff, when they bought his shares on the Boston Stock Exchange without disclosing their possession of material inside information.³⁴ The court held that insiders of a corporation have a fiduciary duty only to the corporation itself, not to individual shareholders.³⁵ Since there is no trust relationship between the insiders and the individual shareholders, insiders are neither under a duty to speak nor are they guilty of fraud if they trade securities based on material nonpublic information.³⁶ From a policy perspective, the court found it significant that the securities were traded on an impersonal stock exchange.³⁷ According to the majority, the plaintiff's theory of liability puts:

[a]n honest director . . . in a difficult situation . . . [since] he could neither buy nor sell on the stock exchange shares of stock in his corpora-

²⁶ 445 U.S. 222 (1980).

²⁷ 463 U.S. 646 (1983).

²⁸ *Chiarella*, 445 U.S. at 228.

²⁹ *Id.*

³⁰ An insider refers to a director, officer, or controlling shareholder of a corporation. *In re Cady, Roberts & Co.*, 40 S.E.C. 907, 911 (1961).

³¹ Hegarty, *supra* note 21, at 817. Because there were no federal securities laws, actions for fraud were within the jurisdiction of the state courts. *See id.*

³² 186 N.E. 659 (Mass. 1933).

³³ Defendant Agassiz was president and director, and defendant MacNaughton a director and general manager of Cliff Mining Company. *Id.*

³⁴ *Id.* at 662.

³⁵ *Id.* at 660.

³⁶ *Id.* at 661.

³⁷ *Id.*

tion without first seeking out the other actual ultimate party to the transaction and disclosing to him everything which a court or jury might later find that he then knew affecting the real or speculative value of such shares Fiduciary obligations of directors ought not to be made so onerous that men of experience and ability will be deterred from accepting such office.³⁸

While the majority of jurisdictions did not impose a duty of disclosure on insiders, an exception developed known as the "special facts" doctrine.³⁹ In *Strong*, the Supreme Court acknowledged the majority rule, but stated that a trust relationship and the concomitant duty to speak exist when the insider knows special facts.⁴⁰ The purpose of the special facts doctrine was to eliminate inherently unfair transactions where a corporate insider intentionally withheld superior knowledge of essential facts to the shareholder's detriment.⁴¹

Since there was no explicit method to distinguish *ex-ante* between those cases that satisfied the special facts exception and those that did not, the exception either swallowed the majority rule or made the rule impossible to administer consistently.⁴² Regardless, the common law actions in fraud did not sufficiently protect shareholders from insiders who traded on impersonal stock markets based on material nonpublic information.⁴³ Due to the increased importance of these impersonal markets, Congress endeavored to better protect investors through the passage of the Securities and Exchange Act of 1934.⁴⁴

³⁸ *Id.* See also *Gladstone v. Murray Co.*, 50 N.E.2d 958, 960 (Mass. 1943) (officer of a company did not have a fiduciary duty to individual stockholders); *Shaw v. Cole Mfg. Co.*, 177 S.W. 479, 480 (Tenn. 1915) (corporate directors have a trust relationship only to the corporation itself, not to the individual shareholders).

³⁹ See Hegarty, *supra* note 21, at 817; see also *Strong v. Repide*, 213 U.S. 419 (1909).

⁴⁰ *Strong*, 213 U.S. at 431. See also *Goodwin*, 186 N.E. at 661 ("[W]here an [insider] personally seeks a stockholder for the purpose of buying his shares without making disclosure of material facts within his peculiar knowledge and not within the reach of the stockholder, the transaction will be closely scrutinized and relief may be granted in appropriate instances."); *Buckley v. Buckley*, 202 N.W. 955, 956 (Mich. 1925) (special facts include events increasing the value of a corporation's stock that are known by the insider, yet unknown and unascertainable from inspection of corporate books by selling shareholders).

⁴¹ Hegarty, *supra* note 21, at 817-18.

⁴² WILLIAM L. CARY & MELVIN ARON EISENBERG, *CORPORATIONS* 551 (concise 7th ed. 1995).

⁴³ Hegarty, *supra* note 21, at 818-19.

⁴⁴ 15 U.S.C. §§ 78a-78ll (1996) (prohibiting fraud in the resale of securities between investors). See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 195 (1976) ("The 1934 Act was intended principally to protect investors against manipulation of stock

C. § 10(B) AND RULE 10B-5

Reacting to the 1929 stock market crash and the impotency of the common law to protect investors, Congress enacted the Securities Act of 1933⁴⁵ and the Securities Exchange Act of 1934.⁴⁶ These federal securities laws were passed "[t]o 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, . . . and to provide, to the maximum degree practicable, markets that are open and orderly."⁴⁷ In particular, Congress wanted to eliminate insiders' grievous abuses of fiduciary duties committed solely for personal profits in the securities markets.⁴⁸ Thus, a prohibition on insider trading⁴⁹ developed under § 10(b) and Rule 10b-5 of the Securities and Exchange Act of 1934.⁵⁰

Section 10(b) prohibits any "deceptive device" used "in connection with" a securities transaction "in contravention of [any] rules . . . the Commission may proscribe as necessary or appropriate in the public interest or for the protection of inves-

prices through regulation of transactions upon securities exchanges and in over-the-counter markets, and to impose regular reporting requirements on companies whose stock is listed on national securities exchanges."); see also Willis W. Hagen II, *Insider Trading under Rule 10b-5: The Theoretical Bases for Liability*, 44 BUS. LAW. 13, 14 (1988).

⁴⁵ 15 U.S.C. §§ 77a-77bbbb (1996) (proscribing fraud in the initial offers and sales of securities). See *Ernst & Ernst*, 425 U.S. at 195 ("The Securities Act of 1933 . . . was designed to provide investors with full disclosure of material information concerning public offerings of securities in commerce, to protect investors against fraud and, through the imposition of specified civil liabilities, to promote ethical standards of honesty and fair dealing").

⁴⁶ 15 U.S.C. §§ 78a-78ll (1996) (prohibiting fraud in the resale of securities between investors). See *supra* note 44.

⁴⁷ H.R. CONF. REP. NO. 94-229, at 91-92 (1975), reprinted in 1975 U.S.C.C.A.N. 179, 182.

⁴⁸ Hegarty, *supra* note 21, at 819. See S. REP. NO. 73-792, at 9 (1934) ("The [Exchange Act] further aims to protect the interests of the public by preventing directors, officers, and principal stockholders of a corporation, the stock of which is traded in on exchanges, from speculating in the stock on the basis of information not available to others.").

⁴⁹ Insider trading is the trading of securities by a person who possesses material information that is not yet available to the general public. Marcy G. Dworkin, *The Misappropriation Theory as a Corollary to the Classic Insider Trading Theory*, 1996 ANN. SURV. AM. L. 315, 315 (1996).

⁵⁰ Hegarty, *supra* note 21, at 819; Olson et al., *supra* note 20, at 230. See H.R. REP. NO. 100-910, at 8 (1988), reprinted in 1988 U.S.C.C.A.N. 6043, 6045 ("Section 10(b) . . . along with Rule 10b-5 . . . [have] been subject to the most extensive judicial interpretation. These provisions broadly prohibit fraudulent practices in connection with the purchase or sale of any security, including trading while in possession of material, nonpublic information.").

tors.”⁵¹ In 1942, the SEC promulgated Rule 10b-5⁵² under its § 10(b) rulemaking authority.⁵³ Rule 10b-5 prohibits any person from making “affirmative misrepresentations, half-truths or omissions . . . in connection with” a securities transaction.⁵⁴ Liability under Rule 10b-5 extends only to conduct encompassed by § 10(b)’s prohibitions.⁵⁵ The majority of violations of § 10(b) and Rule 10b-5 occur from material omissions⁵⁶ rather than misrepresentations.⁵⁷ By their terms, § 10(b) and Rule 10b-5 focus not on unfair insider trading per se, but on deception and fraud.⁵⁸ Since the failure to disclose a material fact becomes fraudulent only when there is a duty to speak,⁵⁹ courts have grappled with the issue of when such a duty arises.⁶⁰

In a 1961 administrative proceeding, the Securities and Exchange Commission attempted to define when a duty to disclose inside information arises before trading on that information.⁶¹ In *Cady, Roberts*, a director of a corporation informed his broker that the corporation decided to decrease its cash dividend by 40%.⁶² Upon receiving this inside information, but before it had been publicized, the broker sold thousands of shares for his personal account.⁶³ The SEC found the broker’s conduct a violation of § 10(b) and Rule 10b-5.⁶⁴ According to the SEC, a duty to speak is based on two principal elements:

⁵¹ 15 U.S.C. § 78j(b) (1996). See *supra* note 23 for the relevant text of § 10(b).

⁵² 17 C.F.R. § 240.10b-5 (1996). See *supra* note 24 for the text of Rule 10b-5.

⁵³ Finigan, *supra* note 17, at 697.

⁵⁴ *Id.*

⁵⁵ *United States v. O’Hagan*, 117 S. Ct. 2199, 2207 (1997); *Santa Fe Indus. v. Green*, 430 U.S. 462, 472 (1977); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 214 (1976).

⁵⁶ An omission is material when “there [is] a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information made available.” *Basic, Inc. v. Levinson*, 485 U.S. 224, 231-32 (1988) (quoting *TSC Indus. v. Northway*, 426 U.S. 438, 449 (1976)).

⁵⁷ Hegarty, *supra* note 21, at 820.

⁵⁸ Olson et al., *supra* note 20, at 230. See *supra* notes 23 and 24 for the relevant text of § 10(b) and Rule 10b-5 respectively.

⁵⁹ See *supra* Part II.B.

⁶⁰ Hegarty, *supra* note 21, at 821.

⁶¹ *In re Cady, Roberts*, 40 S.E.C. 907 (1961). See Hegarty, *supra* note 21, at 820-21.

⁶² *Cady, Roberts*, 40 S.E.C. at 909. The corporation decreased its dividend from \$0.625 to \$0.375 per share. *Id.*

⁶³ *Id.*

⁶⁴ *Id.* at 912.

first, the existence of a relationship giving access . . . to information intended to be available only for a corporate purpose, and not for the personal benefit of anyone, and second the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing.⁶⁵

Accordingly, the *Cady, Roberts* rule meant that individuals who have a special relationship with a company and are privy to its internal affairs either must disclose such information before trading or, if disclosure is impossible, abstain from trading.⁶⁶

In 1968, the United States Court of Appeals for the Second Circuit extended the standard established in the *Cady, Roberts* rule to individuals who are not necessarily insiders of the corporation.⁶⁷ In *Texas Gulf Sulphur*, a corporation made significant mineral discoveries.⁶⁸ Based on this information, corporate directors and officers bought stock in their corporation without disclosing their knowledge to the selling shareholders.⁶⁹ The insiders' conduct, concluded the Second Circuit, violated § 10(b) and Rule 10b-5.⁷⁰ According to the Second Circuit, the central purpose of § 10(b) and Rule 10b-5 is to ensure *all* investors equal access to information.⁷¹ To accomplish this goal, the Second Circuit imposed the *Cady, Roberts* rule on "*anyone* in possession of material inside information."⁷² Thus, this case broadened the *Cady, Roberts* rule by emphasizing fairness rather than the specific status of the trader.⁷³

Although *Texas Gulf Sulphur* was a government action, its broad language created an outbreak of private lawsuits.⁷⁴ To re-

⁶⁵ *Id.* (footnote omitted).

