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INSIDER TRADING LIABILITY FOR TIPPERS AND TIPPEES: A CALL FOR THE CONSISTENT APPLICATION OF THE PERSONAL BENEFIT TEST

By Nelson S. Ebaugh†

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INTRODUCTION

Imagine that your best friend, Chris, is the CEO of a Fortune 500 company. One evening Chris invites you to his house for dinner and makes the following proposition: "If I tell you a secret about my company, will you keep it confidential?" Interested in what Chris has to say, you reply: "Yes."[1]

Chris tells you that his company is engaged in massive corruption and has misrepresented its earnings in its annual report. The company stated that it produced enormous earnings last year when, in reality, it suffered significant losses. The public is unaware of the information that Chris has just relayed to you. Chris also tells you that he does not intend to do anything about the massive corruption because he is making a lot of money from it.

After dining with Chris, you become concerned about the millions of people who could be fleeced by the company's clandestine activities. Despite your promise to keep the information confidential, you relay this information to a few of your acquaintances that own securities in Chris's company. You feel justified in disclosing this information because you are concerned that the public will be swindled by the company's fraud. Your acquaintances that received this confidential information sell all of their securities in the company at a premium before the fraudulent activities of the company are revealed to the general public. Your acquaintances also spread the rumor of the corruption, triggering a Securities and Exchange Commission ("SEC") investigation that validates the accusations of misconduct.

As the saying goes, "no good deed goes unpunished." The SEC files a complaint alleging that you committed insider trading based upon the above facts.[2] How could your conduct have amounted to insider trading when the purpose for your disclosure was to reveal an enormous fraud? You did not disclose this information to obtain a personal benefit, so why should your conduct be discouraged? Why are whistleblowers not protected from such prosecution?

Despite such legitimate questions and your altruistic motive, some courts would hold you liable for insider trading.[3] This article examines the split among the courts on this issue and recommends that courts should not find an insider trading violation in fact patterns similar to the above illustration. As long as an individual does not reveal inside information in an effort to obtain a personal benefit, such individual should not be liable for insider trading.

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[1] Under the securities laws, "a 'duty of trust or confidence' exists . . . [w]henever a person agrees to maintain information in confidence." 17 C.F.R § 240.10b5-2(b)(1) (2003). As discussed in great detail in this article, a breach of this duty can serve as the basis for an insider-trading claim under the misappropriation theory.

[2] The SEC would assert a claim under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5, promulgated thereunder. The claim would rely upon the misappropriation theory to prove liability. Section 10(b), Rule 10b-5, and the misappropriation theory are examined in greater detail later in this article.

[3] Some, but not all, courts would hold you liable for insider trading under the misappropriation theory, as will be thoroughly discussed later in this article.

I. OVERVIEW

A. Tipper/Tippee Liability

The legal terms that the prosecution or plaintiff would use to identify you and your acquaintances in the above illustration are "tipper" and "tippee," respectively. A "tipper" is a person who discloses material, nonpublic information to another individual. A "tippee" is a person who trades on the basis of the information received from the tipper.[4] Both are potentially subject to insider trading liability.[5] A tipper is exposed to insider trading liability for simply communicating material, nonpublic information even if he did not personally use the information to trade in the company's securities.[6]

The basic concept of tipper/tippee liability under the insider trading laws is relatively straightforward. However, the legal analysis required to prove tipper/tippee liability is slightly more complicated. The insider trading laws establish three alternative bases for establishing tipper/tippee liability. Each basis is applicable in different factual circumstances, although there is some overlap. Tipper/tippee liability may be established upon any of the following bases:

1. The "classical theory" under Section 10(b)[7] of the Securities Exchange Act of 1934 and Rule 10b-5;[8]

2. The "misappropriation theory" under Section 10(b)[9] of the Securities Exchange Act of 1934 and Rule 10b-5; or

3. Section 14(e)[10] of the Securities Exchange Act of 1934 and Rule 14e-3.[11]

These three bases for establishing tipper/tippee liability are theoretically distinct from each other and are examined in detail below.

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[4] Professor Louis Loss coined the term "tippee" in the second edition of the Loss Securities Regulation Treatise. THE OXFORD ENGLISH DICTIONARY 135 (2d ed. 1989).

