

# Insider Trading and *United States v. O'Hagan*: The Supreme Court Reinstates Securities Fraud Convictions Based on the Misappropriation Theory

Rachel Goldstein

It can begin with an innocent conversation. It can happen any time, any place, in public or behind closed doors. It has been known to involve Wall Street executives,<sup>1</sup> stockbrokers,<sup>2</sup> doctors,<sup>3</sup> lawyers,<sup>4</sup> lottery directors,<sup>5</sup> New York City's finest,<sup>6</sup> and even print shop employees.<sup>7</sup> What is it? It is insider trading.

In the absence of a statutory definition, insider trading has, by default, been defined by case law; the law of insider trading has been extensively developed by the courts. The landmark case of

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<sup>1</sup> Securities & Exch. Comm'n v. Boesky, Fed. Sec. L. Rep. (CCH) ¶ 92,991 (S.D.N.Y. 1986); Securities & Exch. Comm'n v. Levine, 689 F. Supp. 317 (S.D.N.Y. 1988); Securities & Exch. Comm'n v. Siegel, Fed. Sec. L. Rep. (CCH) ¶ 93,123 (S.D.N.Y. 1987).

<sup>2</sup> United States v. Newman, 664 F.2d 12 (2d Cir. 1981) (convicting securities trader of Rule 10b-5 violation for trading on inside securities information obtained from employees of stock brokerage); United States v. Chestman, 947 F.2d 551 (2d Cir. 1991) (reversing conviction on Stockbroker's Rule 10b-5 due to absence of a showing of a fiduciary relationship existing between stockbroker's client and client's wife regarding inside information pertaining to client's wife's family business).

<sup>3</sup> Securities & Exch. Comm'n v. Willis, 777 F. Supp. 1165 (S.D.N.Y. 1991), *later proceeding*, 825 F. Supp. 617 (S.D.N.Y. 1993) (convicting psychiatrist of securities fraud for giving his stockbroker inside information he obtained from his patient, the wife of a corporate executive). In 1995, a psychotherapist admitted guilty to insider trading resulting from investing in his patient's company after being tipped by the patient, an aerospace company executive, about the company's planned merger with another company. Jeff Cole, *Executive's Therapist Pleads Guilty to Fraud in Trading of Lockheed Stock*, WALL ST. J., Dec. 14, 1995, at B5.

<sup>4</sup> United States v. O'Hagan, 117 S. Ct. 2199 (1997); United States v. Reich, 661 F. Supp. 371 (S.D.N.Y. 1987) (denying motion to reduce 366-day sentence for crime of securities fraud). In 1987, a 34-year-old lawyer was convicted of 38 counts of insider trading after he tipped family and friends to invest in a company that the lawyer learned through his law firm was planning a corporate restructuring. James Sterngold, *Lawyer, 34, Is Convicted of Passing Insider Tips*, N.Y. TIMES, Aug. 19, 1987, at D1, D2.

<sup>5</sup> United States v. Bryan, 58 F.3d 933 (4th Cir. 1995).

<sup>6</sup> In 1983, the Securities and Exchange Commission charged four New York police officers, along with five other New York residents, with illegally earning over \$1.2 million from trading on inside information regarding tender offers they obtained from a New York law firm that was working on the offers. Richard L. Hudson and Tim Metz, *SEC Charges That 4 Policemen, 5 Others Earned \$1.2 Million on Insider Trading*, WALL ST. J., Jan. 12, 1983 at 8.

<sup>7</sup> Chiarella v. United States, 445 U.S. 222 (1980).

*Securities and Exchange Commission v. Texas Gulf Sulphur Co.*<sup>8</sup> defined "insider" as referring to "employees as well as officers, directors and controlling stockholders who are in possession of material undisclosed information obtained in the course of their employment."<sup>9</sup> Material information was defined as information "which in reasonable and objective contemplation might affect the value of the corporation's stock or securities . . ." <sup>10</sup> Furthermore, material information was also extended to include information which, if known, would clearly affect "investment judgment,"<sup>11</sup> or which directly bears on the intrinsic value of a company's stock.<sup>12</sup>

The significance of *Texas Gulf Sulphur* lies not only in its useful definitions of insider trading, but also in its far-reaching decision regarding the prohibition on insider trading. In *Texas Gulf Sulphur*, officers, directors and employees of a large minerals company secretly profited from trading on material, nonpublic information they received regarding the company's successful exploratory mining activities in Canada.<sup>13</sup> Instead of refraining from acting on this information until it was released to the shareholders and to the public, the defendants secretly purchased shares of company stock, enabling these insiders to enjoy tremendous profits once the information was publicly released. The company also published misleading press releases informing the public that its exploratory mining activities were inconclusive at a time when defendants already knew the company's mining activities had been tremendously successful in yielding valuable copper deposits.<sup>14</sup>

The court held two of the defendants had committed securities trading violations under Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934.<sup>15</sup> In essence, the court held that these defendants violated the law by trading on material, nonpublic information. The case set an important precedent for future cases involving classic "insiders" and illegality of insider trading based on Section 10(b) and Rule 10b-5.

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<sup>8</sup> *Securities & Exch. Comm'n v. Texas Gulf Sulphur Co.*, 258 F. Supp. 262 (S.D.N.Y. 1966), *aff'd in part and rev'd in part en banc*, 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

<sup>9</sup> *Id.* at 279 (citing *In re Cady, Roberts & Co.*, 40 S.E.C. 907, 912 (1961) (pointing out that Section 10(b) refers to an "insider" as "any person," which includes persons who are not directors, officers or major stockholders)).

<sup>10</sup> *Id.* at 280 (quoting *List v. Fashion Park, Inc.*, 340 F.2d 457, 462 (2d Cir. 1965), *citing Kohler v. Kohler Co.*, 319 F.2d 634, 642 (7th Cir. 1963)).

<sup>11</sup> *Id.* at 280 (citing *In re Cady, Roberts & Co.*, 40 S.E.C. at 911).

<sup>12</sup> *Id.* at 280 (referring to *Kardon v. National Gypsum Co.*, 73 F. Supp. 798 (E.D. Pa. 1947); *Speed v. Transamerica Corp.*, 99 F. Supp. 808 (D. Del. 1951); *Ward LaFrance Truck Corp.*, 13 S.E.C. 373 (1943)).

<sup>13</sup> *Id.* at 262.

<sup>14</sup> *Id.*

<sup>15</sup> *Id.* at 287 n.23.

In addition, *Texas Gulf Sulphur* dealt with insiders known as tippers.<sup>16</sup> A tipper is "a person who possesses material inside information, and who makes selective disclosure of such information for trading or other personal purposes."<sup>17</sup> Inside information is regarded as company information that is not publicly disclosed and could be used to facilitate personal market transactions.<sup>18</sup> Possession of material inside market information may give rise to a duty to either reveal that material inside information prior to trading on it, or refrain from trading on the basis of the material inside information altogether.<sup>19</sup>

The duty to disclose or abstain<sup>20</sup> from trading on the basis of nonpublic material information does not arise from the mere possession of inside information.<sup>21</sup> Instead, it arises from the existence of a fiduciary relationship between the parties.<sup>22</sup> A fiduciary relationship is one involving an individual or entity who "is under a duty to act for or to give advice for the benefit of the other party upon matters within the scope of the relation."<sup>23</sup> The term "insider" presumes a fiduciary duty is owed by the insider to the person from whom the insider receives material, undisclosed information.<sup>24</sup>

Insider trading can also refer to the act of receiving material information from insiders and then using that information to the recipient's benefit, without disclosing that information.<sup>25</sup> These individuals are commonly referred to as "tippees."<sup>26</sup> In the securities law area,<sup>27</sup> a tippee is "a person who acquires material non-

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<sup>16</sup> Insiders are not the focus of the misappropriation theory; they are the focus of the classical theory, which is beyond the topic of this case note. See generally *Chiarella v. United States*, 445 U.S. 222 (1980); *Dirks v. Securities & Exch. Comm'n*, 463 U.S. 646 (1983).

<sup>17</sup> BLACK'S LAW DICTIONARY 1484 (6th ed. 1990).

<sup>18</sup> Gregory R. Andre, Note, *Constructive Insider Liability and the Arm's Length Transaction Under Footnote 14 of Dirks*, 52 GEO. WASH. L. REV. 872, 872 n.1 (1984).

<sup>19</sup> *Securities & Exch. Comm'n v. Texas Gulf Sulphur Co.*, 258 F. Supp. 262, 280 (S.D.N.Y. 1966), *aff'd in part and rev'd in part en banc*, 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

<sup>20</sup> The duty to disclose or abstain originated with the recognition of "[a]n affirmative duty to disclose material information [, which] has been traditionally imposed on corporate 'insiders,' particularly officers, directors, or controlling stockholders. We, and the courts, have consistently held that insiders must disclose material facts which are known to them by virtue of their position but which are not known to persons with whom they deal and which, if known, would affect their investment judgment." The duty arises from (i) the existence of information only intended to be used for corporate purposes, and (ii) the unfairness of allowing a corporate insider to benefit from trading on that information without prior full disclosure. *In re Cady, Roberts & Co.*, 40 S.E.C. 907, 911-12 (1961), *cited in Chiarella*, 445 U.S. at 227.

<sup>21</sup> *Dirks*, 463 U.S. at 646.

<sup>22</sup> *Id.* at 646 (citing *Chiarella*, 445 U.S. at 222).

<sup>23</sup> RESTATEMENT OF TORTS § 874 cmt. a (1939), Andre, *supra* note 18, at 875.

<sup>24</sup> *Securities & Exch. Comm'n v. Cherif*, 933 F.2d 403, 409 (7th Cir. 1991).

<sup>25</sup> *Chiarella*, 445 U.S. at 230.

<sup>26</sup> *Id.* at 230 n.12.

<sup>27</sup> BLACK'S LAW DICTIONARY 1484 (6th ed. 1990).

public information from another who enjoys a fiduciary relationship with the company to which such information pertains."<sup>28</sup> Tippees are generally distinguished from "outsiders." Outsiders are viewed as neither insiders of companies, nor tippees of insiders.<sup>29</sup> While a tippee may differ from an outsider, in some instances an outsider may be considered to owe the same fiduciary duty as a tipper because of the outsider's fiduciary relationship to the tippee.<sup>30</sup>

Tippees generally do not possess the kind of independent fiduciary relationships with respect to the corporation and its shareholders that tippers have.<sup>31</sup> However, certain relationships, such as those between attorneys (tippees) and their clients (tippers), where confidential client company information may be shared with other attorneys in the firm (outsiders), may cause the outsider with whom that confidential information is shared to be regarded not only as a tippee, but also as a fiduciary.<sup>32</sup> In this context, an outsider who uses the confidential information to the outsider's sole benefit should, therefore, be regarded as breaching his or her fiduciary duty to the company's shareholders because of his or her fiduciary relationship to the tippee. The United States Supreme Court confronted this issue in the insider trading case, *United States v. O'Hagan*.<sup>33</sup>

*O'Hagan* addresses the conduct of an "outsider" under Section 10(b) and accompanying Rule 10b-5 of the Securities Exchange Act of 1934.<sup>34</sup> James Herman O'Hagan was an attorney, who secretly profited from investing in a takeover target of his firm's corporate clients after learning about the proposed takeover from

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<sup>28</sup> *Id.*

<sup>29</sup> Securities & Exch. Comm'n v. Clark, 915 F.2d 439, 442 (9th Cir. 1990).