⁶⁶ *Id.* at 911. The disclose-or-abstain-from-trading principle under § 10(b) is known as the *Cady, Roberts* rule. See *Texas Gulf Sulphur Co. v. SEC*, 401 F.2d 833, 848 (2d Cir. 1968).

⁶⁷ *Texas Gulf Sulphur Co.*, 401 F.2d at 847-48.

⁶⁸ *Id.* at 843-47.

⁶⁹ *Id.* at 847-48.

⁷⁰ *Id.* at 842.

⁷¹ *Id.* at 848-49 ("Rule 10b-5 is based in policy on the justifiable expectation of the securities marketplace that all investors trading on impersonal exchanges have relatively equal access to material information.").

⁷² *Id.* at 848 (emphasis added).

⁷³ Hegarty, *supra* note 21, at 821.

⁷⁴ CARY & EISENBERG, *supra* note 42, at 573. See, e.g., *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228, 236 (2d Cir. 1974) ("Although *Texas Gulf* was an SEC injunction action, the strong public policy considerations behind our [equal-access-to-information rule] there are equally applicable [in a private damage action].").

duce this flurry of private litigation, the Supreme Court restricted the *Cady, Roberts* rule in *Santa Fe Industries v. Green* by requiring that the insiders' conduct be fraudulent, rather than just unfair.⁷⁵ Santa Fe Industries (Santa Fe) owned 95% of Kirby Lumber Corporation common stock.⁷⁶ In order to become the sole shareholder, Santa Fe cashed out the minority shareholders through a short-form merger statute.⁷⁷ Although the provisions of the statute were satisfied,⁷⁸ the minority shareholders claimed that they received an unfairly low price for their shares.⁷⁹ Rather than seek an appraisal remedy in state court, the minority shareholders alleged that Santa Fe's low-ball price was a "deceptive device" used "in connection with" a securities transaction in violation of § 10(b) and Rule 10b-5.⁸⁰

The Supreme Court held that Santa Fe did not violate § 10(b) and Rule 10b-5 because its conduct was neither deceptive nor manipulative.⁸¹ While the offer price may have been low, Santa Fe fairly presented all relevant information to the minority shareholders, and, thus, could not have deceived or manipulated them.⁸² The Court held that breaches of fiduciary duty "without any deception, misrepresentation, or nondisclosure" do not violate § 10(b) and Rule 10b-5.⁸³ According to the majority, the essential purpose of the federal securities laws is full disclosure: "[O]nce full and fair disclosure has occurred, the

⁷⁵ *Santa Fe Indus. v. Green*, 430 U.S. 462, 473 (1977).

⁷⁶ *Id.* at 465.

⁷⁷ *Id.* at 465-66. The short-form merger statute allows a parent corporation owning at least 90% of the stock of a subsidiary to merge with, or buy out, that subsidiary if approved by the parent's board of directors. DEL. CODE ANN. tit. 8 § 253 (1991). The statute does not require approval from the minority shareholders who are bought out. *Id.*

⁷⁸ To comply with the statute, Santa Fe informed the minority shareholders the day after the short form merger became effective and notified them of their right to obtain an appraisal in state court if displeased with the offer price per share. *Santa Fe*, 433 U.S. at 466. In addition, the minority shareholders received all relevant financial data about Kirby and its assets, and an independent investment banking firm's appraisal of the fair market value of their shares. *Id.*

⁷⁹ *Id.* Santa Fe offered the minority shareholders \$150 per share when the stock was worth at least \$772 per share based on the fair market value of Kirby's physical assets. *Id.*

⁸⁰ *Id.* at 467-68.

⁸¹ *Id.* at 474.

⁸² *Id.*

⁸³ *Id.* at 476.

fairness of the terms of the transaction is at most a tangential concern of [courts interpreting § 10(b) and Rule 10b-5]."⁸⁴

D. *CHIARELLA V. UNITED STATES* AND *DIRKS V. SEC*: THE FIDUCIARY DUTY PRINCIPLE

Following *Santa Fe*, the Court decided *Chiarella*⁸⁵ and *Dirks*,⁸⁶ which further restricted the *Cady, Roberts* rule by demanding that the insider breach a fiduciary duty to the purchaser or seller of securities. Vincent Chiarella was a printer employed at Pandick Press, a financial printer.⁸⁷ Chiarella was responsible for five documents that announced corporate takeover bids.⁸⁸ Although these documents intentionally omitted the names of the soon-to-be acquired company, Chiarella was able to determine the identity of the targets from other information contained in the announcements.⁸⁹ Without disclosing his knowledge, Chiarella bought stock in the targets and sold the shares immediately after the takeover bids were made public.⁹⁰ Through this scheme, Chiarella realized \$30,000 in profits over fourteen months.⁹¹ The SEC investigated his trading activities and indicted Chiarella on seventeen counts of violating § 10(b) and Rule 10b-5.⁹² According to the government, Chiarella violated § 10(b) and Rule 10b-5 when he willfully bought securities based upon: (1) inside information; and (2) undisclosed material information he learned through his employment at the print shop, in breach of a fiduciary duty to Pandick Press and its customers.⁹³ Chiarella was convicted on all counts in the district court, and the Second Circuit affirmed his convictions.⁹⁴

The Supreme Court reversed Chiarella's convictions.⁹⁵ Writing for the majority, Justice Powell expressly rejected the theory

⁸⁴ *Id.* at 477-78.

⁸⁵ *Chiarella v. United States*, 445 U.S. 222 (1980).

⁸⁶ *Dirks v. SEC*, 463 U.S. 646 (1983).

⁸⁷ *Chiarella*, 445 U.S. at 224.

⁸⁸ *Id.*

⁸⁹ *Id.*

⁹⁰ *Id.*

⁹¹ *Id.*

⁹² *Id.* at 225.

⁹³ *Id.* at 235-36 (1980). The Court called this second prong of liability the misappropriation theory. See *id.* at 237 n.21.

⁹⁴ *Chiarella v. United States*, 588 F.2d 1358 (2d Cir. 1978).

⁹⁵ *Chiarella*, 445 U.S. at 237.

that a duty to disclose or abstain from trading could be based on mere possession of inside information.⁹⁶ Rather, the duty arises when one party has information that the other party has the right to know "because of a fiduciary or similar relationship of trust and confidence between them."⁹⁷ Since Chiarella was not a corporate insider and did not receive inside information from the target company, he had no fiduciary or similar duty to the shareholders of the target corporation.⁹⁸ Without such a relationship, Justice Powell concluded, Chiarella was not under a duty to speak and, thus, was not "deceptive" in violation of § 10(b) and Rule 10b-5.⁹⁹ The Court thus restricted the *Cady, Roberts* rule by emphasizing the specific status of the trader.¹⁰⁰

While expressly rejecting the "equal access to information" theory, the majority declined to explain or reach the merits of the misappropriation theory of liability since it was not presented to the jury.¹⁰¹

By contrast, in dissent, Chief Justice Burger addressed the misappropriation theory and would have affirmed Chiarella's convictions.¹⁰² While acknowledging that neither party to an impersonal transaction is required to disclose inside information absent some fiduciary relation, Chief Justice Burger argued that this general rule should "give way when an informational advantage is obtained, not by superior experience, foresight, or industry, but by some unlawful means."¹⁰³ According to the

⁹⁶ *Id.* at 235. Without explicitly stating so, Justice Powell mooted *Texas Gulf Sulphur*. See Hegarty, *supra* note 21, at 849 n.66; see also Chiarella, 445 U.S. at 235 ("We hold that a duty to disclose under § 10(b) does not arise from the mere possession of non-public market information"). But see SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968) ("[A]nyone in possession of material inside information must either disclose it to the investing public, or, if he is disabled from disclosing it [in order to protect a corporate confidence], must abstain from trading in or recommending the securities concerned while such inside information remains undisclosed").

⁹⁷ *Chiarella*, 445 U.S. at 228.

⁹⁸ *Id.* at 232.

⁹⁹ *Id.* at 232-33.

¹⁰⁰ See Lawrence E. Mitchell, *The Jurisprudence of the Misappropriation Theory and the New Insider Trading Legislation: From Fairness to Efficiency and Back*, 52 ALB. L. REV. 775, 823 (1989).

¹⁰¹ *Chiarella*, 445 U.S. at 228.

¹⁰² *Id.* at 239 (Burger, C.J., dissenting).

¹⁰³ *Id.* at 240 (Burger, C.J., dissenting).

Chief Justice, if an individual misappropriates¹⁰⁴ material information, then he has "an absolute duty" to either disclose that information *to the other party of the securities transaction* or refrain from trading.¹⁰⁵ Accordingly, Chiarella violated § 10(b) and Rule 10b-5 when he traded on misappropriated nonpublic information without informing the selling shareholders of the target companies.¹⁰⁶

Three years after *Chiarella*, the Supreme Court extended the requirement of a breach of a fiduciary duty to tippers/tippees of inside information.¹⁰⁷ As an officer of a New York broker-dealer firm, Raymond Dirks provided financial analysis of insurance company securities to institutional investors.¹⁰⁸ Through a former officer of a major insurance company, Dirks learned that the company was fraudulently overstating the value of its assets.¹⁰⁹ Dirks verified the former officer's allegations through his own investigation of the insurance company.¹¹⁰ While Dirks never owned or traded the insurance company's securities, he did openly discuss the fraud with many of his clients.¹¹¹ In response, Dirks' clients liquidated over \$16 million of the insurance company's securities.¹¹² The SEC's investigation of Dirks' role in the exposure of the fraud resulted in Dirks' conviction for violating § 10(b) and Rule 10b-5.¹¹³ According to the SEC, a tippee like Dirks who learns material information that he knows is confidential and that he knows or should know came from a corporate insider must either publicly disclose that information or abstain from trading.¹¹⁴

¹⁰⁴ Misappropriation means "[t]he unauthorized, improper, or unlawful use of property for a purpose other than that for which intended." BLACK'S LAW DICTIONARY 998 (6th ed. 1990).

¹⁰⁵ *Chiarella*, 445 U.S. at 240 (Burger, C.J., dissenting).

¹⁰⁶ *Id.*

¹⁰⁷ *Dirks v. SEC*, 463 U.S. 646 (1983).