[5] The precedents supporting a finding of liability in such cases will be explored later in this article.

[6] *See Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228, 237 (2d Cir. 1974) (clarifying that liability for a tipper extends to a mere disclosure of confidential information to third parties).

[7] 15 U.S.C. § 78j(b) (1997).

[8] 17 C.F.R. § 240.10b-5 (2003).

[9] *See generally United States v. O'Hagan*, 521 U.S. 642 (1997) (holding that a person may be held liable for violating Section 10(b) and Rule 10b-5 when misappropriating confidential information for securities trading purposes).

[10] 15 U.S.C. § 78n(e) (1997). Section 14(e) only applies if the tipper discloses material, nonpublic information regarding a tender offer.

[11] 17 C.F.R. § 240.14e-3 (2003). Rule 14e-3 only applies if the tipper discloses material, nonpublic information regarding a tender offer.

B. Present Insider Trading Jurisprudence and Recommended Changes

In tipper/tippee liability cases under the classical theory, courts uniformly require proof of "personal benefit" to the tipper before finding liability.[12] Evidence must be presented that the tipper derived a personal benefit by disclosing the material, nonpublic information to the tippee.[13] Courts have defined personal benefit somewhat vaguely; however, there are some clear parameters discussed in more detail below. For instance, it is clear that a tipper has not derived a personal benefit if the tipper's sole purpose in disclosing the material, nonpublic information was to expose a fraud.[14]

In tipper/tippee liability cases under the misappropriation theory, district courts are split[15] as to whether proof of personal benefit to the tipper is necessary before finding tipper/tippee liability.[16] This article examines the district courts' division and urges all courts to apply the personal benefit test to insider trading cases prosecuted under the misappropriation theory.

In tipper/tippee liability cases under Rule 14e-3, at least one district court has explicitly held that proof of personal benefit is not required to prove tipper/tippee liability.[17] Appellate courts have not considered whether a personal benefit is required to find tipper/tippee liability under Rule 14e-3. In fact, courts typically omit any reference to the personal benefit test in tipper/tippee cases under Rule 14e-3.[18] However, at least one district court has held that the prosecution must prove a personal benefit in Rule 14e-3 cases.[19] For the same reasons that the personal benefit test should apply to cases asserted under the classical and misappropriation theories, this article also urges courts to apply the personal benefit test in the context of Rule 14e-3 cases.

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[12] *See Dirks v. SEC*, 463 U.S. 646, 662 (1983).

[13] *Id.*

[14] *Id.* at 667.

[15] The following district courts held that proof of personal benefit is not necessary to prove tipper/tippee liability under the misappropriation theory: *SEC v. Yun*, 130 F. Supp. 2d 1348, 1353 (M.D. Fla. 2001), *vacated by* 327 F.3d 1263 (11th Cir. 2003); *SEC v. Willis*, 777 F. Supp. 1165, 1172 n.7 (S.D.N.Y. 1991); *SEC v. Musella*, 748 F. Supp. 1028, 1038 n.4 (S.D.N.Y. 1989), *aff'd*, 898 F.2d 138 (2d Cir. 1990). The following district courts reached the opposite conclusion: *SEC v. Gonzalez de Castilla*, 145 F. Supp. 2d 402, 414 (S.D.N.Y. 2001); *SEC v. Trikilis*, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,015, at 94,462 (C.D. Cal. July 28, 1992), *vacated on other grounds*, 1993 WL 43571 (C.D. Cal. Jan. 22, 1993); *United States v. Santoro*, 647 F. Supp. 153, 170 (E.D.N.Y. 1986), *aff'd*, 880 F.2d 1319 (2d Cir. 1989); *SEC v. Gaspar*, [1984–1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,004, at 90,979 (S.D.N.Y. Apr. 15, 1985).

[16] *In re Lohmann*, Initial Decision Release No. 214, 78 S.E.C. Docket 1327 (Sept. 19, 2002). In *SEC v. Sargent*, the First Circuit recognized the division among district courts but did not resolve the split because it held that the issue was not before the court. 229 F.3d 68, 77 (1st Cir. 2000).

[17] *See SEC v. Downe*, 969 F. Supp. 149, 153 (S.D.N.Y. 1997).