<sup>30</sup> For example, an attorney who is in-house counsel for a client is an insider because he is also an employee of that client. If that attorney acts on nonpublic, material information obtained from the client, that attorney becomes a tippee. An attorney who is not affiliated with a client's business but is acting on behalf of the client is generally considered an outsider. Even as an outsider, however, the attorney still owes a fiduciary duty to the attorney's client because of the fiduciary relationship that exists between attorneys and clients. When an attorney is a partner in a law firm, that attorney also owes a fiduciary duty to the other attorneys in the law firm and to those attorneys' clients. Therefore, an attorney who acts on nonpublic, material information obtained from another attorney in that firm and which belongs to a firm client, may also be viewed as a tippee. Supreme Court Justice Ginsburg elaborated on the distinction between *O'Hagan* and Pillsbury, the takeover target of a Dorsey & Whitney client, "Although an 'outsider' with respect to Pillsbury, O'Hagan had an intimate association with, and was found to have traded on confidential information from, Dorsey & Whitney, counsel to tender offeror Grand Met." *United States v. O'Hagan*, 117 S. Ct. 2199, 2221 n.5 (1997).

<sup>31</sup> *Dirks v. Securities & Exch. Comm'n*, 463 U.S. 646, 655 (1983).

<sup>32</sup> *Id.*

<sup>33</sup> *O'Hagan*, 117 S. Ct. at 2199.

<sup>34</sup> 15 U.S.C. § 78j(b) (1997). Regulation of insider trading is primarily federal in nature. The SEC regulates deception requirements under the Securities Exch. Act of 1934 through Section 10(b) and disclosure requirements through antifraud provisions such as Rule 10b-5. 17 C.F.R. 240.10b-5 (1997).

the client's attorney in the firm. The critical issue was whether O'Hagan, a partner in the law firm which represented the bidder of a takeover target, could be held liable for trading on and profiting from the takeover information he obtained by talking with another attorney in the firm. O'Hagan was originally convicted on securities fraud, mail fraud and money laundering charges.<sup>35</sup> However, his convictions were overturned on appeal, based on the court of appeal's narrow interpretation of Section 10(b) and Rule 10b-5.<sup>36</sup> The long-standing conflict<sup>37</sup> among the lower courts in interpreting whether the scope of the statutory language of Section 10(b) and Rule 10b-5 of the Securities Exchange Act extends to insider trading cases such as *O'Hagan* culminated in the need for the Supreme Court's resolution of the issue.

The specific issue was whether O'Hagan's securities fraud convictions could be sustained under the "misappropriation theory," which allows a broad prohibition against insider trading. The misappropriation theory is one of two theories created under Section 10(b)'s proscription of deception.<sup>38</sup> The older theory is known as the classical theory. The classical theory, based on *Texas Gulf Sulphur*, is the original basis upon which insider trading has been proscribed.<sup>39</sup> This theory pertains only to an insider, including a tippee of the insider, who has a fiduciary or similar relationship to the company shareholders in whose stock the insider traded.<sup>40</sup> Under the classical theory, an "insider owes a fiduciary duty to the corporation's shareholders not to trade on inside information for his personal benefit."<sup>41</sup>

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<sup>35</sup> Securities Exch. Comm'n v. O' Hagan, 901 F. Supp. 1461 (D. Minn. 1995).

<sup>36</sup> United States v. O' Hagan, 92 F.3d 612, 619 (8th Cir. 1996).

<sup>37</sup> Circuit courts which have applied the misappropriation theory to securities fraud cases include: the Second Circuit, *see, e.g.*, United States v. Newman, 664 F.2d 12 (2d Cir. 1981), Securities & Exch. Comm'n v. Materia, 745 F.2d 197 (2d Cir. 1984); the Third Circuit, *see, e.g.*, Rothberg v. Rosenbloom, 771 F.2d 818 (3d Cir. 1985); the Seventh Circuit, *see, e.g.*, Securities & Exch. Comm'n v. Cherif, 933 F.2d 403 (7th Cir. 1991), Securities & Exch. Comm'n v. Maio, 51 F.3d 623 (7th Cir. 1995); and the Ninth Circuit, *see, e.g.*, Securities & Exch. Comm'n v. Clark, 915 F.2d 439 (9th Cir. 1990). Circuit courts that have rejected the misappropriation theory in securities fraud cases include: the Fourth Circuit, *see, e.g.*, United States v. Bryan, 58 F.3d 933 (4th Cir. 1995); and the Eighth Circuit, *see, e.g.*, O'Hagan, 92 F.3d at 612.

<sup>38</sup> *O' Hagan*, 92 F.3d at 616.

<sup>39</sup> *Id.* at 616. The Eighth Circuit refers to *Chiarella*, 445 U.S. 222, 233 (1980), as the germinal case outlining the classical theory approach to the prohibition on insider trading. "[T]he duty to disclose arises when one party has information that the other party is entitled to know because of a fiduciary or other relationship of trust and confidence between them." *Chiarella*, 445 U.S. at 226-35 (citing RESTATEMENT (SECOND) OF TORTS § 551(2)(a) (1976)).

<sup>40</sup> *Clark*, 915 F.2d at 443.

<sup>41</sup> *O'Hagan*, 92 F.3d at 616 (quoting *Cherif*, 933 F.2d at 409). The classical theory focuses solely on corporate "insiders"; that is, those within the corporation who personally benefit by secretly trading on inside information they receive from the corporation regarding the corporation's shares. The misappropriation theory, on the other hand, extends the reach of the prohibition against insider trading to those traders who exhibit the same pro-

O'Hagan was neither an insider of the company whose shares were being traded, nor a tippee of any insider. Therefore, he falls outside the reach of the classical theory.<sup>42</sup> Thus, even though O'Hagan traded securities based on material, nonpublic information, he owed no fiduciary duty to the shareholders of the company in whose stock he traded.<sup>43</sup> However, O'Hagan is within the reach of the misappropriation theory, which specifically extends the prohibition against insider trading to trading by outsiders, such as O'Hagan.<sup>44</sup> The misappropriation theory "extends the reach of Rule 10b-5 to outsiders who would not ordinarily be deemed fiduciaries of the corporate entities in whose stock they trade . . . ."<sup>45</sup>

While it is clear that the classical theory does not apply to *O'Hagan*, the Supreme Court's recent decision to reverse the Eighth Circuit's ruling and uphold O'Hagan's convictions now makes it equally clear that the misappropriation theory applies to cases involving outsiders who trade on privileged information. The Supreme Court's decision is consistent with several prior circuit court decisions<sup>46</sup> that have applied the misappropriation theory in insider trading cases. The decision puts an end to inconsistent holdings made by some of the lower courts in applying the misappropriation theory. The Supreme Court has now established a long awaited definitive ruling for insider trading cases coming under this previously undefined area of securities law.

This case note will analyze the merits of the misappropriation theory and set forth the reasons justifying the Supreme Court's recent decision to apply the misappropriation theory in *O'Hagan*. Part I will discuss the background and facts surrounding *O'Hagan*. Part II will discuss the origins of the misappropriation theory, particularly the language of Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934. Part III will present the arguments in support of the theory, looking specifically at previously decided cases which have applied and rejected the misappropriation theory as a basis for Section 10(b) and Rule 10b-5 liability and compare them to *O'Hagan*. Part IV will address the policy

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scribed conduct, but who would not otherwise be liable because they are outsiders. The misappropriation theory turns on the existence of a fiduciary duty between the misappropriation and the lawful possessor of that misappropriated information and whether a breach of that duty occurred. *Id.*

<sup>42</sup> *Clark*, 915 F.2d at 442.

<sup>43</sup> *O'Hagan*, 92 F.3d at 617 n.5.

<sup>44</sup> *Cherif*, 933 F.2d at 408.

<sup>45</sup> *Id.* at 409.

<sup>46</sup> Circuit courts that have applied the misappropriation theory to securities fraud cases include the Second Circuit, *see, e.g.*, *United States v. Newman*, 664 F.2d 12 (2d Cir. 1981), *Securities & Exch. Comm'n v. Materia*, 745 F.2d 197 (2d Cir. 1984); the Third Circuit, *see, e.g.*, *Rothberg v. Rosenbloom*, 771 F.2d 818 (3d Cir. 1985); the Seventh Circuit, *see, e.g.*, *Cherif*, 933 F.2d 403, *Securities & Exch. Comm'n v. Maio*, 51 F.3d 623 (7th Cir. 1995); and the Ninth Circuit, *see, e.g.*, *Clark*, 915 F.2d 439 (9th Cir. 1990).

considerations behind the misappropriation theory and Part V will state the conclusion.

## I. BACKGROUND AND FACTS

### A. *State v. O'Hagan*

O'Hagan, an attorney and partner with the Minneapolis law firm of Dorsey and Whitney, was convicted in a Minnesota state court of misappropriating client trust funds between October 1986 and March 1988.<sup>47</sup> These criminal charges resulted from the firm's discovery that O'Hagan had taken money out of two client trust fund accounts to pay off his personal bank loans.<sup>48</sup>

O'Hagan claimed during the state trial that he understood that temporarily taking money from a client's account was allowable at the discretion of the client's attorney. However, it later became clear that O'Hagan unlawfully took the money when both clients at trial denied giving O'Hagan permission to take the money from their accounts.<sup>49</sup> O'Hagan was subsequently disbarred<sup>50</sup> and convicted of misappropriation.<sup>51</sup>

### B. *Securities and Exchange Commission v. O'Hagan*

#### 1. The Facts and the Charges

In the summer of 1988, O'Hagan received material, nonpublic information from another partner in the firm, Thomas Tinkham.<sup>52</sup> The information concerned a tender offer<sup>53</sup> about to be made by the firm's client, Grand Met PLC, for the common shares of a target company, Pillsbury. Shortly thereafter, O'Hagan purchased a total of 7,500 shares in Pillsbury: 5,000 shares of common stock<sup>54</sup>

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<sup>47</sup> *State v. O' Hagan*, 474 N.W.2d 613 (Minn. Ct. App. 1991).

<sup>48</sup> *Id.* at 616-17. The two trust accounts consisted of settlement money that had been obtained for two of O'Hagan's clients; the Mayo Clinic and Northrup King & Co.

<sup>49</sup> *Id.* at 615-16.

<sup>50</sup> *In re O'Hagan*, 450 N.W.2d 571 (Minn. 1990).

<sup>51</sup> *State v. O'Hagan*, 474 N.W.2d at 615. Therefore, by the time federal securities charges were later filed by the Securities and Exchange Commission against O'Hagan, he already had one conviction on his record. He had displayed a tendency toward misconduct by significantly deviating from the firm's standard practice of not allowing attorneys to take money out of clients' accounts for their personal use.

<sup>52</sup> No charges were filed against Mr. Tinkham, who was said to have been unaware of O'Hagan's intent on acquiring Pillsbury stock. Brief for Appellee at 9, *United States v. O'Hagan*, 92 F.3d 612 (8th Cir. 1996) (Nos. 94-3714 and 94-3856).

<sup>53</sup> "A tender offer is a public announcement by a company or individual indicating that it will pay a price above the current market price for the shares 'tendered' of a company it wishes to acquire or take control of." BLACK'S LAW DICTIONARY 1468 (6th ed. 1990). In general, see Denis Binder, *The Securities Law of Contested Tender Offers*, 18 N.Y.L.F. 569 (1973).