¹⁰⁸ *Id.* at 648.

¹⁰⁹ *Id.* at 649.

¹¹⁰ *Id.*

¹¹¹ *Id.*

¹¹² *Id.*

¹¹³ *Id.* at 650-51. The SEC held that Dirks had aided and abetted violations of § 10(b) and Rule 10b-5 by repeating the allegations of fraud to his clients who later sold their stock in the insurance company. *See id.*

¹¹⁴ *See id.* at 651. This is true regardless of the tippee's motivation or occupation. *Id.*

Writing for the majority, Justice Powell reversed Dirks' convictions under § 10(b) and Rule 10b-5.¹¹⁵ The majority unambiguously stated that the duty to disclose or abstain from trading arises from a fiduciary relationship between the parties to the securities transaction and not from the mere possession of inside information.¹¹⁶ Since Dirks was a stranger to the insurance company, he had no pre-existing duty to its shareholders.¹¹⁷

In addition, the Court held that Dirks did not "inherit" any fiduciary duty to the shareholders.¹¹⁸ According to Justice Powell, a tippee's duty to disclose or abstain from trading derives from the insider tipper's duty.¹¹⁹ This duty does not arise merely from receiving inside information; rather, it is triggered by obtaining information from an insider who has breached a fiduciary duty to the corporation and the tippee knows or should know of the breach.¹²⁰ According to the majority, the insider did not breach a fiduciary duty to the corporation because he was motivated to "expose the fraud," not to "directly or indirectly personally benefit."¹²¹ Moreover, the insider did not expect Dirks to keep the information confidential and Dirks did not misappropriate the information about the insurance company.¹²² Thus, the Court concluded, Dirks was not "deceptive" under § 10(b) and Rule 10b-5 because he neither had a pre-existing duty to speak, nor did he inherit such a duty from the insider.¹²³

¹¹⁵ *Id.* at 667.

¹¹⁶ *Id.* at 657-58. Justice Powell stressed that:

We were explicit in *Chiarella* in saying that there can be no duty to disclose where the person who has traded on inside information was not the [corporation's] agent, . . . was not a fiduciary, [or] was not a person in whom the sellers [of the securities] had placed their trust and confidence.

Id. at 654.

¹¹⁷ *Id.* at 665.

¹¹⁸ *Id.* at 665-66.

¹¹⁹ *Id.* at 659.

¹²⁰ *Id.* at 660.

¹²¹ *Id.* at 667.

¹²² *Id.* at 665.

¹²³ *Id.* at 666-67. In addition, Justice Powell rejected the SEC's argument that § 10(b) and Rule 10b-5 distinguish between corporate information and market information. *Id.* at 656 n.15. See also Brudney, *supra* note 20, at 329-33 (no justification for federal securities laws to distinguish between corporate and market information).

E. AFTER *CHIARELLA* AND *DIRKS*: THE ERA OF THE MISAPPROPRIATION THEORY

By holding that the trader must have a fiduciary duty to the other party of a securities transaction, *Chiarella* and *Dirks* restricted the reach of § 10(b) and Rule 10b-5.¹²⁴ This standard allowed outsiders, who owe no fiduciary duty to the corporation or its shareholders, to trade on material nonpublic information without violating § 10(b) and Rule 10b-5.¹²⁵

To remedy this situation,¹²⁶ the SEC espoused the misappropriation theory based on Chief Justice Burger's dissent in *Chiarella*.¹²⁷ Under the misappropriation theory, a breach of fiduciary duty to the *source* of the inside information, regardless of any duty to any other party to a securities transaction, followed by the use of that information to trade securities, violates § 10(b) and Rule 10b-5's prohibition against "deceptive devices" used "in connection with" a securities transaction.¹²⁸ Because the misappropriation theory prohibits fraud on the source of the information instead of the purchaser or seller of securities as was required in *Chiarella* and *Dirks*, some courts of appeals were ambivalent about the misappropriation theory.¹²⁹

However, the Second Circuit endorsed the misappropriation theory even before the holding in *Dirks*.¹³⁰ In *Newman*, two employees of two investment banking firms misappropriated confidential information regarding potential mergers and acquisitions that was entrusted to their employer by corporate clients.¹³¹ The two employees covertly conveyed the misappropriated information to Newman, a securities trader and

¹²⁴ Hegarty, *supra* note 21, at 826.

¹²⁵ *Id.*

¹²⁶ Because of the increasing number of mergers and corporate takeovers, the *Chiarella* standard permitted many nonfiduciary insider traders to go unpunished. *Id.*

¹²⁷ *Id.* See *Chiarella v. United States*, 445 U.S. 222, 239-45 (1980) (Burger, C.J., dissenting).

¹²⁸ Hegarty, *supra* note 21, at 827. In contrast to the misappropriation theory, the classical theory as used in *Chiarella* holds that a corporate insider, such as a director, officer, or controlling shareholder, violates § 10(b) and Rule 10b-5 when he uses confidential information for personal securities trading purposes, in breach of a fiduciary duty owed to the other party to the securities transaction. See *O'Hagan v. United States*, 117 S. Ct. 2199, 2207 (1997).

¹²⁹ Dworkin, *supra* note 49, at 337.

¹³⁰ *United States v. Newman*, 664 F.2d 12 (2d Cir. 1981) (upholding the validity of the misappropriation theory).

¹³¹ *Id.* at 15.

manager of the over-the-counter trading department of a New York brokerage firm, who in turn conveyed it to two of his confederates.¹³² Using secret foreign bank and trust accounts, Newman and his two counterparts profited by purchasing stock in the target companies and immediately selling when the takeovers were publicly announced.¹³³

The government charged Newman with conduct violating § 10(b) and Rule 10b-5 based on the misappropriation theory.¹³⁴ The district court dismissed the complaint,¹³⁵ but the Second Circuit reversed, agreeing with the Government's application of the misappropriation theory.¹³⁶ According to the Second Circuit, Newman and his cohorts "defrauded [the investment banking firms] as surely as if they took their money."¹³⁷ The court also quickly disposed of the "in connection with" requirement since Newman's only purpose for participating in this scheme was to profit from trading securities in the target companies.¹³⁸ Thus, *Newman* represents the first time a court held that § 10(b) and Rule 10b-5 liability could be based upon the misappropriation theory.¹³⁹

In contrast, the Fourth Circuit rejected the validity of the misappropriation theory in *United States v. Bryan*.¹⁴⁰ Elton Bryan,

¹³² *Id.*

¹³³ *Id.*

¹³⁴ *Id.* at 14.

¹³⁵ *Id.* The district court concluded that no "clear and definite statement" in the Securities Exchange Act of 1934 gave Newman reasonable notice that his conduct was unlawful. *Id.*

¹³⁶ *Id.* at 16.

¹³⁷ *Id.* at 17.

¹³⁸ *Id.* at 18.

¹³⁹ Hagen, *supra* note 44, at 24. For other Second Circuit cases that support the misappropriation theory, see *United States v. Libera*, 989 F.2d 596 (2d Cir. 1993), *United States v. Chestman*, 947 F.2d 551 (2d Cir. 1991), *Carpenter v. United States*, 791 F.2d 1024 (2d Cir. 1986), and *SEC v. Materia*, 745 F.2d 197 (2d Cir. 1984). For other circuits that approve the misappropriation theory, see *SEC v. Maio*, 51 F.3d 623 (7th Cir. 1995), *SEC v. Cherif*, 933 F.2d 403 (7th Cir. 1991), *SEC v. Clark*, 915 F.2d 439 (9th Cir. 1990), and *Rothberg v. Rosenbloom*, 771 F.2d 818 (3d Cir. 1985).

In *Chestman*, the Second Circuit affirmed the validity of the misappropriation theory, but held that the defendant had not violated § 10(b) because he had not breached any fiduciary duty. *Chestman*, 947 F.2d at 570-71. In his partial concurrence, Judge Winter cogently analyzed the misappropriation theory from a "property rights in inside information" perspective and would have upheld Chestman's convictions under § 10(b) based on the misappropriation theory. *Id.* at 572, 576-81 (Winter, J., concurring in part and dissenting in part).

¹⁴⁰ 58 F.3d 933 (4th Cir. 1995).

the director of the West Virginia Lottery (Lottery), was responsible for negotiating and securing \$2.8 million worth of advertising contracts.¹⁴¹ After Lottery officials decided which advertising companies to award the contracts, but before that information was publicly announced, Bryan purchased common stock in the "winning" advertising companies.¹⁴² The government claimed that, in so doing, Bryan violated § 10(b) and Rule 10b-5 based on the misappropriation theory.¹⁴³ The district court convicted Bryan,¹⁴⁴ but the Fourth Circuit unanimously reversed.¹⁴⁵

According to the Fourth Circuit, § 10(b) and Rule 10b-5 proscribed only "the use of deception, in the form of material misrepresentations or omissions, to induce action or inaction by purchasers or sellers of securities. . . ."¹⁴⁶ By contrast, the court reasoned, the misappropriation theory is too broad; it allows criminal conviction for mere breaches of fiduciary duty, regardless of whether the breach involves deception and whether the parties deceived are purchasers or sellers of securities.¹⁴⁷

While the appellate courts were busy with the misappropriation theory,¹⁴⁸ the Supreme Court's lone statement on the theory came in *Carpenter v. United States*.¹⁴⁹ R. Foster Winans was a reporter for the *Wall Street Journal* (*Journal*).¹⁵⁰ In the summer of 1982, he began writing a daily column, *Heard on the Street*, which discussed the profitability potential of selected stocks.¹⁵¹ Due to its perceived quality and integrity, the column had the potential of affecting the price of the stocks which it discussed.¹⁵² Winans was aware of the *Journal's* official policy which deemed the contents of the column the *Journal's* own confidential information prior to publication.¹⁵³ Despite that rule, Winans gave two

¹⁴¹ *Id.* at 937.

¹⁴² *Id.* at 939.

¹⁴³ *Id.* at 936.

¹⁴⁴ *Id.*

¹⁴⁵ *Id.*

¹⁴⁶ *Id.* at 944.

¹⁴⁷ *Id.*

¹⁴⁸ See *supra* note 139.

¹⁴⁹ 484 U.S. 19 (1987).

¹⁵⁰ *Id.* at 22.

¹⁵¹ *Id.*

¹⁵² *Id.* See *United States v. Winans*, 612 F. Supp. 827, 830 (S.D.N.Y. 1985) ("We find that the Heard column does have an impact on the market, difficult though it may be to qualify in any particular case.").