[18] *See, e.g.*, *Hollywood Casino Corp. v. Simmons*, [2002 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,958 (N.D. Tex. July 18, 2002); *SEC v. Gonzalez de Castilla*, 184 F. Supp. 2d 365 (S.D.N.Y. 2002).

[19] *See Burlington Indus., Inc. v. Edelman*, 666 F. Supp. 799, 813–14 (M.D.N.C. 1987).

II. BACKGROUND OF THE INSIDER TRADING LAWS

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

The principal tools used by the SEC and private plaintiffs to prosecute insider trading are Section 10(b)[20] of the Securities Exchange Act of 1934 ("Exchange Act") and Rule 10b-5[21] promulgated thereunder. Section 10(b) is the general anti-fraud statute within the securities laws that has been judicially developed in a far more expansive manner than its drafters ever imagined. As Justice Rehnquist aptly observed, Section 10(b) as implemented by Rule 10b-5 is a "judicial oak which has grown from little more than a legislative acorn."[22]

Section 10(b) is not a self-executing statute. Consequently, in 1942 the SEC used the authority granted by Section 10(b)[23] to promulgate Rule 10b-5. Through Section 10(b) and Rule 10b-5, the SEC is able to prosecute securities fraud through administrative actions and federal court lawsuits.[24] Neither Section 10(b) nor Rule 10b-5 explicitly grant a private cause of action, but in *Superintendent of Insurance v. Bankers Life & Casualty Co.*, the United States Supreme Court recognized a private cause of action to be implied under Section 10(b) and Rule 10b-5.[25]

Neither Section 10(b) nor Rule 10b-5 explicitly mention insider trading. Yet, years of litigation have led to the development of two principal theories within Rule 10b-5 that are exclusively used to prosecute insider trading: the classical theory and the misappropriation theory.[26] "Under the classical theory, a person violates [Rule 10b-5] when he or she buys or sells securities on the basis of material, non-public information and at the same time is an insider of the corporation whose securities are traded."[27] Likewise, under the misappropriation theory, a person may be liable for insider trading for buying or selling securities on the basis of material, nonpublic information.[28] However, unlike the classical theory, the misappropriation theory does not require that the person be an insider of the company.[29]

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[20] Section 10(b) of the Securities Exchange Act of 1934 reads in pertinent part: "It shall be unlawful . . . [t]o use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance." 15 U.S.C. § 78(j)(b) (1997).

[21] 17 C.F.R. § 240.10b-5 (2003).

[22] *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 737 (1975).

[23] Section 10(b) of the Exchange Act reads in pertinent part: "[T]he Commission may prescribe [rules and regulations under Section 10(b)] as necessary or appropriate in the public interest or for the protection of investors." 15 U.S.C. § 78(j)(b) (1997).

[24] Sections 21B and 21C of the Exchange Act grant the SEC the authority to pursue administrative actions. 15 U.S.C §§ 78u-2, 78u-3 (1997). Sections 20A, 21A, and 21(d) of the Exchange Act grant the SEC the authority to pursue actions in federal court. 15 U.S.C. § 78u(d) (1997).

[25] *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 7 (1971).

[26] *See generally United States v. O'Hagan*, 521 U.S. 642, 651–53 (1997).

[27] *SEC v. Cherif*, 933 F.2d 403, 408 (7th Cir. 1991), *cert. denied*, 502 U.S. 1071 (1992).

[28] *See, e.g.*, *O'Hagan*, 521 U.S. at 652–53.

[29] *SEC v. Maio*, 51 F.3d 623, 631 (7th Cir. 1995) (stating that the "[m]isappropriation theory 'extends the reach of Rule 10b-5 to outsiders [or their tippees] who would not ordinarily be deemed fiduciaries of the corporate entities in whose stock they trade.'").