<sup>54</sup> Common stock is a class of stock that allows for ultimate or residual ownership of the corporation. BLACK'S LAW DICTIONARY 278 (6th ed. 1990).

and an additional 2,500 shares on a call option contract<sup>55</sup> basis. Immediately after the takeover was announced in the fall of 1988, O'Hagan sold these shares, realizing a profit of over \$4 million. The Securities and Exchange Commission (SEC) charged O'Hagan with misappropriating insider information in violation of Section 10(b) and Rule 10b-5 of the Securities Exchange Act.<sup>56</sup> The SEC also charged O'Hagan with perpetrating securities fraud in violation of Section 14(e) and Rule 14e-3 promulgated under Section 14(e).<sup>57</sup> O'Hagan was convicted in a Minnesota district court in 1994 of 57 counts of securities fraud, mail fraud and money laundering.<sup>58</sup> The court also ordered a disgorgement of O'Hagan's profits, and permanently enjoined him from engaging in any securities trading.<sup>59</sup> O'Hagan appealed his securities fraud convictions on the grounds that the government's use of the misappropriation theory was an inapplicable theory of Section 10(b) liability on which to convict him.<sup>60</sup>

## 2. The Reversal

After reviewing the language of the Section 10(b), which explicitly requires "deception," the Eighth Circuit Court of Appeals determined that "deception" is not a necessary component of the misappropriation theory.<sup>61</sup> The court then proceeded not only to reverse O'Hagan's securities fraud convictions, but also to overturn his mail fraud and money laundering convictions, which were predicated on the securities fraud convictions.<sup>62</sup> The court also ordered the forfeiture of O'Hagan's profits. The court further noted in its opinion that "[N]either the Supreme Court nor this court has yet determined whether the misappropriation theory is a permissible basis upon which to impose 10(b) liability."<sup>63</sup>

In reversing O'Hagan's securities fraud, mail fraud and money laundering convictions,<sup>64</sup> the Eighth Circuit joined the

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<sup>55</sup> "A call option is a negotiable instrument whereby writer of option, for a certain sum of money (the 'premium'), grants to the buyer of option the irrevocable right to demand, within a specified time, the delivery by the writer of a specified number of shares of a stock at a fixed price (the 'exercise' or 'striking' price)." BLACK'S LAW DICTIONARY 204 (6th ed. 1990).

<sup>56</sup> 15 U.S.C. § 78j(b) (1985); 17 C.F.R. 240.10b-5 (1998). Taken from *O'Hagan*, 92 F.3d at 615.

<sup>57</sup> *O'Hagan*, 92 F.3d at 625. 15 U.S.C. § 78n(e) (1985); 17 C.F.R. 240.14e-3(a) (1998). This case note does not address Section 14 or Rule 14.

<sup>58</sup> *O'Hagan*, 92 F.3d 612; Securities & Exch. Comm'n v. O'Hagan, 901 F. Supp. 1461, 1474 (D. Minn. 1995).

<sup>59</sup> *O'Hagan*, 901 F. Supp at 1472.

<sup>60</sup> *O'Hagan*, 92 F.3d at 622.

<sup>61</sup> *Id.* at 617.

<sup>62</sup> *Id.* at 628.

<sup>63</sup> *Id.* at 617.

<sup>64</sup> *Id.* at 612.

Fourth Circuit,<sup>65</sup> the only other federal circuit which has expressly refused to base a securities fraud conviction on the misappropriation theory.<sup>66</sup> The rulings of the Eighth and Fourth Circuit courts stand in sharp contrast to those of the Second,<sup>67</sup> Third,<sup>68</sup> Seventh<sup>69</sup> and Ninth<sup>70</sup> Circuit courts, all of which have embraced the misappropriation theory, and welcomed its application to securities fraud cases.

### C. U.S. Supreme Court Applies Misappropriation Theory in *United States v. O'Hagan*

The government's efforts to reinstate O'Hagan's prior convictions in an en banc hearing by the Eighth Circuit were unsuccessful.<sup>71</sup> However, the denial was followed by a granting of certiorari by the U.S. Supreme Court.<sup>72</sup> The Court reinstated O'Hagan's prior convictions based on the misappropriation theory.<sup>73</sup> The decision settles the long-standing dispute regarding the application of the misappropriation theory in securities fraud cases.<sup>74</sup> The Court's official endorsement of the misappropriation theory in securities fraud cases also sends a resounding new warning throughout the securities world: "Outsiders" who trade on misappropriated information are just as liable under the misappropriation theory for insider trading as "insiders" are under the classical theory.

## II. ORIGINS OF MISAPPROPRIATION

### A. Section 10(b) and Rule 10b-5

An understanding of the origins of the misappropriation theory requires a closer look at the background of Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934. Section 10(b) of the Securities Exchange Act of 1934 originated as part of the

<sup>65</sup> *United States v. Bryan*, 58 F.3d 933, 949 (4th Cir. 1995).

<sup>66</sup> The misappropriation theory was first used by the government in *Chiarella v. United States*, 445 U.S. 222, 235 (1980), cited in *Securities & Exch. Comm'n v. Clark*, 915 F.2d 439, 444 (9th Cir. 1990). The theory was first adopted by the court, however, in *United States v. Newman*, 664 F.2d 12 (2d Cir. 1981), cited in *Bryan*, 58 F.3d at 954.

<sup>67</sup> *Newman*, 664 F.2d at 12; *Securities & Exch. Comm'n v. Materia*, 745 F.2d 197 (2d Cir. 1984).

<sup>68</sup> *Rothberg v. Rosenbloom*, 771 F.2d 818 (3d Cir. 1985), on remand, 628 F. Supp. 746 (E.D. Pa. 1986), rev'd and remanded, 808 F.2d 252 (3d Cir. 1986), cert. denied, 481 U.S. 1017 (1987).

<sup>69</sup> *Securities & Exch. Comm'n v. Cherif*, 933 F.2d 403 (7th Cir. 1991); *Securities & Exch. Comm'n v. Maio*, 51 F.3d 623 (7th Cir. 1995).

<sup>70</sup> *Clark*, 915 F.2d at 439.

<sup>71</sup> *United States v. O'Hagan*, 92 F.3d 612 (8th Cir.), reh'g en banc denied (8th Cir. 1996), cert. granted, 117 S. Ct. 759 (1997).

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

<sup>73</sup> *United States v. O'Hagan*, 117 S. Ct. 2199 (1997).

<sup>74</sup> Jonathan E.A. ten Oever, Note, *Insider Trading and the Dual Role of Information*, 106 YALE L.J. 1325 (1997).

New Deal legislation regulating securities exchanges.<sup>75</sup> In 1942, the Securities and Exchange Commission promulgated Rule 10b-5.<sup>76</sup> Section 10(b) prohibits deceptive conduct,<sup>77</sup> while Rule 10b-5 proscribes fraudulent conduct.<sup>78</sup>

A proper analysis of Section 10(b) and Rule 10b-5 requires a close look at the statutory language.<sup>79</sup> The language of these provisions lays the foundation for the misappropriation theory.

Section 10(b), in part, states:

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

. . . .

- b) To use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.<sup>80</sup>

Rule 10b-5, in part, states:

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

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

. . . .

- (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.<sup>81</sup>

An important difference exists in the language of Section 10(b) and Rule 10b-5. Both Section 10(b) and Rule 10b-5 speak of "deception"<sup>82</sup> in the same context of "in connection with the purchase or sale of any security."<sup>83</sup> The key difference is that Sec-

<sup>75</sup> *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 727-28 (1975).

<sup>76</sup> *Id.* at 729.

<sup>77</sup> *O'Hagan*, 92 F.3d at 616.

<sup>78</sup> *Id.* at 615.

<sup>79</sup> "*Ernst & Ernst* makes clear that in deciding whether a complaint states a cause of action for 'fraud' under Rule 10b-5, 'we turn first to the language of § 10(b), for '[t]he starting point in every case involving construction of a statute is the language itself.'" *Santa Fe Indus. v. Green*, 430 U.S. 462, 472 (1977) (citing *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 197 (1976) (quoting *Blue Chip Stamps*, 421 U.S. at 756 (Powell, J., concurring))).

<sup>80</sup> 15 U.S.C. § 78j(b) (1985).

<sup>81</sup> 17 C.F.R. 240.10b-5 (1998).

<sup>82</sup> "The act of deceiving; intentional misleading by falsehood spoken or acted." BLACK'S LAW DICTIONARY 406 (6th ed. 1990).

<sup>83</sup> *O'Hagan*, 92 F.3d 612, at 615.

tion 10(b) refers to a prohibition of "manipulation,"<sup>84</sup> whereas Rule 10b-5 refers to a prohibition of "fraud."<sup>85</sup> Section 10(b) bans only that which the Securities Exchange Commission specifically proscribes, namely manipulation and/or deception in connection with the purchase or sale of a security.<sup>86</sup> However, Rule 10b-5, which was specifically created as an addendum to Section 10(b),<sup>87</sup> introduces a proscription against fraud, which is not specifically included in the proscription on manipulation and deception as defined by Rule 10(b). At the same time, however, it has been declared that Rule 10b-5 does not extend liability beyond that conduct which Section 10(b) specifically prohibits.<sup>88</sup>

Rule 10b-5 has been said to require the element of scienter or intent in wrongdoing,<sup>89</sup> while Section 10(b) has been described as a general antifraud statute.<sup>90</sup> Section 10(b) has also been referred to as the "catch-all" section.<sup>91</sup> The statute was originally worded to protect only brokers and dealers involved in securities purchases from deceptive conduct, while the rule was added to extend protection against intentional fraudulent conduct to anyone in connection with the purchase or sale of securities.<sup>92</sup>

By proscribing intentional fraudulent conduct, Rule 10b-5 closed a gap in coverage that the language of Section 10(b) had

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<sup>84</sup> *Id.* Manipulation has been defined to be a term of art within the securities market context, referring to practices such as wash sales, matched orders, or rigged prices to intentionally mislead the investing public by artificially influencing market prices. *Id.* at 615 n.4 (citing *Santa Fe Indus. v. Green*, 430 U.S. 462, 476 (1977) (quoting *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 199 (1976))).

<sup>85</sup> "A false representation of a matter of fact, whether by words or by conduct, by false or misleading allegations, or by concealment of that which should have been disclosed, which deceives and is intended to deceive another so that he shall act upon it to his legal injury." BLACK'S LAW DICTIONARY 660 (6th ed. 1990).

<sup>86</sup> *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164, 177 (1994).

<sup>87</sup> *Ernst & Ernst*, 425 U.S. at 214 n.32.

<sup>88</sup> *Id.* at 214 (1976). In *United States v. O'Hagan*, the Eighth Circuit extrapolated the restricted interpretation of Rule 10b-5 from the Supreme Court's narrow interpretation of Section 10(b) in *Central Bank of Denver*: "With respect . . . to . . . the scope of conduct prohibited by Section 10(b), the text of the statute controls our decision." *O'Hagan*, 92 F.3d at 616. However, *Central Bank's* ruling pertains to an aiding and abetting charge, not to insider trading activities. While Section 10(b) and accompanying Rule 10b-5 were intended to proscribe activities in connection with the purchase or sale of securities, they were not intended to cover aiding and abetting charges.

<sup>89</sup> *Ernst & Ernst*, 425 U.S. at 214.

<sup>90</sup> *United States v. Chestman*, 947 F.2d 551, 559 (2d Cir. 1991).