¹⁵³ *Carpenter*, 484 U.S. at 23.

friends advance notice of the timing and content of his forthcoming columns.¹⁵⁴ Consequently, these friends were able to trade securities based on the likely impact of the column on the market price of the discussed securities.¹⁵⁵ For four months, Winans' confederates made prepublication trades based on the advanced information.¹⁵⁶ Winans and his associates shared in over \$690,000 in profits.¹⁵⁷ The Government alleged, and the district court convicted, Winans of violating § 10(b) and Rule 10b-5 under the misappropriation theory.¹⁵⁸ The Second Circuit affirmed Winan's convictions based in part on its decision in *Newman*.¹⁵⁹

On review, the Supreme Court cursorily addressed the misappropriation theory: "The Court is evenly divided with respect to the convictions under the securities laws [based on the misappropriation theory] and for that reason affirms the judgment below on those counts."¹⁶⁰ Due to this even split, the Court merely affirmed the findings of the Second Circuit without adopting or rejecting the misappropriation theory of securities fraud.¹⁶¹ As a result, the validity of the misappropriation theory was undecided until the *O'Hagan* Court expressly invoked it to impose § 10(b) and Rule 10b-5 liability.¹⁶²

III. FACTS AND PROCEDURAL HISTORY

James Herman O'Hagan was an attorney at Dorsey & Whitney, a law firm located in Minneapolis, Minnesota.¹⁶³ In July, 1988, Grand Metropolitan PLC, a company based in London, England, hired Dorsey as counsel to represent Grand Met in a potential tender offer for the common stock of Pillsbury Com-

¹⁵⁴ *Id.*

¹⁵⁵ *Id.*

¹⁵⁶ *Id.*

¹⁵⁷ *Id.*

¹⁵⁸ *Id.* at 23-24.

¹⁵⁹ *United States v. Carpenter*, 791 F.2d 1024, 1031-34 (2d Cir. 1986).

¹⁶⁰ *Carpenter*, 484 U.S. at 24. There were only eight sitting Justices at the time *Carpenter* was decided because Justice Powell had retired but Justice Kennedy had not yet been seated. *Id.* at iv (note page). In addition, the Court unanimously upheld the defendant's convictions under the mail and wire fraud statutes. *Id.* at 24-28. See *infra* Part IV.A.1.

¹⁶¹ Hagen, *supra* note 44, at 28.

¹⁶² *United States v. O'Hagan*, 117 S. Ct. 2199, 2205 (1997).

¹⁶³ *Id.*

pany, headquartered in Minneapolis, Minnesota.¹⁶⁴ Both Grand Met and Dorsey made significant attempts to keep the planned tender offer confidential.¹⁶⁵

While Dorsey was still counsel to Grand Met, but before Grand Met had publicly announced its tender offer plans, O'Hagan engaged in a series of transactions involving Pillsbury's securities.¹⁶⁶ On August 18, 1988, O'Hagan made his first purchase of Pillsbury call options, with each option representing the right to purchase 100 shares of Pillsbury common stock.¹⁶⁷ By August 25, 1988, O'Hagan had accumulated 500 Pillsbury call options.¹⁶⁸ On August 29, 1988, O'Hagan bought another 100 Pillsbury call options, and, within twenty-four hours, he purchased 150 more Pillsbury call options.¹⁶⁹ By the end of September, 1988, O'Hagan owned 2,500 Pillsbury call options, making him the largest individual investor in Pillsbury call options in the world.¹⁷⁰ On September 9, 1988, Dorsey withdrew from its representation of Grand Met.¹⁷¹ On September 20, 1988, O'Hagan made his last transaction in Pillsbury securities when he purchased 5000 shares of Pillsbury common stock.¹⁷²

In October, 1988, Grand Met publicly announced its tender offer, and the price of Pillsbury common stock increased from \$39 to nearly \$60 a share.¹⁷³ At this point, O'Hagan liquidated

¹⁶⁴ *Id.*

¹⁶⁵ Petitioner's Brief at 3-4, *United States v. O'Hagan*, 117 S. Ct. 2199 (1997) (No. 96-842). Only seven or eight people within Grand Met were aware of the planned tender offer before it was publicly announced. *Id.* For its part, Dorsey restricted communication of the information to as few people as possible within the firm, filed the subject of the representation under "general matters," and imposed a written policy that Grand Met's planned tender offer information be kept strictly confidential. *Id.*

¹⁶⁶ *Id.* at 5-6.

¹⁶⁷ *Id.* at 5. The owner of a call option has the right to buy a fixed amount of the underlying stock at a predetermined price until a specific future date, in exchange for a premium today. For investors who believe a stock will rise dramatically, call options permit a profit from a smaller initial investment than would be required to buy the underlying stock outright. *Id.* at 6.

¹⁶⁸ *Id.* at 5.

¹⁶⁹ *Id.*

¹⁷⁰ *Id.*

¹⁷¹ *Id.* at 5 n.2. Dorsey withdrew because it believed that it was a bad idea to represent Grand Met in the takeover of a local Minneapolis company. *Id.* at 4.

¹⁷² *Id.* at 5.

¹⁷³ *United States v. O'Hagan*, 117 S. Ct. 2199, 2205 (1997).

all of his holdings in Pillsbury call options and common stock, making a profit of more than \$4.3 million.¹⁷⁴

The SEC investigated O'Hagan's transactions and, although O'Hagan never personally worked on the legal representation of Grand Met,¹⁷⁵ charged him with fifty-seven violations of federal securities laws.¹⁷⁶ O'Hagan was charged with defrauding both Dorsey and Grand Met when he misappropriated confidential information regarding Grand Met's planned tender offer for personal trading purposes.¹⁷⁷ Specifically, the indictment alleged that O'Hagan violated § 10(b) of the Securities Exchange Act of 1934 (Exchange Act)¹⁷⁸ and SEC Rule 10b-5¹⁷⁹ based on the misappropriation theory of securities fraud.¹⁸⁰ In addition, O'Hagan was charged with violating § 14(e) of the Exchange Act¹⁸¹ and SEC Rule 14e-3(a),¹⁸² which, even where there

¹⁷⁴ *Id.*

¹⁷⁵ Respondent's Brief at 4-6, *United States v. O'Hagan*, 117 S. Ct. 2199 (1997) (No. 96-842).

¹⁷⁶ *O'Hagan*, 117 S. Ct. at 2205.

¹⁷⁷ *Id.*

¹⁷⁸ 15 U.S.C. § 78j(b) (1996). See *supra* note 23 for the relevant text of § 10(b).

¹⁷⁹ 17 C.F.R. § 240.10b-5 (1996). See *supra* note 24 for the text of Rule 10b-5.

¹⁸⁰ *O'Hagan*, 117 S. Ct. at 2205. The classical theory, see *supra* note 128, did not apply to O'Hagan since he was not an insider of Pillsbury, the corporation in whose stock he traded, and thus owed no fiduciary duty to the sellers of Pillsbury common stock and call options. *Id.* at 2208 n.5.

¹⁸¹ In relevant part, § 14(e) of the Securities Exchange Act of 1934 states:

It shall be unlawful for any person to make any untrue statement of a material fact or omit to state any material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading, or to engage in any *fraudulent*, deceptive, or manipulative acts or practices, in connection with any tender offer. . . . 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, or manipulative.

15 U.S.C. § 78n(e) (1996) (emphasis added).

¹⁸² Rule 14e-3(a) was adopted pursuant to the Commission's § 14(e) rulemaking authority and states:

(a) If any person has taken a substantial step or steps to commence, or has commenced, a tender offer (the "offering person"), it shall constitute a *fraudulent*, deceptive or manipulative act or practice within the meaning of section 14(e) of the Act for any other person who is in possession of material information relating to such tender offer which information he knows or has reason to know is nonpublic and which he knows or has reason to know has been acquired directly or indirectly from:

- (1) The offering person,
- (2) The issuer of the securities sought or to be sought by such tender offer, or
- (3) Any officer, director, partner or employee or any other person acting on behalf of the offering person or such issuer, to purchase or sell or cause

is no breach of a fiduciary duty, prohibit trading while in possession of material nonpublic information regarding a tender offer.¹⁸³ Finally, O'Hagan was charged with violating federal mail fraud and money laundering statutes.¹⁸⁴ O'Hagan was convicted on all fifty-seven counts by a jury in the United States District Court for the District of Minnesota.¹⁸⁵ He was sentenced to forty-one months imprisonment.¹⁸⁶

On appeal, a divided panel for the Court of Appeals for the Eighth Circuit reversed all of O'Hagan's convictions.¹⁸⁷ Following the lead of the Fourth Circuit in *United States v. Bryan*,¹⁸⁸ the Eighth Circuit held that neither the statutory language of § 10(b), nor the Supreme Court's interpretations of that language, supports use of the misappropriation theory of securities fraud.¹⁸⁹ Under the misappropriation theory, an individual violates § 10(b) and Rule 10b-5 when he: "(1) misappropriates material nonpublic information (2) by breaching a duty arising out of a relationship of trust and confidence and (3) uses that information in a securities transaction, (4) regardless of whether he owed any duties to the shareholders of the traded stock."¹⁹⁰

to be purchased or sold any of such securities or any securities convertible into or exchangeable for any such securities or any option or right to obtain or to dispose of any of the foregoing securities, unless within a reasonable time prior to any purchase or sale such information and its source are publicly disclosed by press release or otherwise.

17 C.F.R. § 240.14e-3(a) (1996) (emphasis added).

¹⁸³ *O'Hagan*, 117 S. Ct. at 2205.

¹⁸⁴ See 18 U.S.C. § 1341 (1996); 18 U.S.C. §§ 1956(a)(1)(B)(i), 1957 (1996).

¹⁸⁵ The jury rejected O'Hagan's defense that he did not possess material, nonpublic information regarding Grand Met's tender offer when he purchased Pillsbury stock and call options. See Reply Brief at 2, *United States v. O'Hagan*, 117 S. Ct. 2199 (1997) (No. 96-842).

¹⁸⁶ *O'Hagan*, 117 S. Ct. at 2205.

¹⁸⁷ *United States v. O'Hagan*, 92 F.3d 612, 613 (8th Cir. 1996).

¹⁸⁸ 58 F.3d 933 (4th Cir. 1995) (holding the misappropriation theory an invalid basis upon which to impose § 10(b) and Rule 10b-5 liability). See *supra* notes 140-47 and accompanying text.

¹⁸⁹ *O'Hagan*, 92 F.3d at 622. The Eighth Circuit relied on *Chiarella v. United States*, 445 U.S. 222, 228 (1980) (holding that a duty to speak arises when one party has information that the other party has the right to know because of a fiduciary relationship between them), *Dirks v. SEC*, 463 U.S. 646, 657-58 (1983) (affirming the holding in *Chiarella*), and *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164, 191 (1994) (holding that a private plaintiff does not have standing to bring an aiding and abetting suit under § 10(b)). *O'Hagan*, 92 F.3d at 618-19, 622.

¹⁹⁰ *O'Hagan*, 92 F.3d at 616-17.