The Supreme Court has long recognized the validity of the classical theory to prove insider trading under Rule 10b-5.[30] However, recently the Supreme Court approved the misappropriation theory as an alternative method to prove insider trading liability under Rule 10b-5.[31]

The SEC relies heavily upon the misappropriation theory because it is able to reach many perceived insider trading violations that the classical theory is unable to address. For instance, assume a psychiatrist breached his duty of trust or confidence to his patient, a corporate officer of XYZ Corporation, by trading in XYZ Corporation stock on material, nonpublic information disclosed by the patient during a session. The psychiatrist could be liable for insider trading under the misappropriation theory, but not under the classical theory.[32]

Courts are still fleshing out the contours of the recently developed misappropriation theory. Because the classical theory is older, it has been litigated far more often than the misappropriation theory. Consequently, the analysis under the classical theory is more predictable than the analysis under the misappropriation theory. Under the classical theory, the Supreme Court has firmly established that the personal benefit test must be considered when assessing the liability of a tipper or tippee.[33] The personal benefit test is a means of determining whether disclosure of material, nonpublic information by a tipper to a tippee is improper.[34]

1. Classical Theory

Prior to the enactment of Rule 10b-5, the SEC could prosecute "sellers" of securities who committed fraudulent practices under Section 17(a) of the Securities Act of 1933. However, the SEC could not prosecute "purchasers" of securities pursuant to that section. In 1942, the SEC adopted Rule 10b-5 to curb the fraudulent practices of "purchasers" of securities.[35] The first judicial pronouncement of Rule 10b-5 did not take place until 1947.

In 1947, the United States District Court for the Eastern District of Pennsylvania decided *Kardon v. National Gypsum Co*.[36] The facts in *Kardon* arose out of a transaction among the four shareholders of two small paper companies—the Western Board and Paper Co. and the Michigan Paper Stock Co.[37] The four shareholders were also the sole officers and directors of the two companies.[38] Two of the shareholders purchased the other shareholders' stock.[39] Prior to their purchase, the purchasing shareholders failed to disclose to the selling

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[30] *See supra* note 12 and accompanying text.

[31] *See O'Hagan*, 521 U.S. at 653 (1997).

[32] *See, e.g.*, *SEC v. Brody*, Litig. Release No. 16313, 70 S.E.C. Docket 1685 (Sept. 29, 1999) (providing that psychiatrist consented to a permanent injunction after breaching a fiduciary duty to a patient).

[33] *See Dirks v. SEC*, 463 U.S. 646 (1983).

[34] *Id.*

[35] *See* Exchange Act Release No. 3230, 7 Fed. Reg. 3804 (May 21, 1942).

[36] 73 F. Supp. 798 (E.D. Pa. 1947).

[37] *Id.* at 800.

[38] *Id.*

[39] *Id.*at 801.

shareholders that they had arranged to sell one of the companies to a third party at a premium.[40] Consequently, the selling shareholders sued the purchasing shareholders under Section 10(b) and Rule 10b-5.[41] The District Court found that the purchasing shareholders had "fail[ed] to disclose a fact coming to their knowledge by reason of their position, which . . . materially affect[ed] the judgment of the other party to the transaction."[42] The District Court held the purchasing shareholders liable for fraud under Section 10(b) and Rule 10b-5.[43]

In *Kardon*, the plaintiffs knew the defendants well and engaged in a face-to-face transaction when the defendants purchased the plaintiffs' stock.[44] Thus, under *Kardon*, the Rule 10b-5 prohibition against insider trading only applied to face-to-face transactions, as opposed to transactions with complete strangers on the open market.[45]

However, *Kardon* is a significant decision for three reasons: (1) it is the first case where the court found insider trading liability under Rule 10b-5; (2) the court announced that an implied right of private action exists under Rule 10b-5; and (3) it is a predecessor to the "abstain or disclose" rule. Briefly stated, the abstain or disclose rule under the classical theory provides that insiders have a duty to either abstain from trading on material, nonpublic information or to disclose the information to the corporation's shareholders before trading.[46] The abstain or disclose rule became central to the analysis under the classical theory. Federal courts and the SEC, through administrative proceeding opinions, subsequently built on the holding in *Kardon* to formulate the abstain or disclose rule.