<sup>91</sup> *Ernst & Ernst*, 425 U.S. at 202. The term "catch-all," however, belongs to Thomas G. Corcoran, the spokesman for the drafters of Section 10(b). *Id.*

<sup>92</sup> "The Securities & Exch. today announced the adoption of a rule prohibiting fraud by any person in connection with the purchase of securities. The previously existing rules against fraud in the purchase of securities applied only to brokers and dealers." SEC Release No. 3230 (May 21, 1942) (issued by the Securities and Exchange Commission concurrent with the adoption of Rule 10b-5), quoted in *Ernst & Ernst*, 425 U.S. at 214 n.32.

previously left open.<sup>93</sup> However, the Eighth Circuit's narrow interpretation of "fraud" in Rule 10b-5 ignored the purpose of the Rule. The specific language at issue in the Eighth Circuit's review of the *O'Hagan* case involved the word "deception" as an element of Section 10(b) and the term "fraud" in Rule 10b-5. The court understood "fraud" was used to define the scope of "deception."<sup>94</sup> The Eighth Circuit concluded that "fraud" as used in Rule 10b-5, could not be construed to refer to a prohibition that was broader than what "deception" referred to in Section 10(b) because Rule 10b-5 grew out of Section 10(b).<sup>95</sup> Therefore, despite the rule's purpose in extending coverage to reach fraudulent securities conduct, the Eighth Circuit narrowly construed Rule 10b-5 within the confines of the statutory language set forth in Section 10(b).

The Eighth Circuit's decision resulted from the refusal to broaden the statutory language of "deception" to encompass the meaning of "fraud" as used in Rule 10b-5. This strict construction caused the Eighth Circuit to conclude that the misappropriation theory did not provide the requisite "deception" element upon which Section 10(b) liability could be based. Furthermore, there was no basis for finding "deception" "in connection with the purchase or sale of any security."<sup>96</sup>

The Supreme Court, on the other hand, found O'Hagan met the "deceptive" element within the meaning of Section 10(b) when he intentionally failed to disclose to Dorsey & Whitney, and its client, Grand Met, that he planned to trade on the confidential, material information he received from a Dorsey and Whitney partner regarding Pillsbury: "Concretely, it was O'Hagan's failure to disclose his personal trading to Grand Met and Dorsey, in breach of his duty to do so, that made his conduct 'deceptive' under Section 10(b)."<sup>97</sup>

Furthermore, the Supreme Court found the "in connection with the purchase or sale of a security" element had been established when O'Hagan purchased and sold his Pillsbury stock without the knowledge of Dorsey & Whitney or Grand Met: "This

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<sup>93</sup> "The new rule closes a loophole in the protection against fraud administered by the Commission by prohibiting individuals or companies from buying securities if they engage in fraud in their purchase." *Id.*

<sup>94</sup> *O'Hagan*, 92 F.3d at 615. Deception within the language of Section 10(b) has been defined as "the making of a material misrepresentation or the nondisclosure of material information in violation of a duty to disclose." *United States v. Bryan*, 58 F.3d 933, 945 (4th Cir. 1995) (quoting *Santa Fe Indus. v. Green*, 430 U.S. 462, 474 (1977)).

<sup>95</sup> *O'Hagan*, 92 F.3d at 615.

<sup>96</sup> *Id.* at 617.

<sup>97</sup> *United States v. O'Hagan*, 117 S. Ct. 2199, 2211 (1997). Justice Ginsburg also points out that when the trader owes a fiduciary duty to more than one person, as in a relationship involving a lawyer, his law firm and the client, the trader's disclosure to only one of the parties may still not shield the trader from liability under the misappropriation theory. *Id.* at 2209 n.7.

element is satisfied because the fiduciary's fraud is consummated not when the fiduciary gains the confidential information, but when, without disclosure to his principal, he uses the information to purchase or sell securities."<sup>98</sup>

## B. Interpretation of the Statutory Language

The Eighth Circuit cited several cases which supported its conclusion that the language of the statute cannot be more broadly construed than what the words explicitly state.<sup>99</sup> At the same time, other courts have also acknowledged tremendous concern for ensuring fairness and integrity of conduct within the securities markets; a concern which underlies the securities laws.<sup>100</sup>

Clearly the scope of Rule 10b-5 cannot exceed the power of the Commission under Section 10(b).<sup>101</sup> However, some courts had chosen to narrowly interpret the statutory language.<sup>102</sup> The Eighth Circuit sided with a narrow interpretation of Section 10(b), thereby reversing O'Hagan's convictions based on the intent expressed by the explicit statutory language of Section 10(b).<sup>103</sup>

In reviewing the statutory language more closely, however, another logical inference may be made. The framers of Rule 10b-5 intended to expand coverage over proscribed conduct that was implicitly but not expressly prohibited by Section 10(b). Little purpose is served in including the word "fraud" in Rule 10b-5 if its meaning is restricted by the preexisting meaning of "deception" in Section 10(b). While fraud is a vehicle by which one can deceive,<sup>104</sup> fraud and deceit are not synonymous in meaning. Fraud comprises all acts, omissions and concealments involving a breach of a legal or equitable duty and resulting in damage to another.<sup>105</sup> The inclusion of "fraud" in Rule 10b-5 was not simply to restate the meaning of "deception." Otherwise, "deception" would have been inserted in Rule 10b-5 as well. A logical inference is that the in-

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<sup>98</sup> *Id.* at 2209.

<sup>99</sup> *O'Hagan*, 92 F.3d at 615 (citing *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164, 174 (1994) and *Santa Fe Indus. v. Green*, 430 U.S. 462, 472 (1977) (quoting *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 197 (1976)); *See also* *Chiarella v. United States*, 445 U.S. 222, 234-35 (1980) (citing *Touche Ross & Co. v. Redington*, 442 U.S. 560, 578 (1979) (quoting *SEC v. Sloan*, 436 U.S. 103, 116 (1978))).

<sup>100</sup> *United States v. Carpenter*, 791 F.2d 1024, 1027 (2d Cir. 1986). This concern is echoed in the majority opinion rendered by the Supreme Court in the *O'Hagan* case: "The theory is also well-tuned to an animating purpose of the Exchange Act: to ensure honest securities markets and thereby promote investor confidence." *O'Hagan*, 117 S. Ct. at 2210.

<sup>101</sup> *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 472-73 (1977) (quoting *Ernst & Ernst*, 425 U.S. at 214).

<sup>102</sup> *United States v. Newman*, 664 F.2d 12, 17 (2d Cir. 1981).

<sup>103</sup> "It is inconsistent with settled methodology in § 10(b) cases to extend liability beyond the scope of conduct prohibited by the statutory text." *O'Hagan*, 92 F.3d at 617 (citing *Central Bank of Denver*, 511 U.S. at 177).

<sup>104</sup> *Id.* at 615 n.4.

<sup>105</sup> BLACK'S LAW DICTIONARY 660 (6th ed. 1990).

sersion of "fraud," which has a broader meaning than "deception," is supportive of an expansive rather than a narrow interpretation of the statutory language of Section 10(b).

### C. The Misappropriation Theory

The misappropriation theory was born out of a need to reach those who previously could not be held liable under Section 10(b) and Rule 10b-5. The theory allows for Section 10(b) and Rule 10b-5 violations for fraud when a person "(1) misappropriates material nonpublic information (2) by breaching a duty arising out of a relationship of trust and confidence and (3) uses the information in a securities transaction, (4) regardless of whether he owed any duties to the shareholders of the traded stock."<sup>106</sup> The misappropriation theory does not involve a requisite showing of a defrauded party, or that the party from whom the misappropriator obtained the material nonpublic information was even involved in any securities transaction.<sup>107</sup> The theory merely requires a showing of a breach of fiduciary duty between the misappropriating securities trader and the party from whom the information was obtained.<sup>108</sup> At the same time, the misappropriation theory specifically addresses misappropriators operating in the area of securities transactions.<sup>109</sup>

### D. Outsiders and Fiduciary Duties

The Eighth Circuit dismissed the argument that O'Hagan owed a duty to Pillsbury because he was an outsider in relation to Pillsbury.<sup>110</sup> Similarly, in *United States v. Bryan*,<sup>111</sup> the Fourth Circuit criticized *Moss v. Morgan Stanley*<sup>112</sup> for misinterpreting a footnote in *United States v. Newman*<sup>113</sup> to mean an outsider owed

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<sup>106</sup> Securities & Exch. Comm'n v. Clark, 915 F.2d 439, 443 (9th Cir. 1990).

<sup>107</sup> *United States v. Bryan*, 58 F.3d 933, 944 (4th Cir. 1995).

<sup>108</sup> *O'Hagan*, 92 F.3d at 616 (citing *Bryan*, 58 F.3d at 944, quoting *Clark*, 915 F.2d at 443).

<sup>109</sup> *United States v. O'Hagan*, 117 S. Ct. 2199, 2209 (1997).

<sup>110</sup> While no standard definition exists for "outsider," it has been thought to refer to both tippees and recipients of information by insiders who breach a fiduciary duty in doing so. *Andre*, *supra* note 18, at 874. *Andre* also refers to *List v. Fashion Park, Inc.*, 340 F.2d 457, 463 (2d Cir. 1965).

<sup>111</sup> *Bryan*, 58 F.3d at 956 n.23.

<sup>112</sup> *Moss v. Morgan Stanley, Inc.*, 719 F.2d 5, 12 (2d Cir. 1983), *cert. denied*, 465 U.S. 1025 (1984).

<sup>113</sup> *United States v. Newman*, 664 F.2d 12, 15 n.1 (2d Cir. 1981). The *Bryan* court criticized the *Moss* court's interpretation of footnote 1 of the *Newman* opinion, which reads as follows: "In two instances the targets themselves were clients of the investment banking firms. The Government belatedly suggests that the indictment should be construed to alleged securities laws violations in these two instances, on the theory that the defendants, by purchasing stock in the target companies, defrauded the shareholders of those companies. Whatever validity that approach might have, it is not fairly within the allegations of the indictment, which allege essentially that the defendants defrauded the investment banking firms and the firms' takeover clients." *Id.* at 15. The *Bryan* court found the *Moss*

a duty to a target company that was not a "client" of the outsider's company.<sup>114</sup> Further, the *Bryan* court criticized *Moss* for its failure to show whether or how the defendant outsider owed a duty to the "non client" target company.<sup>115</sup>

O'Hagan was neither an employee nor a current shareholder of the target company, Pillsbury, prior to his sudden purchases of the Pillsbury stock. However, he was a partner of the firm engaged by Grand Met, which confidentially disclosed to the firm its intent to make a tender offer for Pillsbury stock. Even though Grand Met may not have been O'Hagan's particular client, Grand Met was a client of O'Hagan's law firm. A partner in a law firm is an agent who acts not only on behalf of its clients, but also on behalf of the other partners.<sup>116</sup> Grand Met could also then be regarded as a client of O'Hagan's. Therefore, O'Hagan owed a fiduciary duty to Grand Met and its shareholders not to act upon the material nonpublic information he indirectly obtained from Grand Met without first disclosing his intentions to Grand Met. O'Hagan also owed a duty to his law firm partnership not to act on this nonpublic information without prior disclosure to the partnership. A partnership, by definition, requires that each partner owes a fiduciary duty not only to his or her client, but also to fellow partners.<sup>117</sup>

Pillsbury was admittedly not a "client" of the law firm, per se. However, O'Hagan could still be shown to indirectly owe a fiduciary duty to Pillsbury's shareholders through his firm's direct association with its client. Grand Met initially disclosed the confidential information regarding Pillsbury, which O'Hagan later used for his sole advantage. In doing so, O'Hagan caused injury to Pillsbury's shareholders who did not have the same trading ad-

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court's interpretation to be flawed for two reasons: first, because the footnote did not attempt to "limit" the holding of the case; and second, because the footnote failed to address "whether or how" Newman and his accomplices could have owed a duty to the target company, which was not a client of the accomplices' employer, Morgan Stanley. *Bryan*, 58 F.3d at 956 n.23.

<sup>114</sup> *Bryan*, 58 F.3d at 956 n.23.

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

<sup>116</sup> Section 9(1) of the Uniform Partnership Act of 1914 states: "Every partner is an agent of the partnership for the purpose of its business, and the act of every partner, including the execution in the partnership name of any instrument, for apparently carrying on in the usual way the business of the partnership of which he is a member binds the partnership . . . ."