According to the Government, O'Hagan violated § 10(b) and Rule 10b-5 when he learned material nonpublic information relating to Grand Met's planned tender offer through his employment at Dorsey and subsequently used that information for personal securities trading purposes.¹⁹¹ In rejecting the misappropriation theory, the Eighth Circuit noted that "deception" is not a required element of the misappropriation theory, nor must any potential deception be "in connection with" a securities transaction as specified in § 10(b).¹⁹² Relying on *Chiarella*,¹⁹³ *Dirks*,¹⁹⁴ and *Central Bank of Denver*,¹⁹⁵ the Eighth Circuit stated that "only a breach of a duty to parties to the securities transaction or, at the most, to other market participants such as investors" can create liability under § 10(b).¹⁹⁶

The Eighth Circuit also held that Rule 14e-3(a)¹⁹⁷ is an invalid exercise of the Commission's rulemaking authority under § 14(e).¹⁹⁸ The Eighth Circuit reasoned that "fraudulent" under § 14(e) requires "the breach of a fiduciary obligation or similar trust relationship," and, therefore, Rule 14e-3(a) cannot stand without such a requirement.¹⁹⁹

Finally, the Eighth Circuit reversed O'Hagan's mail fraud and money laundering convictions because they were based on violations of § 10(b) and § 14(e) and could not be maintained once these convictions were overturned.²⁰⁰

On petition from the Government, the Supreme Court granted certiorari²⁰¹ to determine whether the statutory language of § 10(b) and Rule 10b-5 supports the misappropriation theory of securities fraud and whether Rule 14e-3(a) is a proper

¹⁹¹ *Id.* at 617.

¹⁹² *Id.* See *supra* note 23 for the relevant text of § 10(b).

¹⁹³ 445 U.S. 222 (1980).

¹⁹⁴ 463 U.S. 646 (1983).

¹⁹⁵ 511 U.S. 164 (1994).

¹⁹⁶ *O'Hagan*, 92 F.3d at 618.

¹⁹⁷ See *supra* note 182 for the text of Rule 14e-3(a).

¹⁹⁸ *O'Hagan*, 92 F.3d at 627. The Eighth Circuit relied on *Chiarella v. United States*, 445 U.S. 222 (1980), and *Schreiber v. Burlington Northern, Inc.*, 472 U.S. 1 (1985) (holding that the term "manipulative" in § 14(e) requires misrepresentation or nondisclosure). *O'Hagan*, 92 F.3d at 625.

¹⁹⁹ *O'Hagan*, 92 F.2d at 626-27.

²⁰⁰ *Id.* at 628.

²⁰¹ *United States v. O'Hagan*, 117 S. Ct. 759 (1997).

exercise of the Commission's rulemaking authority under § 14(e).²⁰²

IV. THE SUPREME COURT OPINIONS

A. THE MAJORITY OPINION

Writing for the majority,²⁰³ Justice Ginsberg reversed the Eighth Circuit's judgment, holding that the statutory language of § 10(b) and Supreme Court precedent²⁰⁴ validate the misappropriation theory of securities fraud.²⁰⁵ Rejecting the Eighth Circuit's contentions, Justice Ginsberg found that the misappropriation theory requires both a "deceptive device or contrivance" and that the deception be "in connection with" the purchase or sale of securities as stated in § 10(b).²⁰⁶ The majority also held that Rule 14e-3(a), "to the extent relevant to this case," constitutes a valid exercise of the Commission's rulemaking authority under § 14(e).²⁰⁷ Finally, the Court concluded O'Hagan violated the mail fraud and money laundering statutes.²⁰⁸

1. § 10(b) and Rule 10b-5

First, Justice Ginsberg observed that a misappropriator, like O'Hagan, "who [pretends] loyalty to the principal while secretly converting the principal's information for personal gain, . . . [defrauds] the principal."²⁰⁹ In rejecting O'Hagan's argument that he merely converted Grand Met's confidential information, Justice Ginsberg noted that O'Hagan's conduct "deal[t] in deception."²¹⁰

In finding that O'Hagan's conduct was deceptive, Justice Ginsberg relied on *Carpenter v. United States*,²¹¹ which concerned the mail fraud statute's prohibition of "any scheme or artifice to

²⁰² United States v. O'Hagan, 117 S. Ct. 2199, 2205 (1997).

²⁰³ Justices Stevens, O'Connor, Kennedy, Souter, and Breyer joined in Justice Ginsberg's opinion.

²⁰⁴ See *supra* note 189 for a discussion of the Supreme Court precedent.

²⁰⁵ O'Hagan, 117 S. Ct. at 2205-06.

²⁰⁶ *Id.* at 2208-09.

²⁰⁷ *Id.* at 2214.

²⁰⁸ *Id.* at 2220.

²⁰⁹ *Id.* at 2208.

²¹⁰ *Id.*

²¹¹ 484 U.S. 19 (1987).

defraud.”²¹² In *Carpenter*, the Supreme Court unanimously affirmed the defendant’s convictions under the mail fraud statute and recognized that an employee commits fraud when, promising not to use his employer’s confidential information, he gave the information to his co-conspirators to obtain trading profits.²¹³ According to the *Carpenter* Court, a company’s confidential information is property to which the company has the right of exclusive use; the furtive misappropriation of that information constitutes fraud similar to embezzlement.²¹⁴ Like the defendant in *Carpenter*, O’Hagan’s promise not to use Grand Met’s confidential information became a “deceptive device” when he used this information in a scheme to obtain trading profits.²¹⁵ Thus, Justice Ginsberg found that O’Hagan had deceived both Dorsey and Grand Met.²¹⁶

In addition to finding deception in this specific case, Justice Ginsberg found that the misappropriation theory, in general, is not based merely on a breach of a fiduciary duty as O’Hagan claimed, but rather on “deception through nondisclosure” to the source of the information.²¹⁷ Because of this essential element of deception, Justice Ginsberg found the misappropriation theory consistent with *Santa Fe Industries, Inc. v. Green*,²¹⁸ which held that § 10(b) outlaws only manipulation or deception, not simply a breach of fiduciary duty.²¹⁹ Accordingly, when the misappropriator comes clean and fully discloses to the source his scheme to use the nonpublic information, there is no “deceptive device” and thus no § 10(b) liability under the mis-

²¹² *O’Hagan*, 117 S. Ct. at 2208 (quoting 18 U.S.C. § 1341 (1996)).

²¹³ *Carpenter*, 484 U.S. at 27.

²¹⁴ *Id.* at 25-27.

²¹⁵ *O’Hagan*, 117 S. Ct. at 2208.

²¹⁶ *Id.* Manipulation, the other type of conduct creating § 10(b) liability, was not relevant to O’Hagan because it is “virtually a term of art when used in connection with the securities markets, referring to such practices as wash sales, matched orders, or rigged prices, that are intended to mislead investors by artificially affecting market activity,” and there was no evidence that O’Hagan engaged in such conduct. *United States v. O’Hagan*, 92 F.3d 612, 615 n.4 (8th Cir. 1996) (quoting *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 199 (1976)).

²¹⁷ *O’Hagan*, 117 S. Ct. at 2208.

²¹⁸ 430 U.S. 462 (1977). See *supra* notes 75-84 and accompanying text discussing *Santa Fe*.

²¹⁹ *O’Hagan*, 117 S. Ct. at 2209. See *Santa Fe*, 430 U.S. at 473-76.

appropriation theory.²²⁰ Since O'Hagan never fully informed Dorsey or Grand Met of his clandestine trading scheme, Justice Ginsberg held that O'Hagan's conduct was "deceptive" under § 10(b).²²¹

Next, Justice Ginsberg concluded that O'Hagan's deception was "in connection with" the purchase or sale of securities as required under § 10(b).²²² Justice Ginsberg rejected O'Hagan's argument that this element can be satisfied only if an actual purchaser or seller of securities is deceived, emphasizing that § 10(b) refers to "the purchase or sale of any security."²²³ According to Justice Ginsberg, this requirement of § 10(b) was satisfied because O'Hagan's deception was complete, not when he learned of Grand Met's confidential information, but only after he secretly used the information to trade securities.²²⁴ The securities transaction and the deception occurred simultaneously.²²⁵

So ruling, Justice Ginsberg limited the scope of the misappropriation theory.²²⁶ First, Justice Ginsberg explained that O'Hagan would not have violated § 10(b) if he had used Grand Met's confidential information in other potentially profitable ways, such as selling it to the *Wall Street Journal* or using it in a fantasy stock trading game.²²⁷ The misappropriation theory does not prohibit all possible forms of deception involving confidential information, but only deceptive uses through securities transactions.²²⁸ Second, Justice Ginsberg concluded that O'Hagan would not have breached § 10(b) if he had embezzled cash from Grand Met, and subsequently used the money in a securities transaction.²²⁹ In this type of situation, the "in connection with" requirement would not be satisfied because the deception would be accomplished as soon as O'Hagan obtained

²²⁰ *O'Hagan*, 117 S. Ct. at 2209. Justice Ginsberg altered Chief Justice Burger's version of the misappropriation theory, since the Chief Justice believed the misappropriator had "an absolute duty" to disclose the information to the one with whom he trades. See *Chiarella v. United States*, 445 U.S. 222, 240 (1980) (Burger, C.J., dissenting).

²²¹ *O'Hagan*, 117 S. Ct. at 2211.

²²² *Id.*

²²³ *Id.* (quoting 15 U.S.C. § 78j(b) (1996)).

²²⁴ *Id.* at 2209.

²²⁵ *Id.*

²²⁶ *Id.*

²²⁷ *Id.* at 2210 n.8.

²²⁸ *Id.* at 2209.

²²⁹ *Id.*

the money, regardless of any subsequent securities transaction.²³⁰

To bolster her conclusion, Justice Ginsberg analyzed the underlying purposes of the Securities Exchange Act of 1934.²³¹ According to Justice Ginsberg, the misappropriation theory comports well with a central objective of § 10(b) "to insure honest securities markets and thereby promote investor confidence."²³² Although it is impossible to ensure equal access and total parity of information to all investors in the securities markets, investors likely would hesitate to risk their money in a securities market where the law condoned O'Hagan's conduct: trading based on misappropriated nonpublic information.²³³ This hesitation, according to Justice Ginsberg, stems from the fact that O'Hagan's informational advantage is based on "contrivance, not luck; it is a disadvantage that the uninformed investor cannot overcome with research or skill."²³⁴ Thus, considering the adverse effect on market integrity from O'Hagan's conduct and the underlying goals of § 10(b), Justice Ginsberg found that it would be illogical to hold O'Hagan liable under the classical theory if he represented Pillsbury,²³⁵ but not liable under the misappropriation theory if he worked for Grand Met.²³⁶

Finally, according to Justice Ginsberg, the Eighth Circuit misread prior Supreme Court holdings as precluding § 10(b) liability under the misappropriation theory.²³⁷ The Eighth Cir-

²³⁰ *Id.*

²³¹ *Id.* at 2210.