In 1961, the SEC released an administrative opinion, *In re Cady, Roberts & Co.*,[47] which led to a significant expansion of the prohibition against insider trading. The respondents in the administrative proceeding were Cady, Roberts & Co., a brokerage firm, and Robert M. Gintel, one of Cady, Roberts & Co.'s partners.[48] A director of Curtiss-Wright Corporation ("Curtiss-Wright"), a public company, disclosed to Gintel that Curtiss-Wright was about to make an unexpected announcement of a dividend reduction.[49] The upcoming announcement constituted material, nonpublic information. Before the public announcement was made, Gintel sold 7,000 shares of Curtiss-Wright stock.[50] The SEC brought an administrative disciplinary proceeding against Cady, Roberts & Co. and Gintel, alleging, among other claims, insider trading violations under Rule 10b-5.[51] The respondents submitted a settlement offer to the SEC, which included a stipulation of the facts recited above.[52]

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40 *Id.* at 800–01.
41 *Id.* at 800.
42 *Kardon*, 73 F. Supp. at 800.
43 *Id.*
44 *Id.* at 800–01.
45 *Id.* at 803.
46 *Chiarella v. United States*, 445 U.S. 222, 229–31 (1980).
47 Release No. 34-6668, 40 S.E.C. 907 (1961).
48 *Id.* at 908.
49 *Id.* at 909.
50 *Id.*
51 *Id.*
52 *Id.* at 908.

The SEC accepted the respondents' proposed settlement and issued an opinion, which found insider trading activity in violation of Rule 10b-5.[53] The SEC's opinion in *Cady, Roberts & Co.* concluded that the respondents were insiders because they had access to material, nonpublic information and consequently had an unfair advantage over people trading in the open market.[54] The SEC required the respondents to disclose this information to the public before the respondents could trade on the open market.[55] This was the first time that the SEC had ever announced such a broad definition of the term "insider" and the first time that the SEC imposed a duty on insiders to disclose material, nonpublic information to the public before trading on the open market. Until the release of the SEC's opinion in *Cady, Roberts & Co.*, the term "insider" generally only referred to a company's board of directors or the company's employees, not an outsider who received material, nonpublic information from a company's board member. In addition, the SEC's finding that the respondents owed a duty of disclosure to the open market far exceeded the scope of the duty to disclose as announced by the courts previously. As discussed above, courts initially recognized a prohibition against insider trading that only applied to face-to-face transactions.

In 1968, the Second Circuit in *SEC v. Texas Gulf Sulphur Co*. adopted the SEC's finding in *Cady, Roberts & Co*. that insiders owe a duty to the investing public to disclose material, nonpublic information before trading on the open market.[56] However, the Second Circuit slightly rephrased the SEC's wording in *Cady, Roberts & Co.* as follows:

> [A]nyone in possession of material inside information must either disclose it to the investing public, or, if he is disabled from disclosing it in order to protect a corporate confidence, or he chooses not to do so, must abstain from trading in or recommending the securities concerned while such inside information remains undisclosed.[57]

This was the first pronouncement of what is widely referred to as the abstain or disclose rule. Courts, including the Supreme Court, have subsequently referred to this rule consistently in their analyses of insider trading under the classical theory.[58] Since the Second Circuit's announcement of the abstain or disclose rule in *Texas Gulf Sulphur*, the Supreme Court has slightly modified the scope of this rule by redefining who qualifies as an insider. However, the Supreme Court has retained this recitation of the abstain or disclose rule in all other respects when conducting a classical theory analysis.

Until the Supreme Court's 1980 decision in *Chiarella v. United States*,[59] courts often utilized the parity of information doctrine to identify insiders subject to the abstain or disclose rule. The parity of information doctrine is extremely broad because it essentially imposes

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[53] *In re Cady, Roberts & Co.*, 40 S.E.C. at 908.

[54] *Id.*

[55] *Id.*

[56] *SEC v. Tex. Gulf Sulphur Co.*, 401 F.2d 833, 849 (2d Cir. 1968) (en banc).

[57] *Id.* at 848.

[58] *See Chiarella v. United States*, 445 U.S. 222 (1980); *Dirks v. SEC*, 463 U.S. 646 (1983); *United States v. O'Hagan*, 521 U.S. 642, 652 (1997).