<sup>117</sup> "The only fiduciary duties a partner owes to the partnership and the other partners are the duty of loyalty and the duty of care set forth in subsections (b) and (c)." Uniform Partnership Act, § 404(a), cited in Allan W. Vestal, *The Disclosure Obligations of Partners Inter Se Under The Revised Uniform Partnership Act of 1994: Is the Contractarian Revolution Failing?*, 36 WM. & MARY L. REV. 1559, 1631 n.16 (1995), reprinted in 36 CORP. PRAC. COMMENTATOR 923 (1995).

vantage O'Hagan possessed through the material, nonpublic information.<sup>118</sup>

The Eighth Circuit viewed O'Hagan's purchase of Pillsbury's stock as a legitimate arm's-length transaction.<sup>119</sup> This premise would be valid if O'Hagan had not known the confidential information regarding the identity of Grand Met's tender offer target, but had simply deduced it<sup>120</sup> based on financial expertise or through some other legitimate means. However, O'Hagan gained a tremendous financial windfall by using nonpublic material information he had intentionally obtained directly from a Dorsey and Whitney partner and indirectly from a firm client. In doing so, he not only gained an unfair advantage over ordinary investors, but he also breached a fiduciary duty explicitly owed to the firm and a duty implicitly<sup>121</sup> owed to the client.

### III. APPLICATION OF THE MISAPPROPRIATION THEORY

#### A. *United States v. Newman*

The Second Circuit was the first appellate court to apply the misappropriation theory. In *Newman*, the Second Circuit used the theory to reverse a United States District Court's prior dismissal of charges for illegal insider trading activity which did not involve a direct relationship between the parties.<sup>122</sup> James Mitchell Newman, a securities trader and manager of a brokerage firm's over-the-counter trading department, misappropriated inside information he received from two employees of two investment banking firms, Morgan Stanley & Co., Inc. and Kuhn Loeb & Co., regarding proposed mergers and acquisitions. He and two co-conspirators<sup>123</sup> purchased stock in the target companies of the proposed

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<sup>118</sup> This unfair trading advantage forms the basis for the policy considerations underlying the misappropriation theory of Rule 10b-5: "[T]he Rule 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." *Securities & Exch. Comm'n v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 848 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

<sup>119</sup> This inference is based on a statement made by Chief Justice Burger in his famous *Chiarella* dissent, "As a general rule, neither party to an arm's-length business transaction has an obligation to disclose information to the other unless the parties stand in some confidential or fiduciary relation." *Chiarella v. United States*, 445 U.S. 222, 239-40 (1980). An arm's-length transaction is understood to be a complete transaction between two unrelated parties acting in their own interest. *Andre*, *supra* note 18, at 872.

<sup>120</sup> The Court in *Chiarella* used the word "deduced" to describe how Vincent Chiarella determined the identities of the target companies. *Chiarella*, 445 U.S. at 224.

<sup>121</sup> A fiduciary relationship implies that an individual entering into one will not use any revealed confidential information to that individual's advantage. *Securities & Exch. Comm'n v. Cherif*, 933 F.2d 403, 410 (7th Cir. 1991) (citing *Securities & Exch. Comm'n v. Clark*, 915 F.2d 439, 448 (9th Cir. 1990)).

<sup>122</sup> *United States v. Newman*, 664 F.2d 12, 16 (2d Cir. 1981).

<sup>123</sup> While additional defendants were named in the indictment as co-conspirators, only Newman was within the district court's jurisdiction. *Newman*, 664 F.2d at 15.

mergers and takeovers and shared the profits with the two employees. The Second Circuit held Newman's conduct "could be found to constitute a criminal violation of Section 10(b) and Rule 10b-5, despite the fact neither Morgan Stanley or Kuhn Loeb, nor their clients, were at the time purchasers or sellers of the target company securities or in any transaction with any of the defendants."<sup>124</sup> The court based the requisite finding of fraud on Newman's use of material, nonpublic information, contrary to an implicit agreement not to do so.<sup>125</sup>

O'Hagan also profited from gaining access to confidential, material information from an insider. Newman and O'Hagan both received confidential information from tippers. However, unlike Newman's tippers, O'Hagan's tipper did not share in the profits. *Newman* involved a knowing tipper. In *O'Hagan*, Tinkham was an unknowing tipper and, in fact, also appeared to be suspicious of O'Hagan after disclosing the material nonpublic information to O'Hagan.<sup>126</sup>

Newman had no direct relationship with the company in whose stock his clients traded. O'Hagan also had no direct relationship with the company in whose stock he traded. Newman did not hold a fiduciary position with his company. O'Hagan, on the other hand, held a fiduciary position within his firm. Therefore, unlike Newman, O'Hagan owed a duty to the firm's clients. The fiduciary status may have entitled him to certain officer perks. However, any perks no more included insider trading and profiting from misusing a client's nonpublic material information than they would have allowed him to embezzle money out of client trust funds to pay his personal loans.<sup>127</sup>

Even though Newman did not have a fiduciary relationship with Morgan Stanley or Kuhn Loeb or their clients, he was still found to owe a duty to the shareholders of these investment banking companies and the target companies.<sup>128</sup> As a fiduciary, O'Hagan is held to an even higher standard than a nonfiduciary like Newman. In light of the holding in *Newman*, O'Hagan should

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<sup>124</sup> *Id.* at 16.

<sup>125</sup> *Clark*, 915 F.2d at 445 (citing *Newman*, 664 F.2d at 17-18).

<sup>126</sup> Tinkham's suspicions concerning O'Hagan began with the conversation initiated by O'Hagan in the doorway of Tinkham's office regarding the Pillsbury takeover. Tinkham believed O'Hagan's interest in Pillsbury to be of a highly irregular nature. Brief for Appellee at 8-9, *United States v. O'Hagan*, 92 F.3d 612 (8th Cir. 1996) (Nos. 94-3714 and 94-3856). Later, Tinkham was observed by O'Hagan's secretary to be going through O'Hagan's mail while O'Hagan was away in Europe. Confirmation slips of purchases of Pillsbury options were among the mail pieces. Brief for Appellant at 9, *O'Hagan* (No. 94-3714).

<sup>127</sup> O'Hagan had previously been convicted of "theft by temporary taking" in a Minnesota state criminal trial for unlawfully taking money out of his clients' trust fund accounts at Dorsey and Whitney. *State v. O'Hagan*, 474 N.W.2d 613 (Minn. Ct. App. 1991).

<sup>128</sup> *Newman*, 664 F.2d at 16.

be held liable for his actions. O'Hagan stood in closer proximity as fiduciary to the shareholders of Pillsbury and Grand Met than Newman in relation to the shareholders of Morgan Stanley and Kuhn Loeb or their clients. Such inconsistency in declaring that one who is clearly in a greater fiduciary position is not liable, while another who owes a lesser duty is liable, gives rise to an inexplicable result. The Supreme Court's decision in *O'Hagan* restores consistency and logic to the scenario.

### B. *Chiarella v. United States*

The *Newman* holding, which is the most widely accepted view of the misappropriation theory to date,<sup>129</sup> stands in sharp contrast to the Supreme Court's holdings in *Chiarella v. United States*<sup>130</sup> and *Dirks v. Securities and Exchange Commission*.<sup>131</sup> The Supreme Court set forth the first restriction in *Chiarella*, holding liability under Section 10(b) and Rule 10b-5 could only be imposed based on a relationship of trust and confidence between the parties to disclose, material nonpublic information. A mere possession of material nonpublic information is insufficient.<sup>132</sup> Vincent Chiarella, a print shop employee, had deduced the identities of takeover target companies from the announcements his employer received from the acquiring companies. Even though Chiarella was in possession of nonpublic information, he was found to owe no duty to the sellers of the stocks he purchased, based on the absence of any special relationship with them.

*O'Hagan* is clearly distinguishable from *Chiarella*. Chiarella merely deduced the identities of the target companies prior to purchasing their stock, where O'Hagan intentionally elicited the target company's identity from another attorney in his firm. No relationship existed between Chiarella and the target companies. However, O'Hagan was indirectly tied as a fiduciary partner to Pillsbury and its shareholders through his firm's fiduciary relationship with Grand Met.

Both the concurring and dissenting opinions in *Chiarella* stated that the question of whether the defendant breached a duty he owed others, including the acquiring corporation and his employer, had not been presented. If it had, the Court may have upheld Chiarella's securities fraud convictions.<sup>133</sup> However, the Court noted the conviction could not rest on a theory which had not been presented to the jury. As Justice Powell remarked,

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<sup>129</sup> *Clark*, 915 F.2d at 445.

<sup>130</sup> *Chiarella v. United States*, 445 U.S. 222, 235 (1980).

<sup>131</sup> *Dirks v. Securities & Exch. Comm'n*, 463 U.S. 646, 667 (1983).

<sup>132</sup> *Chiarella*, 445 U.S. at 235.

<sup>133</sup> *Securities & Exch. Comm'n v. Cherif*, 933 F.2d 403, 409 (7th Cir. 1991).

[T]he United States offers an alternative theory to support petitioner's conviction. It argues that petitioner breached a duty to the acquiring corporation when he acted upon information that he obtained by virtue of his position as an employee of a printer employed by the corporation . . . . We need not decide whether this theory has merit for it was not submitted to the jury.<sup>134</sup>

Justice Powell's comment also served as a reminder that a theory which is not introduced at trial cannot be argued on appeal.

In *Chiarella*, misappropriation assumed an appropriately negative connotation in being equated with stealing. As dissenting Chief Justice Burger stated in *Chiarella*, "In sum, the evidence shows beyond all doubt that Chiarella, working literally in the shadows of the warning signs in the print shop, misappropriated—stole to put it bluntly—valuable nonpublic information entrusted to him in the utmost confidence."<sup>135</sup> Like *Chiarella*, O'Hagan had also been accused of stealing.

As a partner in a law firm, O'Hagan was obligated to refrain from misusing confidential client information. O'Hagan specialized in the area of securities law. His duty as a partner and his knowledge as an expert in the area of securities law caused him to be fully aware of the illegality of misappropriating clients' nonpublic material information. He, therefore, knowingly broke the law by trading in material, nonpublic information.

O'Hagan's obligations to his firm and his clients were even greater than those of a printing shop employee. While O'Hagan's status as a partner entitled him to certain rights, it also held him to a higher standard of accountability for his actions. A partners' core rights and obligations are status-based, unamendable and broadly construed.<sup>136</sup> O'Hagan's partnership status placed him on a more intimate basis with the firm's clients than *Chiarella*'s employee status placed him with his employer's clients. Thus, there was even less room for O'Hagan to escape liability under the misappropriation theory than there was for *Chiarella*, because of the difference in the fiduciary obligations that accompanied their relative positions within the hierarchical framework of their companies.

### C. *Dirks v. Securities and Exchange Commission*

In *Dirks v. Securities and Exchange Commission*,<sup>137</sup> the Supreme Court overturned the Section 10(b) and Rule 10b-5 se-

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<sup>134</sup> *Chiarella*, 445 U.S. at 235-36.

<sup>135</sup> *Id.* at 245.

<sup>136</sup> Larry E. Ribstein, *A Mid-Term Assessment of the Project to Revise the Uniform Partnership Act*, 46 BUS. LAW. 111, 113 (1990), cited in Vestal, *supra* note 117.