²³² *Id.* (quoting 45 Fed. Reg. 60,412 (1980)).

²³³ *Id.*

²³⁴ *Id.*

²³⁵ See *supra* note 180.

²³⁶ *O'Hagan*, 117 S. Ct. at 2210-11. In addition, Justice Ginsberg rejected O'Hagan's claim that the misappropriation theory would violate his due process right to fair notice of what is criminal conduct. *Id.* at 2214. She stated that in order to impose criminal liability under Rule 10b-5, the Government must establish that an individual "willfully" violated the provision. *Id.* (relying on 15 U.S.C. § 78ff(a) (1996)). Furthermore, an individual may not be imprisoned if he proves that he had no knowledge of Rule 10b-5. *Id.* Accordingly, O'Hagan's due process rights were not violated since criminal liability is limited to individuals who breach a recognized duty and who have culpable intent. *Id.*

²³⁷ *Id.* at 2211 ("According to the Eighth Circuit, three of our decisions reveal that § 10(b) liability cannot be predicated on a duty owed to the source of the information."). See *supra* note 189 for a discussion of the Supreme Court precedent.

cuit's reliance on *Chiarella v. United States*,²³⁸ said Justice Ginsberg, was misplaced since that case expressly left unanswered the validity of the misappropriation theory.²³⁹ *Dirks v. SEC*²⁴⁰ also left open the validity of the misappropriation theory.²⁴¹ *Dirks* did not suggest that a person who misappropriates nonpublic information in breach of a fiduciary duty to the source avoids § 10(b) liability.²⁴² Finally, Justice Ginsberg dismissed the Eighth Circuit's reading of *Central Bank of Denver v. First National Bank of Denver*²⁴³ as irrelevant to the instant case.²⁴⁴ The issue before the Court in *Central Bank* was whether a private plaintiff could maintain an aiding and abetting suit under § 10(b), not criminal liability.²⁴⁵

Accordingly, Justice Ginsberg concluded that Supreme Court precedent did not prohibit the imposition of § 10(b) liability based on a duty owed to the source of the nonpublic information.²⁴⁶ Therefore, Justice Ginsberg held that criminal liability under § 10(b) and Rule 10b-5 may be based on the misappropriation theory of securities fraud.²⁴⁷

2. § 14(e) and Rule 14e-3(a)

Justice Ginsberg next concluded that Rule 14e-3(a),²⁴⁸ "to the extent relevant to this case," is a valid exercise of the SEC's § 14(e)²⁴⁹ rulemaking authority, even though Rule 14e-3(a) does not require the breach of any fiduciary duty.²⁵⁰ The Court did not determine the scope of the SEC's power to define fraud under § 14(e).²⁵¹ Rather, Justice Ginsberg held that Rule 14e-3(a)

²³⁸ 445 U.S. 222, 236 (1980) ("We need not decide whether [the misappropriation] theory has merit for it was not submitted to the jury.").

²³⁹ *O'Hagan*, 117 S. Ct. at 2212.

²⁴⁰ 463 U.S. 646 (1983).

²⁴¹ *O'Hagan*, 117 S. Ct. at 2212. In *Dirks*, the Court observed that the principal did not expect *Dirks* to keep the information in confidence. *Dirks*, 463 U.S. at 665. Nor did *Dirks* misappropriate the confidential information. *Id.*

²⁴² *O'Hagan*, 117 S. Ct. at 2213.

²⁴³ 511 U.S. 164 (1994).

²⁴⁴ *O'Hagan*, 117 S. Ct. at 2213.

²⁴⁵ *Id.*

²⁴⁶ *Id.* at 2211.

²⁴⁷ *Id.* at 2205.

²⁴⁸ See *supra* note 182 for the text of Rule 14e-3(a).

²⁴⁹ See *supra* note 181 for the text of § 14(e).

²⁵⁰ *O'Hagan*, 117 S. Ct. at 2205.

²⁵¹ *Id.* at 2217.

represents a "means reasonably designed to prevent" fraud in tender offers under § 14(e).²⁵² Citing *SEC v. Peters*,²⁵³ Justice Ginsberg found that it was a "fair assumption" by the SEC to conclude that trading based on confidential information often will involve a breach of a fiduciary duty either to the acquirer or acquiree.²⁵⁴ This breach, furthermore, would be difficult to prove in tender offers since a wide range of insiders, including directors, officers, and controlling shareholders, and outsiders, such as lawyers, investment bankers, and accountants, have access to the confidential information.²⁵⁵ Thus, the Court concluded that Rule 14e-3(a) could create a "disclose or abstain from trading" principle without requiring specific evidence of a breach of fiduciary duty.²⁵⁶

3. *Mail Fraud and Money Laundering Statutes*

Finally, Justice Ginsberg reinstated O'Hagan's convictions under the mail fraud and money laundering statutes because "the indictment was so structured that the mail fraud [and money laundering] charges could not be disassociated from [O'Hagan's violations of § 10(b) and § 14(e)]"²⁵⁷ Thus, the Court's decision on the securities fraud issues "require[d]" a conviction under the mail fraud and money laundering statutes.²⁵⁸

B. JUSTICE SCALIA'S PARTIAL CONCURRENCE

Justice Scalia rejected the misappropriation theory of securities fraud because it violates the principle of lenity.²⁵⁹ Since it

²⁵² *Id.*

²⁵³ 978 F.2d 1162, 1165 (10th Cir. 1992). According to the Tenth Circuit, "[p]articularly in the context of a tender offer, . . . [it is] almost impossible to prove that [a] trader obtained [material nonpublic information] in breach of a fiduciary duty owed either by the trader or by the ultimate insider source of the information." *Id.* at 1167.

²⁵⁴ *O'Hagan*, 117 S. Ct. at 2219.

²⁵⁵ *Id.*

²⁵⁶ *Id.*

²⁵⁷ *Id.* at 2219-20.

²⁵⁸ *Id.* at 2220.

²⁵⁹ *Id.* (Scalia, J., concurring in part and dissenting in part). See *Reno v. Koray*, 515 U.S. 50, 64-65 (1995) (the rule of lenity applies when, after gathering aid from all possible sources, a court can only guess as to the intent of Congress); *United States v. Bass*, 404 U.S. 336, 347-48 (1971) (if a choice has to be made between two readings of what conduct is criminal, Congress must, before the Court chooses the harsher alternative, speak in language that is clear and definite).

is not clear to whom § 10(b) and Rule 10b-5 apply, Justice Scalia concluded that the vague statutory language must be restricted to deceptive devices used on an actual purchaser or seller of securities.²⁶⁰

C. JUSTICE THOMAS'S PARTIAL CONCURRENCE

Justice Thomas rejected the misappropriation theory of securities fraud because it does not provide a "coherent and consistent" interpretation of § 10(b)'s requirement that the deception be "in connection with" the purchase or sale of securities.²⁶¹ According to Justice Thomas, the critical issue under the misappropriation theory is that the information is nonpublic, not that the source of the information is deceived.²⁶² Using the majority's own words, Justice Thomas reasoned that "[t]here can be no 'deceptive device' under the misappropriation theory if the fiduciary discloses to the source that he plans to trade on the nonpublic information."²⁶³ Yet, regardless of whether there is full disclosure, Justice Thomas argued, the adverse effects on the integrity of the market would be identical: "[O'Hagan] would still be trading based on nonpublic information that the average investor had no hope of obtaining through his own [research or skill]."²⁶⁴ Therefore, the misappropriation theory does not satisfy the "in connection with" requirement under § 10(b) because the deceptive device is irrelevant to the integrity of any future trading.²⁶⁵

With regard to Rule 14e-3(a), Justice Thomas found that it was not a valid exercise of the SEC's § 14(e) rulemaking authority.²⁶⁶ According to Justice Thomas, it is just as difficult to prove breach of a fiduciary duty in the § 14(e) tender offer context as

²⁶⁰ *O'Hagan*, 117 S. Ct. at 2202 (Scalia, J., concurring in part and dissenting in part). Justice Scalia joined the majority opinion with respect to O'Hagan's convictions under § 14(e) and the federal mail fraud and money laundering statutes. *Id.* (Scalia, J., concurring in part and dissenting in part). Justice Scalia did not join Justice Thomas's dissent because Justice Scalia believed it irrelevant whether the Government's misappropriation theory provides a "coherent and consistent" interpretation of § 10(b). *Id.* (Scalia, J., concurring in part and dissenting in part).

²⁶¹ *Id.* at 2221 (Thomas, J., concurring in part and dissenting in part).

²⁶² *Id.* at 2225 (Thomas, J., concurring in part and dissenting in part).

²⁶³ *Id.* (Thomas, J., concurring in part and dissenting in part) (quoting *id.* at 2209).

²⁶⁴ *Id.* (Thomas, J., concurring in part and dissenting in part).

²⁶⁵ *Id.* at 2226 (Thomas, J., concurring in part and dissenting in part).

²⁶⁶ *Id.* (Thomas, J., concurring in part and dissenting in part).

it is under the § 10(b) misappropriation theory.²⁶⁷ Since there is no particular difficulty in proving a breach of fiduciary duty, removing the requirement of such a breach under Rule 14e-3(a) is not a "means reasonably designed to prevent" fraud in tender offers under § 14(e).²⁶⁸

V. ANALYSIS

The Court was correct in its judgment that the misappropriation theory satisfies the requirements of § 10(b) and Rule 10b-5. The misappropriation theory is consistent with Supreme Court interpretations of § 10(b)'s statutory language, including *Chiarella v. United States*²⁶⁹ and *Dirks v. SEC.*²⁷⁰ By prohibiting trading based on misappropriated nonpublic information, the misappropriation theory preserves property rights in information and elevates investor confidence in the securities market. This, in turn, promotes market efficiency and integrity. Finally, the misappropriation theory satisfies the "in connection with" requirement of § 10(b) and Rule 10b-5.

A. THE MISAPPROPRIATION THEORY IS CONSISTENT WITH THE HOLDINGS IN *CHIARELLA* AND *DIRKS*

In *Chiarella* and *Dirks*, the Court unequivocally established that a person violates § 10(b) and Rule 10b-5 when he trades securities on the basis of material nonpublic information in breach of a fiduciary or similar relationship to the other party of a securities transaction.²⁷¹ While these two cases seem to contradict the misappropriation theory's prohibition of "fraud-on-the-source," *Chiarella* and *Dirks* did not deny that there are other ways to violate § 10(b) and Rule 10b-5.²⁷²

In *Chiarella*, Justice Powell declined to rule on the validity of the misappropriation theory since it was not submitted to the

²⁶⁷ *Id.* at 2229 (Thomas, J., concurring in part and dissenting in part).