[59] 445 U.S. 222 (1980).

insider status on all parties who have access to any material, nonpublic information. The rationale for the parity of information doctrine is that "all investors should have equal access to information that a reasonable investor would consider material to investment decisions, and that any trade in which only one party had an opportunity to learn and did learn such information is inherently unfair."[60] In *Chiarella*, the Supreme Court rejected this broad doctrine in favor of a fiduciary duty analysis.[61]

Vincent Chiarella, the defendant in *Chiarella*, worked at Pandick Press, a financial printing company.[62] Through his employment, Chiarella learned material, nonpublic information about companies that were clients of Pandick Press.[63] Chiarella used this information to earn profits by trading on the open market.[64] The Second Circuit held that under the "regular access to market information" test, Chiarella was an insider subject to the abstain or disclose rule.[65] The Supreme Court reversed the Second Circuit's holding that the "regular access to market information" was the appropriate analysis to determine who are insiders subject to the abstain or disclose rule.[66] The Supreme Court held that in order to establish insider status, there must be a fiduciary duty.[67] The Supreme Court held that there is a fiduciary duty between the employees of the issuer and the issuer's shareholders to abstain or disclose.[68] The Supreme Court refused to find a fiduciary duty to abstain or disclose from the mere possession of material, nonpublic information.[69] Pursuant to this analysis, the Supreme Court held that because Chiarella was not an employee of the issuer in whose securities he traded, he had no fiduciary duty to abstain or disclose.[70]

In addition to corporate insiders, "temporary insiders" also owe a fiduciary duty to the shareholders of the corporation to abstain or disclose.[71] Corporations often hire outsiders, such as lawyers, accountants, investment bankers, or other similar consultants, to assist them in their corporate activities. A corporation will often reveal nonpublic, material information to these outsiders so that they may effectively assist the corporation. Disclosure to these outsiders is conditioned upon their agreement to keep the material, nonpublic information confidential. Disclosure in this manner to lawyers, accountants, investment bankers, or other similar consultants does not make them corporate insiders, but rather temporary insiders. As temporary insiders, they are subject to the same abstain or disclose rule as corporate insiders.[72]

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[60] *Dirks v. SEC*, 681 F.2d 824, 835 (D.C. Cir. 1982), *rev'd*, 463 U.S. 646 (1983).
[61] *Chiarella*, 445 U.S. at 233.
[62] *Id.* at 224.
[63] *Id.*
[64] *Id.*
[65] *United States v. Chiarella*, 588 F.2d 1358, 1365–66 (2d Cir. 1978).
[66] *Chiarella*, 445 U.S. at 231–35.
[67] *Id.*
[68] *Id.*
[69] *Id.* at 232–35.
[70] *Id.*
[71] *Dirks v. SEC*, 463 U.S. 646, 655 (1983).
[72] *Id.*

The Supreme Court's holding in *Chiarella* remains sound law today and embodies what is know as the classical theory of insider trading. The Supreme Court's restricted definition of an insider in *Chiarella* led the SEC to seek other means of addressing perceived insider trading problems. Consequently, the SEC pursued cases under the misappropriation theory and adopted Rule 14e-3 in direct response to the Supreme Court's holding in *Chiarella*. These two alternative methods of prosecuting insider trading violations are discussed below.

2. Misappropriation Theory

The SEC introduced the misappropriation theory to 10(b) jurisprudence to fill a perceived gap in insider trading law after the *Chiarella* decision. Over the past twenty years, the misappropriation theory has become the principle basis for insider trading liability under Rule 10b-5.[73] As with the classical theory, analysis under the misappropriation theory begins by identifying a fiduciary duty. But the fiduciary duty that is the center of the misappropriation theory is distinct from the fiduciary duty under the classical theory. Under the misappropriation theory, the duty is one that arises out of a relationship of trust or confidence to the source of the information, rather than to the corporation's shareholders. Most commonly, this exists in an employer-employee relationship.

Although not the focal point of *Chiarella*, the misappropriation theory originates from that decision. In *Chiarella*, the Government anticipated that the Supreme Court might take a restrictive approach towards the issue of who is considered an insider, as the Supreme Court ultimately did. With this in mind, the Government emphasized an alternative basis for holding Chiarella liable for insider trading. The Government proposed two versions of the misappropriation theory to the Supreme Court, the fraud-on-the-investor theory and the fraud-on-the-source theory.[74] The Government's brief to the Supreme Court also stated that Chiarella was liable for insider trading under either of these two misappropriation theories. The Supreme Court refused to consider them as a basis of liability against Chiarella because the jury had not been instructed to consider either misappropriation theory.[75] However, Chief Justice Burger, in his dissent, endorsed the fraud-on-the-investor misappropriation theory.[76] Pursuant to this theory, when a person acquires information illegally, that person has a duty to disclose the stolen information.[77] Burger stated that a fiduciary duty analysis would not be required under the fraud-on-the-investor misappropriation theory because the duty to disclose exists without the breach of a fiduciary duty.[78] The duty to disclose is owed to all investors under the fraud-on-the-investor misappropriation theory.[79]