<sup>137</sup> *Dirks v. Securities & Exch. Comm'n*, 463 U.S. 646 (1983).

curities fraud conviction of Raymond Dirks, an insurance securities investment analyst. Dirks had disclosed to investors, including his clients, information he received from a former officer of an insurance securities company. This information concerned the company's fraudulent conduct. The Supreme Court relied on *Chiarella* in holding Dirks could not be found guilty of misappropriating nonpublic material information because he owed no fiduciary duty to the insurance company's stockholders.<sup>138</sup>

Dirks undoubtedly stood to improve his future client dealings by giving clients the nonpublic material information he received. However, Dirks neither went looking for this information, nor did he personally trade on the information. He disclosed the material, nonpublic information in an effort to expose the insurance company's fraudulent conduct. An attempt to expose this fraud was, in fact, stated to be the motivating reason behind the tipper's behavior in approaching Dirks with the information.<sup>139</sup> At one point, Dirks even stepped in to investigate and expose the fraudulent activity on his own after all other investigative efforts had failed.<sup>140</sup>

O'Hagan, on the other hand, unlawfully withheld secret<sup>141</sup> information that he actively solicited<sup>142</sup> from another partner in the firm. He then acted on this information, even though he knew it gave him at an unfair advantage over other investors. In *Chiarella*, dissenting Chief Justice Burger noted a Section 10(b) and Rule 10b-5 conviction should stand when "an informational advantage is obtained, not by superior experience, foresight, or industry, but by some unlawful means."<sup>143</sup>

Dirks was accused of disclosing nonpublic material information to his clients, while O'Hagan was tried for profiting from not disclosing material, nonpublic information. Clearly, Dirks would not be convicted under the misappropriation theory, unlike O'Hagan, simply on the basis of the traditional "duty to disclose or refrain" rule set forth in *In Re Cady, Roberts & Co.*<sup>144</sup>

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<sup>138</sup> *Id.* at 667.

<sup>139</sup> *Id.* at 666.

<sup>140</sup> *Id.* at 649.

<sup>141</sup> The word "secret" was a bone of contention between O'Hagan's attorneys and the government's attorneys. O'Hagan's attorneys argued the use of the word "secret" was misleading, based on the absence of any alleged "secret" information. Brief for Appellant at 13, 14, 18-19, *United States v. O'Hagan*, 92 F.3d 612 (8th Cir. 1996) (No. 94-3714). The government argued that the information O'Hagan had gleaned from pumping Tinkham about the Pillsbury takeover deal was nonpublic at that time and, therefore, constituted "secret" information. Brief for Appellee at 18, 29, *O'Hagan* (Nos. 94-3714 and 94-3856).

<sup>142</sup> Brief for Appellee at 8-9.

<sup>143</sup> *Chiarella v. United States*, 445 U.S. 222, 240 (1980).

<sup>144</sup> "The obligation to disclose or refrain derives from [a]n affirmative duty to disclose material information [, which] has been traditionally imposed on corporate 'insiders,' particularly officers, directors, or controlling stockholders. We, and the courts have consistently held that insiders must disclose material facts which are known to them by virtue of

Dirks spoke out while O'Hagan remained silent. While Dirks shared his information with others, O'Hagan concealed his information from others. Silence may constitute a fraudulent act when there is a duty to speak, especially within the context of securities trading.<sup>145</sup>

#### D. Classical Theory v. Misappropriation Theory

The holdings of *Dirks* and *Chiarella* suggest that liability under Section 10(b) and Rule 10b-5 must also be predicated upon a finding that the buyer or seller of the securities has been defrauded by the alleged misappropriator.<sup>146</sup> These cases, however, also operate under the classical theory of liability which enables corporation insiders and tippees of those insiders to come within the language set forth under Rule 10b-5.<sup>147</sup> Even later cases appear to have based their holdings on a narrow Section 10(b) interpretation intended to specifically encompass fraudulent conduct.<sup>148</sup>

The misappropriation theory does not require showing the buyer or seller of securities has been defrauded.<sup>149</sup> Unlike the common law elements of fraud,<sup>150</sup> upon which Section 10(b) and Rule 10b-5 liability is based under the classical theory, the misappropriation theory does not narrowly focus only on the purchaser or seller in a securities transaction. Instead, it extends the prohibition of deception to protect anyone in rightful possession of the material, nonpublic information, even if that possessor is neither an investor nor a market participant.<sup>151</sup> Also, unlike the classical

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their position but which are not known to persons with whom they deal and which, if known, would affect their investment judgment." *Id.* at 227 (quoting *In re Cady, Roberts & Co.*, 40 S.E.C. 907, 911 (1961)).

<sup>145</sup> "The American Law Institute recognizes that 'silence when there is a duty to . . . speak may be a fraudulent act.'" *Id.* at 228 n.9 (quoting ALI, Federal Securities Code § 262(b) (Prop. Off. Draft 1978)).

<sup>146</sup> Michael Kenny & Theresa Thebaut, *Misguided Statutory Construction to Cover the Corporate Universe: The Misappropriation Theory of Section 10(b)*, 59 ALB. L. REV. 139 (1995) (citing *United States v. Chestman*, 947 F.2d 55, 566 (2d Cir. 1991) (en banc), cert. denied, 503 U.S. 1004 (1992)).

<sup>147</sup> *Securities & Exch. Comm'n v. Cherif*, 933 F.2d 403, 408 (7th Cir. 1991).

<sup>148</sup> Kenny & Thebaut, *supra* note 146, at 139, 151. The authors cite to the following cases: *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462 (1977); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976); *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164 (1994); *Aaron v. Securities & Exch. Comm'n*, 446 U.S. 680 (1980); *Chiarella*, 445 U.S. at 222; *Dirks v. Securities & Exch. Comm'n*, 463 U.S. 646 (1983); and *Bateman, Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299 (1985).

<sup>149</sup> *United States v. Carpenter*, 791 F.2d 1024, 1029 (2d Cir. 1986) (citing *United States v. Newman*, 664 F.2d 12, 17 (2d Cir. 1981)).

<sup>150</sup> "Elements of a cause of action for 'fraud' include false representation of a past or present fact made by defendant, action in reliance thereupon by plaintiff, and damage resulting to plaintiff from such misrepresentation." BLACK'S LAW DICTIONARY 660 (6th ed. 1990) (quoting *Citizens Standard Life Ins. Co. v. Gilley*, 521 S.W.2d 354, 356 (Tex. Civ. App. 1975)).

<sup>151</sup> *Carpenter*, 79 F.2d at 1029.

theory, which requires a showing of deception, the misappropriation merely requires a breach of fiduciary duty.<sup>152</sup> The Seventh Circuit in *Securities and Exchange Commission v. Cherif* stated, "The misappropriation theory focuses not on the insider's fiduciary duty to the issuing company or its shareholders, but on whether the insider breached a fiduciary duty to any lawful possessor of material, nonpublic information."<sup>153</sup>

### 1. *Securities and Exchange Commission v. Cherif*

In *Securities and Exchange Commission v. Cherif*,<sup>154</sup> the Seventh Circuit upheld Danny Cherif's securities fraud convictions on the basis of the misappropriation theory, despite the absence of a fiduciary duty owed to shareholders of corporations which were the subject of the misappropriated information. Cherif, a former Chicago bank employee, continued to use his identification card after his employment was terminated. By doing so, he was able to access confidential bank information regarding proposed tender offers and leveraged buy-outs of four companies in whose stock he used to trade. Cherif owed no fiduciary duty to the shareholders of those companies. However, his continued use of his identification card, as well as his use of specific, confidential bank information, was found to be a clear breach of a continuing fiduciary duty to his former employer.<sup>155</sup>

The Seventh Circuit held Rule 10b-5 was compatible with the misappropriation theory. Specifically, the court ruled that an employee's breach of a fiduciary duty to his employer constituted a Rule 10b-5 violation, even if the employee or his employer was not found to owe a fiduciary duty to the shareholders of the company from whom the employee purchased the shares as an inside trader.<sup>156</sup> In the same vein, even if O'Hagan was found not to have owed a fiduciary duty to Pillsbury, he clearly owed a fiduciary duty to his partnership, Dorsey and Whitney, and then to Grand Met, one of the firm's clients. In *Cherif*, liability was affirmed, despite the fact that Cherif's inside trading activities occurred after he no longer worked for his employer. O'Hagan purchased stock in Pillsbury while a partner at Dorsey and Whitney. Furthermore, he purchased the stock while Dorsey and Whitney were retained by Grand Met to plan the takeover of Pillsbury.<sup>157</sup>

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<sup>152</sup> *United States v. Bryan*, 58 F.3d 933, 950 (4th Cir. 1995).

<sup>153</sup> *Securities & Exch. Comm'n v. Cherif*, 933 F.2d 403, 409 (7th Cir. 1991).

<sup>154</sup> *Id.* at 410.

<sup>155</sup> *Id.* at 411.

<sup>156</sup> *Id.* at 409.

<sup>157</sup> Brief for Appellee at 11, *United States v. O'Hagan*, 92 F.3d 612 (8th Cir. 1996) (Nos. 94-3714 and 94-3856).

A case which is very similar to *O'Hagan* is *Securities and Exchange Commission v. Clark*.<sup>158</sup> In *Clark*, the Ninth Circuit affirmed the prior conviction of John Naylor Clark III, a former medical supplies company president, who had been charged with violating Section 10(b) and Rule 10b-5 in misappropriating material nonpublic information gained from his employer.<sup>159</sup> Clark learned of his company's confidential plans to acquire a surgical glove company after soliciting an associate in his office. Clark used that nonpublic information to engage in insider trading. Like *O'Hagan*, Clark profited from misusing material, nonpublic information he obtained after initiating conversation about the nonpublic information with an associate he knew was privy to the information. Clark was convicted of securities fraud under the misappropriation theory. Clark's convictions were later affirmed by a circuit court that, like the U.S. Supreme Court, broadly construed the statutory language of Section 10(b) and Rule 10b-5 in order to promote a level playing field in the area of securities law.

## 2. *United States v. Carpenter*

Another case analogous to *O'Hagan* is *United States v. Carpenter*,<sup>160</sup> which involved employees who engaged in insider trading using knowledge gained from their employer while they were still employed. The employees were found to have breached a fiduciary duty owed to their employer.<sup>161</sup> R. Foster Winans, a reporter for the *Wall Street Journal*, was convicted of misappropriating material, nonpublic information he gained from the *Wall Street Journal* during his employment, regarding stock information he received from stockbrokers in preparing his column, "Heard on the Street." Kenneth Felis, a stockbroker with Kidder Peabody, was convicted of conspiring to commit securities fraud, and David Carpenter, a news clerk for the *Journal*, was convicted of aiding and abetting.<sup>162</sup> The Second Circuit held "[S]ection 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 proscribe an employee's unlawful misappropriation . . . of material nonpublic information . . ." <sup>163</sup> While *Carpenter* did not involve information that was unavailable to the public, and the *Wall Street Journal* was not involved in trading securities,<sup>164</sup> the court upheld the misappropriation theory as a basis upon which to affirm a securities fraud conviction.<sup>165</sup> The court's ruling in *Car-*

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<sup>158</sup> *Securities & Exch. Comm'n v. Clark*, 915 F.2d 439 (9th Cir. 1990).

<sup>159</sup> *Id.* at 448.

<sup>160</sup> *United States v. Carpenter*, 791 F.2d 1024, 1035 (2d Cir. 1986).

<sup>161</sup> *Id.* at 1028.

<sup>162</sup> *Id.* at 1024.

<sup>163</sup> *Id.* at 1025.

<sup>164</sup> *Clark*, 915 F.2d at 446.

<sup>165</sup> *Id.*

*penter* further substantiates the application of the misappropriation theory to securities fraud cases, such as *O'Hagan*.