²⁶⁸ *Id.* (Thomas, J., concurring in part and dissenting in part). With respect to O'Hagan's convictions under the federal mail fraud and money laundering statutes, Justice Thomas concurred in the judgment of the majority. *Id.* at 2230 (Thomas, J., concurring in part and dissenting in part).

²⁶⁹ 445 U.S. 222 (1980).

²⁷⁰ 463 U.S. 646 (1983).

²⁷¹ *Dirks*, 463 U.S. at 654; *Chiarella*, 445 U.S. at 228.

²⁷² *O'Hagan*, 117 S. Ct. at 2212.

jury.²⁷³ Furthermore, Justice Stevens, supplying the crucial fifth vote for the Powell majority, wrote separately to emphasize that the Court did not determine the validity of the misappropriation theory.²⁷⁴ In *Dirks*, Justice Powell reaffirmed the holding in *Chiarella*, unambiguously stating that a duty to disclose arises from the relationship between the parties and not simply from possession of inside information.²⁷⁵ While this appears to undermine the credibility of the misappropriation theory, Justice Powell then stressed that there was no expectation by *Dirks*' source that he would keep their information in confidence.²⁷⁶ Nor did *Dirks* misappropriate the information.²⁷⁷ The Court's emphasis on the lack of misappropriating conduct by *Dirks* was dicta since Justice Powell already had concluded that *Dirks* did not violate § 10(b) and Rule 10b-5.²⁷⁸ As such, it suggests that the *Dirks* Court would have reached the opposite result had *Dirks* misappropriated the confidential information.²⁷⁹ Some authors have argued that the Court's focus on *Dirks*' conduct signaled an implicit acceptance of the misappropriation theory.²⁸⁰ At a minimum, it left open the question of the viability of the misappropriation theory.²⁸¹ In conclusion, *Chiarella* and *Dirks* "wrote one chapter with respect to one type of fraudulent trading,"²⁸² but left the chapter on the misappropriation theory an unfinished manuscript.

²⁷³ *Chiarella*, 445 U.S. at 236 ("We will not speculate upon whether such a breach [to *Chiarella*'s employer and its clients] constitutes a violation of § 10(b).").

²⁷⁴ *Id.* at 237-38 (Stevens, J., concurring). Justice Stevens noted that:

[t]he Court correctly does not address the second [theory of liability]: whether [*Chiarella*'s] breach of his duty of silence—a duty he unquestionably owed to his employer and to his employer's customers—could give rise to criminal liability under Rule 10b-5. I think the Court wisely leaves the resolution of this issue for another day.

Id. (Stevens, J., concurring).

²⁷⁵ *Dirks*, 463 U.S. at 654, 657-58.

²⁷⁶ *Id.* at 665.

²⁷⁷ *Id.*

²⁷⁸ *Id.* ("Under the inside-trading and tipping rules [already discussed], we find that there was no actionable violation by *Dirks*").

²⁷⁹ Mark A. Clayton, Comment, *The Misappropriation Theory in Light of Carpenter and the Insider Trading and Securities Fraud Enforcement Act of 1988*, 17 PEPP. L. REV. 185, 197 & n.95 (1989).

²⁸⁰ *Id.* See also Dworkin, *supra* note 49, at 359-64.

²⁸¹ *United States v. O'Hagan*, 117 S. Ct. 2199, 2213-14 (1997).

²⁸² *United States v. Winans*, 612 F. Supp. 827, 842 (S.D.N.Y. 1985), *aff'd in part and rev'd in part*, *United States v. Carpenter*, 791 F.2d 1024 (2d Cir. 1986), *aff'd*, *Carpenter v. United States*, 484 U.S. 19 (1987).

B. THE MISAPPROPRIATION THEORY PROMOTES EFFICIENCY AND INTEGRITY OF THE SECURITIES MARKETS

As stressed by the Second Circuit, "[o]ur era aptly has been styled, and may well be remembered as, the age of information."²⁸³ Nowhere is information more valuable and volatile than in the financial market, where facts can be worth millions of dollars when secret but rendered worthless once publicized.²⁸⁴ Information is costly to produce because it requires research costs.²⁸⁵ For example, many investors perform technical analysis before they buy or sell stock.²⁸⁶ Technical analysis is the "search for recurrent and predictable patterns in stock prices. Technical analysts are sometimes called 'chartists' because they study records or charts of past stock prices, hoping to find patterns they can exploit to make a profit."²⁸⁷ While information is expensive to create, it is "less costly, or even free" to use since it involves facts and ideas that easily can be copied.²⁸⁸ This, in turn, creates an omnipresent risk that those who expend resources to produce information will see free-riders derive profit from it.²⁸⁹ As the return from a costly activity such as information gathering is diverted, investment in that activity will decrease in the future.²⁹⁰ As Frank Easterbrook and Daniel Fischel explain:

Trading on information can be a form of theft. Firms regularly forbid lawyers, accountants, printers, and others to trade on news about the firm. Those who trade notwithstanding promises to abstain are stealing assets of the firm as surely as if they reach into the till for cash exceeding their salaries. Appropriation of information from another reduces the incentive to create information and thus indirectly the efficiency of capital markets; and it is harmful (and should be forbidden) for the same reasons that theft is harmful.²⁹¹

²⁸³ SEC v. Materia, 745 F.2d 197, 198 (2d Cir. 1984).

²⁸⁴ *Id.*

²⁸⁵ Frank H. Easterbrook, *Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information*, 1981 SUP. CT. REV. 309, 309-39.

²⁸⁶ See ZVI BODIE ET AL., INVESTMENTS 345-47 (1989).

²⁸⁷ *Id.* at 345.

²⁸⁸ Easterbrook, *supra* note 285, at 313.

²⁸⁹ United States v. Chestman, 947 F.2d 551, 576-77 (2d Cir. 1991) (Winter, J., concurring in part and dissenting in part).

²⁹⁰ *Id.* at 577 (Winter, J., concurring in part and dissenting in part).

²⁹¹ FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 259-60 (1991).

Therefore, if the law fails to preserve property rights in information, fewer resources will be invested in producing such information and market efficiency will suffer.²⁹²

For example, it is costly for a hostile acquiror to take over another corporation. Not only must the bidding firm incur accounting, investment banking and legal fees, but it also must purchase the target's stock. To control acquisition costs, acquirors generally try to keep their planned activities private.²⁹³ If word does get out, the market price of the target's stock not only will increase, but the target might adopt costly defensive actions, such as poison pills²⁹⁴ or golden parachutes²⁹⁵ to prevent the takeover.²⁹⁶ Consequently, the takeover loses its profitability and the acquiror will invest less in such activities in the future.²⁹⁷

Persons trading securities based upon misappropriated information further increase this risk of untimely disclosure.²⁹⁸ In the instant case, O'Hagan bought Pillsbury securities based upon his knowledge of Grand Met's planned tender offer.²⁹⁹ Although O'Hagan's conduct did not affect the market price of Pillsbury securities,³⁰⁰ others such as O'Hagan's broker, who learned of his trading success, can make the same trades.³⁰¹ The

²⁹² *Chestman*, 947 F.2d at 577 (Winter, J., concurring in part and dissenting in part). Market efficiency refers to how accurately the market price of a security reflects the "true" or intrinsic value of such security. See BODIE ET AL., *supra* note 286, at 342-43. The less information known about a security, the larger the divergence between the market price and intrinsic value of such security. *Id.* This, in turn, reduces market efficiency. *Id.* at 342-71. See also CARY & EISENBERG, *supra* note 42, at 211.

²⁹³ See Petitioner's Brief at 3-4, *O'Hagan* (No. 96-842).

²⁹⁴ A poison pill is a defensive tactic employed by a target company that makes its common stock less attractive and/or more expensive to an acquiror. BLACK'S LAW DICTIONARY, *supra* note 104, at 1156.

²⁹⁵ A golden parachute is an agreement that provides for substantial bonuses and other benefits for top management and directors who are forced to resign from the target company after the acquiror has taken control. *Id.* at 692.

²⁹⁶ *Chestman*, 947 F.2d at 577 (Winter, J., concurring in part and dissenting in part).

²⁹⁷ Easterbrook, *supra* note 285, at 313. See Patrick Diaz & Rosemary Maxwell, *Insider Trading and the Corporate Acquirer: Private Actions Under Rule 10b-5 Against Agents Who Trade on Misappropriated Information*, 56 GEO. WASH. L. REV. 600, 610-15 (1988).

²⁹⁸ *Chestman*, 947 F.2d at 577 (Winter, J., concurring in part and dissenting in part). See *Litton Indus. v. Lehman Bros. Kuhn Loeb Inc.*, 967 F.2d 742, 744 (2d Cir. 1992) (acquiring corporation alleging that its profit from the acquisition of the target company was depressed due to the defendant's trading in the target's stock based upon misappropriated information).

²⁹⁹ *United States v. O'Hagan*, 117 S. Ct. 2199, 2205 (1997).

³⁰⁰ Petitioner's Brief at 3-4, *O'Hagan* (No. 96-842).

³⁰¹ See Easterbrook, *supra* note 285, at 336.

broker, moreover, may recommend the stock to clients or friends and relatives.³⁰² When trading activity in the stock reaches a certain level, unrelated third parties may guess that the reason for the trading is a corporate secret.³⁰³ By this stage, Grand Met's information is worthless.³⁰⁴ The misappropriation theory, therefore, prohibits insider trading that increases the risk that information created at a cost is rendered worthless to the principal.³⁰⁵

While information production and market efficiency would suffer if property rights in information received no protection, they would also be damaged if all trading based on material nonpublic information were prohibited.³⁰⁶ Efficient capital markets require that persons who gather information at a cost, such as hostile acquirors and technical analysts, be able to profit from the information they produce.³⁰⁷ An equal-access-to-information rule³⁰⁸ would "create a securities market governed by relative degrees of ignorance because the profit motive for independently generating information about companies would be substantially diminished."³⁰⁹ Liability rules that critically chill the vigorous production and dissemination of information, therefore, should be avoided.³¹⁰

The misappropriation theory does not stifle legitimate information production because it only outlaws uses of confidential information that are irrelevant to its production.³¹¹ While the potential for profit is required before hostile acquirors and technical analysts create information at their own expense, the same cannot be said for the misappropriator.³¹² By definition,

³⁰² *Chestman*, 947 F.2d at 577 (Winter, J., concurring in part and dissenting in part).

³⁰³ *Id.* at 578 (Winter, J., concurring in part and dissenting in part).

³⁰⁴ *Id.* (Winter, J., concurring in part and dissenting in part).

³⁰⁵ *Id.* (Winter, J., concurring in part and dissenting in part).

³⁰⁶ *Id.* (Winter, J., concurring in part and dissenting in part).

³⁰⁷ *Id.* (Winter, J., concurring in part and dissenting in part).

³⁰⁸ See *Texas Gulf Sulphur v. SEC*, 401 F.2d 833, 848 (2d Cir. 1968) (anyone in possession of material nonpublic information must disclose such information or abstain from trading).