In response to Burger's strong endorsement of the misappropriation theory in *Chiarella*, the Government and the SEC thereafter incorporated the misappropriation theory as an alternative method of asserting insider trading claims. For unknown reasons, the Government

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[73] DONALD C. LANGEVOORT, INSIDER TRADING HANDBOOK 13, § 1.03[1][b] (1986).
[74] *Chiarella*, 445 U.S. at 235–36.
[75] *Id.* at 236.
[76] *Id.* at 240–42.
[77] *Id.*
[78] *Id.*
[79] *Id.*

and the SEC chose not to rely on the fraud-on-the-investor misappropriation theory as endorsed by Chief Justice Burger. Instead, the actions filed by the SEC and the Government relied exclusively upon the fraud-on-the-source misappropriation theory.

In 1981, the Second Circuit in *United States v. Newman*[80] acknowledged the fraud-on-the-source misappropriation theory as an appropriate basis for insider trading liability. The facts in *Newman* were similar to those in *Chiarella*. Some employees of an investment banking firm learned of tender offers and mergers before they were made public.[81] Those investment bank employees traded on this information to make a profit.[82] The United States Attorney's office alleged, among other claims, that the investment bank employees were liable for insider trading under Section 10(b), utilizing the fraud-on-the-source misappropriation theory.[83] The Second Circuit affirmed the conviction of the defendants based on the fraud-on-the-source misappropriation theory.[84]

In 1987, the Supreme Court had the opportunity to affirm the use of the misappropriation theory to prove insider trading as an alternative to the classical theory. In *Carpenter v. United States*, the Supreme Court considered the Government's insider trading claim against two of the defendants based upon the misappropriation theory.[85] Although the Supreme Court ultimately affirmed the conviction of these defendants for insider trading under the misappropriation theory, it did so by an evenly divided court.[86] Consequently, the decision in *Carpenter* does not carry much precedential weight.[87]

Several circuit courts have adopted the misappropriation theory. However, the Fourth and Eighth Circuits rejected the misappropriation theory on the basis of the Supreme Court's holding in *Santa Fe Industries v. Green*.[88] In *Santa Fe Industries*, the Supreme Court held that establishing a Section 10(b) violation requires more than breach of a fiduciary duty; it requires proof of actual deception.[89] As set forth in *Santa Fe Industries*, deception entails either a "material misrepresentation or the nondisclosure of material information, in violation of a duty to disclose."[90] According to the Fourth and Eighth Circuits, the misappropriation theory did not encompass such deception.[91]

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[80] 664 F.2d 12 (2d Cir. 1981).
[81] *Id.* at 15.
[82] *Id.*
[83] *Id.* at 15–16.
[84] *Id.* at 16–17.
[85] *Carpenter v. United States,* 484 U.S. 19, 24 (1987).
[86] *Id.*
[87] *See Neil v. Biggers*, 409 U.S. 188, 192 (1972).
[88] 430 U.S. 462 (1977).
[89] *Id.* at 473–74.
[90] *United States v. O'Hagan*, 92 F.3d 612, 617 (8th Cir. 1996), *rev'd*, 521 U.S. 642 (1997) (citing *Santa Fe Indus., Inc.*, 430 U.S. at 470).
[91] *Id.*