The ruling in *Carpenter* reinforces the Supreme Court's decision to apply the misappropriation theory in other insider trading cases, such as *O'Hagan*, which also involved a breach of fiduciary duty. While *O'Hagan* bears some similarity to *Chiarella* and *Dirks*, the Supreme Court in *Chiarella* and *Dirks* refused to apply the misappropriation theory because the defendants were not found to owe a fiduciary duty. The breach of a fiduciary duty lies at the core of the misappropriation theory. Therefore, the existence of a fiduciary relationship is the critical factor needed to sustain a conviction under the misappropriation theory.

This fiduciary relationship was not fully addressed in *Chiarella*,<sup>166</sup> and it was never established in *Dirks*. However, a fiduciary relationship was shown to exist in *Newman*, *Cherif*, *Clark* and *Carpenter*, where the misappropriation theory was applied to support a conviction. Furthermore, these fiduciary relationships all bore a striking similarity to the type of fiduciary relationships that existed in *O'Hagan*. As in these four cases, *O'Hagan* owed a fiduciary duty which he breached when he traded on inside information he received during the course of business. The outcome of *O'Hagan*, therefore, should be no different than the outcome of each of these four cases, all of which involved the breach of fiduciary relationship and the application of the misappropriation theory.

#### IV. POLICY CONSIDERATIONS

##### A. Policy Arguments

Prior to the Supreme Court's recent decision in *O'Hagan*, there had been a split among the lower courts in determining whether to narrowly or broadly construe the statutory language underlying the misappropriation theory. The debate concerning the application of the misappropriation theory in securities fraud cases had been additionally fueled by policy arguments on both sides. Criticism against a broad statutory construction of Section 10(b) and Rule 10b-5 has been based on the inability to clearly distinguish between the types of fiduciary or similar relationships that apply and do not apply under the misappropriation theory.<sup>167</sup> In *Bryan*, the Fourth Circuit stated, "[i]ndeed, although fifteen years have passed since the theory's inception, no court adopting the misappropriation theory has offered a principled basis for dis-

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<sup>166</sup> *Chiarella v. United States*, 445 U.S. 222, 236 (1980).

<sup>167</sup> Note, *Securities Law—Insider Trading—Fourth Circuit Rejects Misappropriation Theory of Rule 10b-5 Fraud Liability*, 109 HARV. L. REV. 536, 538 (1995) (citing *United States v. Bryan*, 58 F.3d 933, 951 (4th Cir. 1995)).

tinguishing which types of fiduciary or similar relationships of trust and confidence can give rise to Rule 10b-5 liability and which cannot.<sup>168</sup> The Fourth Circuit's ruling essentially declared that this inability to distinguish these types of relationships prevented the misappropriation theory from offering much guidance for market participants in knowing exactly what types of information were unlawful for trading purposes.<sup>169</sup>

Support for a narrow 10(b) statutory construction has also been reflected in the exercise of judicial restraint. A broad interpretation would consist of judicial legislation, which would arguably extend the statute's application beyond what the drafters intended.<sup>170</sup> In a few prior cases, the Supreme Court looked at the specific language used in Section 10(b) and Rule 10b-5 as a basis for hesitating to broadly construe the language. For example, in *Santa Fe Indus., Inc. v. Green*, the Supreme Court concluded that the use of the words "manipulative" and "deceptive" showed Congress's intent to narrow rather than expand the application of the 10(b) statute.<sup>171</sup> The Supreme Court reasoned that, if Congress had intended to prohibit other types of conduct under the statute, that prohibited conduct would have been expressly stated.<sup>172</sup>

In past cases, the Supreme Court has not only examined the specific language in Section 10(b) and Rule 10b-5, but also its meaning. In *Blue Chip Stamps v. Manor Drug Stores*,<sup>173</sup> the Supreme Court looked specifically at the meaning of the language in Section 10(b) and Rule 10b-5 and concluded that construing the fraud language to apply not just to purchasers and sellers, as it expressly states, but to the world at large, is stretching the language too far.<sup>174</sup> The Supreme Court also expressed concern in *Blue Chip Stamps* for the potentially excessive litigation that would undoubtedly arise under a broader construction of the statutory language.<sup>175</sup>

It may be difficult to distinguish which fiduciary relationships apply under the language of Section 10(b). Also, the language of Rule 10b-5 perhaps should prohibit what is only expressly stated

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<sup>168</sup> *Id.*

<sup>169</sup> *Id.*

<sup>170</sup> *Chiarella*, 445 U.S. at 235.

<sup>171</sup> *Santa Fe Indus. v. Green*, 430 U.S. 462, 473 (1977) (quoting *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 214 (1975), "When a statute speaks so specifically in terms of manipulation and deception . . . and when its history reflects no more expansive intent, we are quite unwilling to extend the scope of the statute . . .").

<sup>172</sup> *Id.*

<sup>173</sup> *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975).

<sup>174</sup> *Id.* at 733. The narrow construction of Rule 10b-5's fraud language was held to refer only to purchasers or sellers of securities. This interpretation, also known as the *Birnbaum* rule, was based on the court's holding in *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461, 462-63 (2d Cir. 1952).

<sup>175</sup> *Id.* at 740.

in the 10(b) statute. Furthermore, there may be a valid cause for concern regarding the excessive litigation that a broad construction of the statute permits.

However, a tremendous concern for fairness and integrity of conduct within the securities markets underlies the need for a more expansive construction of the statutory language in Section 10(b) and Rule 10b-5.<sup>176</sup> Primary concern for the maintenance of a level playing field among securities traders was declared early on to be the basis for the policy considerations underlying Rule 10b-5.<sup>177</sup> The concern for ensuring honesty and integrity within the securities markets was recently reiterated by Justice Ginsburg in rendering the majority's opinion in *O'Hagan*: "Because undisclosed trading on the basis of misappropriated, nonpublic information both deceives the source of the information and harms members of the investing public, the misappropriation theory is tuned to an animating purpose of the Exchange Act: to ensure honest markets, thereby promoting investor confidence."<sup>178</sup>

This same concern previously caused several lower courts to also argue against a narrow interpretation of the statutory language. In *Newman*, the Second Circuit stated, "[t]he courts, not the Congress, have limited Rule 10b-5 suits for damages to the purchasers and sellers of securities . . . a plaintiff need not be a defrauded purchaser or seller in order to sue for injunctive relief under Rule 10b-5."<sup>179</sup> In *Newman*, the court's decision to endorse the application of 10b-5 liability beyond mere purchasers and sellers of securities is further supported because the Supreme Court has never held that the statute's sole purpose is to protect only purchasers and sellers.<sup>180</sup> The statute protects against misappropriation of nonpublic securities information which can also involve an individual who is not engaged in the business of buying or selling securities, but who secretly trades on that information knowing that particular information will give him a financial windfall.

The rule set forth in *Texas Gulf Sulphur* also expanded the scope of a Section 10(b) violation by regulating insider trading based on the nature of the material possessed by a misappropriating trader, rather than on how the misappropriating trader obtained it.<sup>181</sup> The rule allows for the mere use of material,

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176 *United States v. Carpenter*, 791 F.2d 1024, 1027 (2d Cir. 1986).

177 "The Rule 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." *Securities & Exch. Comm'n v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 848 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

178 *United States v. O'Hagan*, 117 S. Ct. 2199, 2204-5 (1997).

179 *United States v. Newman*, 664 F.2d 12, 16-17 (2d Cir. 1981).

180 Note, *supra* note 167, at 541.

181 Troy Cichos, *The Misappropriation Theory of Insider Trading: Its Past, Present, and Future*, 18 PUGET SOUND L. REV. 389, 395 (1995).

nonpublic information to constitute fraudulent conduct in the trading of securities. No showing is required of the misappropriating trader's prior agreement not to use the information for personal gain.<sup>182</sup>

The absence of clear statutory language placed a heavy burden on the courts to make their own policy judgments regarding the scope and objectives of the statute and the rule.<sup>183</sup> The absence of clear statutory construction also gave rise to a constant debate among the lower courts as to whether the underlying intent of the statute or its narrow language should govern. It is, therefore, of little surprise that the courts had previously split in interpreting the language of Section 10(b) and Rule 10b-5. Also, historically, the Supreme Court has stayed out of Section 10(b) and Rule 10b-5 cases, allowing the Second Circuit to lead the way. Only in the past 10 to 15 years has the Supreme Court become more extensively involved in this area. As a result of its increasing involvement, the Supreme Court has now resolved a long-standing conflict in favor of a broad statutory interpretation of the misappropriation theory. The theory now unquestionably applies to individuals like James Herman O'Hagan, who trade on inside information, and who are neither "insiders" nor persons who are found to owe a fiduciary duty to the shareholders of the securities in which that person has traded. The Supreme Court decision validates most of the circuit court decisions which favored the theory's application to cases bearing striking similarity to *O'Hagan*.

#### B. Eighth Circuit's Rejection of the Misappropriation Theory is Unfounded

The Eighth Circuit rejected the misappropriation theory in *O'Hagan* because "it permits the imposition of Section 10(b) liability without a particularized showing of misrepresentation or nondisclosure."<sup>184</sup> The Eighth Circuit reasoned that the statutory language of Section 10(b) explicitly requires a showing of misrepresentation or nondisclosure and that the statute cannot be construed more expansively than what the statutory words say.<sup>185</sup> In rendering its decision, the Eighth Circuit relied primarily on the Fourth Circuit's rationale in *Bryan*.<sup>186</sup>

In *Bryan*, the defendant, Elton E. Bryan, was a Virginia state lottery director accused of manipulating state advertising and

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<sup>182</sup> *Id.*

<sup>183</sup> Note, *supra* note 167, at 538.

<sup>184</sup> *United States v. O'Hagan*, 92 F.3d 612, 618 (8th Cir. 1996).

<sup>185</sup> "As we have emphasized before, the 1934 Act cannot be read more broadly than its language and the statutory scheme reasonably permit." *Id.* (quoting *Chiarella v. United States*, 445 U.S. 222, 234 (1980)).

<sup>186</sup> *O'Hagan*, 92 F.3d at 620; *United States v. Bryan*, 58 F.3d 933, 944 (4th Cir. 1995).

video lottery gaming contracts, and secretly profiting from investing in those companies that engaged in business with the Virginia state lottery. The Fourth Circuit held the government's misappropriation theory was inapplicable because the specific statutory language set forth in Section 10(b) explicitly required a showing of deception. The language in Rule 10b-5 further supported the statutory intent of Section 10(b), while prior Supreme Court rulings consistently held the statutory language of Section 10(b) could not be construed more broadly than the language itself.<sup>187</sup>

However, *Bryan* was wrongly decided. Instead of ruling on the basis of whether Bryan's conduct fell within the conduct proscribed by Section 10(b), which the Fourth Circuit conceded it did,<sup>188</sup> the Fourth Circuit concerned itself with only addressing whether conduct deemed criminal under the language of Section 10(b) and Rule 10b-5 could also be declared criminal under the language of the misappropriation theory.<sup>189</sup> Instead of applying the misappropriation theory as other circuit courts had done previously,<sup>190</sup> the Fourth Circuit not only refused to apply the misappropriation theory, but declared the theory invalid.<sup>191</sup> The Fourth Circuit set a precedent which the Eighth Circuit was quick to follow.