³⁰⁹ *Chestman*, 947 F.2d at 578 (Winter, J., concurring in part and dissenting in part). It seems that this concern for market efficiency underscored the Court's rejection of the parity-of-information rule in *Chiarella* and *Dirks*. See *id.* (Winter, J., concurring in part and dissenting in part).

³¹⁰ Olson et al., *supra* note 20, at 225.

³¹¹ Brudney, *supra* note 20, at 356.

³¹² *Id.*

the misappropriator personally profits on information given to him "in the course of fulfilling other purposes, such as rendering services or selling goods to the source of the information."³¹³ Indeed, the fundamental characteristic of the misappropriation theory is that the misappropriator obtains the confidential information for a purpose other than personal profit and then uses the information for his own personal benefit in a securities transaction.³¹⁴

In the instant case, for example, the information regarding the potential takeover of Pillsbury had two distinct values: one in securities trading and the other in legal service fees. According to the original plans, Grand Met was to derive value from the purchase of Pillsbury stock and O'Hagan's performance of legal services.³¹⁵ That was the only reason Grand Met informed O'Hagan of its intentions to acquire Pillsbury common stock.³¹⁶ The information was given to O'Hagan so he could represent Grand Met as local counsel in its takeover attempt, not so he could trade on the stock and option markets.³¹⁷ Based on this compensation structure, the takeover information would have been produced regardless of whether O'Hagan could personally profit from a securities transaction. Therefore, the misappropriation theory does not stifle legitimate information production and profits by Grand Met. Rather, it restricts only extraneous profit-making by persons like O'Hagan.

Finally, the misappropriation theory elevates investor confidence in the financial markets by prohibiting "a game in which [the misappropriator] has loaded dice."³¹⁸ As the task force on insider trading reported:

[w]e traditionally abhor those who refuse to play by the rules, that is, the cheaters and the sneaks. A spitball pitcher, or a card shark with an ace up his sleeve, may win the game but not our respect. And if we know such a person is in the game, chances are we won't play.³¹⁹

³¹³ *Id.*

³¹⁴ *Id.* at 356 n.111.

³¹⁵ See Petitioner's Brief at 3-5, *O'Hagan* (No. 96-842). The legal services likely would include ensuring that Grand Met complied with federal securities law regarding takeovers, such as the Williams Act, 15 U.S.C. §§ 78m(d), 78n(d), (e) (1996).

³¹⁶ *United States v. O'Hagan*, 117 S. Ct. 2199, 2205 (1997).

³¹⁷ *Id.*

³¹⁸ Finigan, *supra* note 17, at 723.

³¹⁹ Olson et al., *supra* note 20, at 227.

These sensible observations indicate that the misappropriation theory satisfies two of the traditional reasons for condemning insider trading: the "fair play" and "integrity of the market" arguments.³²⁰ The former rests on the belief that cheaters like O'Hagan are wrong and the "traditional sympathy [we have] for the victim of the cheat" like Grand Met.³²¹ The latter relies on the common-sense argument that people will hesitate to entrust their money to a market they do not believe is fair.³²² A rational market participant who knows that the use of misappropriated confidential information is not sanctioned by law will demand a risk premium for dealing in the market.³²³ If the market is seen to be saturated with misappropriators, some investors will abstain entirely from dealing in such markets.³²⁴ Still others will incur costs either to avoid dealing with such misappropriators or to overcome illegally their informational disadvantage.³²⁵ As a result, capital formation through the securities market will become more difficult and expensive.³²⁶ Thus, by proscribing trading on misappropriated information, the misappropriation theory reassures investors that the financial markets are honest and fair³²⁷ and prevents inefficient search costs.³²⁸

If the policy considerations are unclear, consider the following not-so-unrealistic hypotheticals. Under scenario one, a lawyer (L) is retained as counsel by Big Corporation to represent it in its takeover of Small Corporation. Upon learning the news of the impending takeover, L buys stock in Big Corporation in anticipation of a stock price increase once the takeover is publicly announced.³²⁹ Under scenario two, the same facts apply except L buys stock in Small Corporation in anticipation of the huge

³²⁰ *Id.*

³²¹ *Id.*

³²² *Id.*

³²³ Brudney, *supra* note 20, at 356.

³²⁴ *Id.*

³²⁵ *Id.*

³²⁶ Olson et al., *supra* note 20, at 228.

³²⁷ Finigan, *supra* note 17, at 723.

³²⁸ See Brudney, *supra* note 20, at 356.

³²⁹ See Michael C. Jensen & Richard S. Ruback, *The Market for Corporate Control: The Scientific Evidence*, 11 J. FIN. ECON. 5, 16 (1983) (acquirers in successful takeover attempts realize an average return of 3.8%).

stock price increase once the takeover is made public.³³⁰ From a policy perspective, it is difficult, if not impossible, to differentiate scenario one, the classic insider trading theory, from scenario two, the misappropriation theory, since both trades are based on identical inside information that L learned through his employment at Big Corporation. In holding the misappropriation theory a valid basis upon which to impose § 10(b) and Rule 10b-5 liability, the Supreme Court refused to credit form over substance and greatly furthered the efficiency and integrity of the securities markets.

C. A NEW VERSION OF THE "IN CONNECTION WITH" REQUIREMENT

While the majority correctly found the deception to be "in connection with" a securities transaction,³³¹ the majority's reasoning was flawed. According to Justice Ginsberg, this requirement 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 [trade] securities."³³² Thus, she reasoned the securities transaction and the breach of duty occur simultaneously.³³³

Justice Ginsberg erred in framing the issue in this manner, a mistake noticed by the dissent.³³⁴ As Justice Thomas noted, the majority's approach is erroneous because it ignores the fact that the supposed threat to market integrity and investor confidence "comes not from the supposed fraud [on the source], but from the mere fact that the information was nonpublic."³³⁵ Even if the source expressly authorizes its agents to trade on the confidential information, the adverse impact on the markets is the same since the misappropriator has an insurmountable informational advantage over the average investor.³³⁶

Justice Thomas's argument is valid only if one takes an overly narrow view of what constitutes "in connection with" a se-

³³⁰ See *id.* at 10 (targets in successful takeover attempts realize an average return of 29.1%). These are essentially the facts of *O'Hagan*. See *United States v. O'Hagan*, 117 S. Ct. 2199, 2205 (1997).

³³¹ *O'Hagan*, 117 S. Ct. at 2209.

³³² *Id.*

³³³ *Id.* To bolster her conclusion, Justice Ginsberg noted that the confidential information had value to *O'Hagan* "ordinarily" in securities transactions. *Id.* at 2210.

³³⁴ See *id.* at 2225 (Thomas, J., concurring in part and dissenting in part).

³³⁵ *Id.* (Thomas, J., concurring in part and dissenting in part).

³³⁶ *Id.* (Thomas, J., concurring in part and dissenting in part).

curities transaction. If one believes, as Justice Ginsberg did, that a securities transaction includes only the actual purchase or sale of securities,³³⁷ then the fraud is irrelevant to the subsequent market integrity and the "in connection with" requirement is not satisfied. The proper view, however, is to consider the gathering of information itself as part of the gatheror's securities transaction. First, as explained above, information gathering has significant costs.³³⁸ A person will not incur these costs if unable to profit from the information produced,³³⁹ which profit ordinarily comes from trading in the securities markets.³⁴⁰ Thus, the gathering of information should be considered part of the gatheror's securities transaction since the search costs are incurred in anticipation of profiting in the purchase or sale of securities.

In addition, information is unique in the financial markets; it is the only asset that can alter the value of the underlying commodity.³⁴¹ For example, the market price of Pillsbury common stock would skyrocket as soon as the information of Grand Met's tender offer became public.³⁴² When O'Hagan learned of this information, his personal valuation of Pillsbury common stock and call options exceeded the market's valuations, and, thus, he bought substantial amounts of both of these securities in anticipation of price increases once the information became public.³⁴³ Misappropriated money, unlike information, does not alter the underlying commodity in any sense.³⁴⁴ It simply gives the misappropriator the option to trade in the underlying commodity if he so chooses. It does not change his personal valuation of the commodity compared to the market's.

Under the view that the gathering of information is part of the gatherer's securities transaction, O'Hagan's fraud was "in connection with" the purchase or sale of securities. O'Hagan defrauded the source of the information in anticipation of earn-

³³⁷ *Id.* at 2209.

³³⁸ See Easterbrook, *supra* note 285, at 313.

³³⁹ *Id.*

³⁴⁰ *O'Hagan*, 117 S. Ct. at 2210.

³⁴¹ See BODIE ET AL., *supra* note 286, at 342-43.

³⁴² *O'Hagan*, 117 S. Ct. at 2205. The price of Pillsbury increased more than 50% from \$39 to \$60 per share of common stock. *Id.*

³⁴³ See Brief for Petitioner at 5-6, *O'Hagan* (No. 96-842).

³⁴⁴ See *O'Hagan*, 117 S. Ct. at 2222-24 (Thomas, J., concurring in part and dissenting in part) (comparing misappropriated information to misappropriated money).

ing profits in the securities markets.³⁴⁵ He knew that this information, once made public, would alter the value of the underlying securities.³⁴⁶ If the gathering of information is deemed part of the gatheror's securities transaction, O'Hagan's deceptive device to acquire the information was "in connection with" a purchase or sale of securities in violation of § 10(b) and Rule 10b-5.

VI. CONCLUSION

In *United States v. O'Hagan*, the Supreme Court concluded that the misappropriation theory is a valid basis upon which to base § 10(b) and Rule 10b-5 liability. *O'Hagan* was correctly decided, but should have employed different reasoning. First, the misappropriation theory as adopted in *O'Hagan* is consistent with the holdings in *Chiarella* and *Dirks*. Second, the misappropriation theory advances the efficiency and integrity of the securities market. Third, O'Hagan's deception was "in connection with" a securities transaction not because the fraud and purchase of securities happen together, as the Court believed, but because the gathering of information by O'Hagan was part of his securities transaction. The majority's approach ignores the fact that the potential threat to market integrity and investor confidence is due to the nonpublic nature of the information, not the fraud on the source.

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³⁴⁵ *Id.* at 2209-10.

³⁴⁶ *See id.* at 2205. For other examples of profits from having inside information regarding tender offers, see *Chiarella v. United States*, 445 U.S. 222, 224 (1980) (\$30,000 profits over 14 month period), *SEC v. Cherif*, 933 F.2d 403, 407 (7th Cir. 1991) (\$247,000 profits during 10 month period), *SEC v. Clark*, 915 F.2d 439, 442 (9th Cir. 1990) (\$57,000 profits over two month period), and *SEC v. Materia*, 745 F.2d 197, 200 (2d Cir. 1984) (nearly \$100,000 profits during two year period).