In addition to following the Fourth Circuit's reasoning in *Bryan*, the Eighth Circuit also based its ruling in *O'Hagan* on prior Supreme Court holdings. The Eighth Circuit specifically referred to the Supreme Court holdings in *Santa Fe Indus., Inc. v. Green*<sup>192</sup> and *Central Bank of Denver v. First Interstate Bank of Denver*.<sup>193</sup> The court asserted that a contrary ruling would contradict those holdings.<sup>194</sup>

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<sup>187</sup> *Bryan*, 58 F.3d at 944. The Fourth Circuit commented that, unlike the statutory language of Section 10(b) which requires "only the use of deception, in the form of material misrepresentations or omissions . . . , the misappropriation theory authorizes criminal convictions for simple breaches of fiduciary duty and similar relationships of trust and confidence, whether or not the breaches entail deception within the meaning of Section 10(b) and whether or not the parties wronged by the breaches were purchasers or sellers of securities, or otherwise connected with or interested in the purchase or sale of securities." *Id.*

<sup>188</sup> *Id.* at 945.

<sup>189</sup> *Id.*

<sup>190</sup> Circuit courts which have applied the misappropriation theory to securities fraud cases include: the Second Circuit *see, e.g.*, *United States v. Newman*, 664 F.2d 12, 16 (2d Cir. 1981); *Securities & Exch. Comm'n v. Materia*, 745 F.2d 197, 199 (2d Cir. 1984); the Third Circuit *see, e.g.*, *Rothberg v. Rosenbloom*, 771 F.2d 818, 823 (3d Cir. 1985); the Seventh Circuit *see, e.g.*, *Securities & Exch. Comm'n v. Cherif*, 933 F.2d 403 (7th Cir. 1991); *Securities & Exch. Comm'n v. Maio*, 51 F.3d 623 (7th Cir. 1995); and the Ninth Circuit *see, e.g.*, *Securities & Exch. Comm'n v. Clark*, 915 F.2d 439 (9th Cir. 1990).

<sup>191</sup> *Bryan*, 58 F.3d at 948 n.12.

<sup>192</sup> *United States v. O'Hagan*, 92 F.3d 612, 618 (8th Cir. 1996) (citing *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462 (1977)).

<sup>193</sup> *Id.* (citing *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164 (1994)).

<sup>194</sup> *Id.*

In *Santa Fe Indus.*, a Delaware corporation's parent company and majority stockholder received board approval to merge with its subsidiary. To facilitate the merger, the parent company exercised Delaware's short-form merger statute which enabled it to offer to buy out the minority shareholders' stock interests at an independently appraised fair market value.<sup>195</sup> Minority shareholders, unwilling to accept the price, were told they could petition the Delaware court for a court-appointed fair market value appraisal. Instead, the minority shareholders filed suit against the parent company to prevent the merger and recover the value of the stock they alleged was worth more than what the parent company offered them. The Supreme Court held charges of fraud and fiduciary breach, absent a showing of material misrepresentation or nondisclosure, constituted insufficient grounds for imposing Section 10(b) and Rule 10b-5 liability under the misappropriation theory.<sup>196</sup>

In *Central Bank of Denver*, \$26 million in bonds were issued by the plaintiff, Colorado Springs-Stetson Hills Public Authority, for construction of public improvements on Stetson-Hills, a combined residential and commercial development in Colorado.<sup>197</sup> Central Bank was the trustee for the bond issues.<sup>198</sup> Landowner assessment liens covering a total of over 522 acres were used for the bond issues.<sup>199</sup> The bond provisions dictated the property tied to those liens be worth a minimum of 160 percent of the bonds' outstanding principal and interest.<sup>200</sup> The bond provisions also required the project's developer to provide Central Bank with an annual appraisal to show compliance with the 160 percent requirement. The developer's 1988 appraisal provided to Central Bank remained unchanged from the 1986 appraisal, despite information from the bond's senior underwriter that showed a decrease in Colorado land values. Central Bank agreed to the developer's request to delay obtaining an outside appraisal. In the interim, the Authority defaulted on the bonds, and Central Bank was held liable. The Supreme Court held the aiding and abetting charges, absent a showing of manipulation or deception, did not fall within the statutory language of Section 10(b).<sup>201</sup>

*Santa Fe Indus.* and *Central Bank of Denver* are clearly distinguishable from *O'Hagan*. In *Santa Fe Indus.*, the Supreme

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195 *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462 (1977).

196 *Id.* at 475.

197 *Central Bank of Denver*, 511 U.S. at 164.

198 *Id.* at 171.

199 *Id.*

200 *Id.*

201 With respect to aiding and abetting another who commits a manipulative, deceptive act, the Supreme Court stated: "The proscription does not include giving aid to a person who commits a manipulative, deceptive act." *Id.* at 177.

Court addressed the question of whether Section 10(b) and Rule 10b-5 applied to a fiduciary breach between majority and minority stockholders. *Santa Fe Indus.* did not involve allegations of misrepresentation or nondisclosure,<sup>202</sup> either one of which must be included in bringing Section 10(b) and Rule 10b-5 violation charges under the misappropriation theory. Under the misappropriation theory, no liability can attach to full disclosure because of the absence of deception.<sup>203</sup> The absence of nondisclosure, coupled with the particular facts of the case, made the misappropriation theory inapplicable to *Santa Fe Indus.*<sup>204</sup>

In *Central Bank of Denver*, the issue was whether Section 10(b) and Rule 10b-5 applied to aiding and abetting charges. However, *Central Bank of Denver* did not involve charges of manipulation or deception,<sup>205</sup> either one of which is required to bring Section 10(b) and Rule 10b-5 violation charges. The Supreme Court refused to extend liability under Section 10(b) and Rule 10b-5 to one who did not directly engage in manipulative or deceptive conduct, even though the accused may have aided another who directly engaged in manipulative or deceptive conduct.<sup>206</sup>

Unlike *Santa Fe Indus.* and *Central Bank of Denver*, *O'Hagan* involved evidence of nondisclosure and, therefore, deception. In *Santa Fe Indus.*, the parent company fully disclosed its merger plans and its stock price purchase offers to the minority shareholders.<sup>207</sup> *O'Hagan* failed to disclose to shareholders his intent to trade on a client's takeover target. Furthermore, *O'Hagan's* failure to disclose his intent to trade on Pillsbury stock was deceptive.<sup>208</sup> *Central Bank* was only indirectly charged with manipulation and deception through an aiding and abetting charge. As the Supreme Court correctly pointed out, there is no aiding and abetting language in Section 10(b) or Rule 10b-5.<sup>209</sup> *O'Hagan* was directly charged with deceiving his firm's clients and

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202 *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 474 (1977).

203 *United States v. O'Hagan*, 117 S. Ct. 2199, 2225 (1997). The majority states: "Similarly, full disclosure forecloses liability under the misappropriation theory. Because the deception essential to the misappropriation theory involves feigning fidelity to the source of information, if the fiduciary discloses to the source that he plans to trade on the nonpublic information, there is no 'deceptive device' and thus no Section 10(b) violation . . ." *Id.*

204 Note, *supra* note 167, at 539 n.25.

205 *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164, 177-78 (1994). The majority commented: "We cannot amend the statute to create a liability for acts that are not themselves manipulative or deceptive within the meaning of the statute." *Id.*

206 *Id.*

207 *O'Hagan*, 117 S. Ct. at 2225.

208 *Id.*

209 The majority commented: "If, as respondents seem to say, Congress intended to impose aiding and abetting liability, we presume it would have used the words 'aid' and 'abet' in the statutory text. But it did not." *Central Bank of Denver*, 511 U.S. at 177.

the firm by trading on material nonpublic information. The Supreme Court further clarified in *O'Hagan*, contrary to the Eighth Circuit's reading, the statutory phrase "in connection with the purchase or sale of any security" does not mean the duty extends only to identifiable purchasers or sellers of securities.<sup>210</sup>

In essence, the Eighth Circuit justified its decision in *O'Hagan* based on two prior Supreme Court cases that involve aspects of the misappropriation theory which bear little resemblance to *O'Hagan*. It was, therefore, unreasonable for the Eighth Circuit to dismiss the merits of the misappropriation theory in *O'Hagan*.

## V. CONCLUSION

O'Hagan did not make a substantial purchase of the Pillsbury securities<sup>211</sup> because of his financial expertise,<sup>212</sup> but because he breached a fiduciary duty in obtaining inside information. O'Hagan had also previously been found guilty of misappropriation. His first misappropriation conviction concerned the taking of client trust fund money. The trust fund accounts constituted confidential information which O'Hagan used for his own purposes, unbeknownst to his clients. Furthermore, O'Hagan deceived his clients and breached their trust by unlawfully taking their money. A fiduciary's deceitful misappropriation of confidential information by theft, conversion or breach of trust, has generally been held to be unlawful.<sup>213</sup>

O'Hagan's misappropriation of client funds constitutes a long-established violation of the law. However, his insider trading activities were not as clear a violation of the law. As an "outsider," O'Hagan's insider trading activities did not fit within the proscribed conduct traditionally reserved for "insiders" under the classical theory. An additional problem has been the lack of any explicit definition of insider trading in the securities laws.<sup>214</sup> Without the misappropriation theory, "outsiders" who engage in insider trading such as O'Hagan would otherwise be allowed to fall

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<sup>210</sup> *O'Hagan*, 117 S. Ct. at 2233.

<sup>211</sup> O'Hagan purchased a total of 2,500 Pillsbury call option contracts which, according to one options analyst, made O'Hagan at that time the world's largest single purchaser of Pillsbury call options. Brief for Appellee at 16, 17, *O'Hagan*, 92 F.3d 612 (Nos. 94-3714 and 94-3856).

<sup>212</sup> O'Hagan had an investment portfolio valued at over \$5 million prior to his Pillsbury profit. Brief for Appellant at 2, *O'Hagan*, 92 F.3d 612 (No. 94-3714). Prior to purchasing the Pillsbury contracts, O'Hagan had been known to purchase call option contracts on only one other occasion (this was stock in a high technology company, not stock in a corporate takeover target), preferring to keep to a strategy of avoiding such high risk stocks. Brief for Appellee at 10, *O'Hagan*, 92 F.3d 612 (Nos. 94-3714 and 94-3856).

<sup>213</sup> *United States v. Newman*, 664 F.2d 12, 18 (2d Cir. 1981).

<sup>214</sup> James B. Stewart, *Law Is Still a Bit Murky on Matter of What Constitutes Insider Trading*, WALL ST. J., July 21, 1989, § 1, at 6.

through the crack, and benefit tremendously, merely because of their status as "outsiders." The significance of the Supreme Court's recent ruling in *O'Hagan* is that courts can now use the misappropriation theory to reach "outsiders" who trade on inside information just as effectively as they have been using the classical theory to convict "insiders" of insider trading. The Supreme Court's endorsement of the misappropriation theory in *O'Hagan* also marks the Supreme Court's official adoption of an expansive interpretation of Section 10(b) and Rule 10b-5.

O'Hagan's conduct was patently unconscionable and called out for judicial retribution. O'Hagan secretly profited from the use of the material, nonpublic information he had gained from another partner regarding the tender offer of Pillsbury stock. Furthermore, he breached the legal duty he owed his firm and his firm's client in knowingly failing to disclose his intention to trade on that information. He intentionally misused this information to profit at the expense of both the Pillsbury and the Grand Met stockholders. Such action constitutes deceptive and fraudulent conduct. It was on those grounds that the Supreme Court held O'Hagan's conduct to be unlawful.<sup>215</sup> An outsider's taking and profiting from the use of nonpublic securities information in breach of a fiduciary relationship is now proscribed under the misappropriation theory. The Supreme Court's decision to reinstate O'Hagan's fraud convictions based on the misappropriation theory, therefore, sends a clear and final warning that everyone should heed: anyone who trades on nonpublic securities information in breach of a fiduciary relationship can be held liable under the misappropriation theory.

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<sup>215</sup> United States v. O'Hagan, 117 S. Ct. 2199 (1997).