The Supreme Court resolved this split among the circuit courts in *United States v. O'Hagan*.[92] O'Hagan, a partner in a law firm, acquired material, nonpublic information about a takeover effort by one of his law firm's clients.[93] Subsequently, O'Hagan purchased stock in the target of the takeover.[94] The Government alleged that O'Hagan was liable for insider trading under the misappropriation theory.[95] The Government claimed that O'Hagan owed a duty of trust or confidence to the law firm's client and that he had violated this duty when he traded in the target's stock.[96] The Eighth Circuit held that O'Hagan could not be liable under the misappropriation theory, basing its decision in part on the holding in *Santa Fe Industries*.[97] However, the Supreme Court reversed, holding that the misappropriation theory is valid and did apply in this factual setting.[98] The Supreme Court held that the misappropriation theory is consistent with *Santa Fe Industries* and that the deception requirement is met by the misappropriator "feigning fidelity to the source of information."[99] If the "fiduciary discloses to the source that he plans to trade on the nonpublic information, there is no 'deceptive device' and thus no § 10(b) violation."[100]

The possible relationships creating a duty of trust or confidence for purposes of the misappropriation theory are numerous and varied.[101] Due to the enormous variety of relationships that could entail a duty of trust or confidence, it is not surprising that this issue is often litigated. The Second Circuit's decision in *United States v. Chestman*[102] is a significant decision in this area. Chestman was a stockbroker prosecuted for insider trading.[103] Chestman had received material, nonpublic information through a chain of several individuals that were all family members of the president of Waldbaum, Inc.[104] The material, nonpublic information revealed that Waldbaum was the target of a friendly merger where the bidder would acquire

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[92] 521 U.S. 642 (1997).

[93] *Id.* at 647.

[94] *Id.*

[95] *Id.* at 648–49.

[96] *Id.* at 653.

[97] *United States v. O'Hagan*, 92 F.3d 612, 618 (8th Cir. 1996), *rev'd*, 521 U.S. 642 (1997).

[98] *O'Hagan*, 521 U.S. at 665.

[99] *Id.* at 655.

[100] *Id.*

[101] *See, e.g.*, *O'Hagan*, 521 U.S. at 647–49 (1997) (attorney-client relationship); *United States v. Carpenter*, 791 F.2d 1024, 1028 (2d Cir. 1986) (employer-employee relationship); *SEC v. Yun*, 327 F.3d 1263 (11th Cir. 2003) (husband-wife relationship); *SEC v. Brody*, Litig. Release No. 16313, 70 S.E.C. Docket 1685 (Sept. 29, 1999) (psychiatrist-patient relationship); *In re Goldman, Sachs & Co.*, Release No. 34-48436, 2003 WL 22056978, at *6 (Sept. 4, 2003) (relationship between the United States Department of Treasury and the audience at a press conference hosted by the Treasury Department); *SEC Sues U.S. Postal Worker Who Tipped & Traded on Inside Information From Business Week Magazine*, SEC News Digest 2003-160, 2003 WL 21978586 (Aug. 20, 2003) (relationship between the United States Post Office and one of its employees). *See also* George F. Gabel, Jr., *Who May be Liable Under "Misappropriation Theory" of Imposing Duty to Disclose or Abstain From Trading Under § 10(b) of Securities Exchange Act of 1934 (15 U.S.C.A. § 78j(b)) and SEC Rule 10b-5 (17 CFR § 240.10b-5)*, 114 A.L.R. FED. 323, § 1b (1993).

[102] 947 F.2d 551 (2d Cir. 1991) (en banc).

[103] *Id.* at 555.

[104] *Id.*

the company at a substantial premium.[105] Each person in the chain was cautioned to keep the material, nonpublic information confidential.[106] The issues before the court were: (1) whether cautioning recipients of material, nonpublic information is enough to create a fiduciary duty; and (2) whether marital and family relationships create a fiduciary duty.[107] The Second Circuit's answer to each question was "no."[108] The court then enumerated a non-exclusive list of inherently fiduciary relationships: "[A]ttorney and client, executor and heir, guardian and ward, principal and agent, trustee and trust beneficiary, and senior corporate official and shareholder."[109]

In 2000, the SEC adopted Rule 10(b)5-2, presumably in response to the Second Circuit's holding in *Chestman* that marital and family relationships do not create a fiduciary duty under the misappropriation theory. Rule 10(b)5-2 lists three nonexclusive bases for determining when a fiduciary duty is present in a misappropriation case:

> (1) Whenever a person agrees to maintain information in confidence . . . ; (2) Whenever the person communicating the material, nonpublic information and the person to whom it is communicated have a history, pattern, or practice of sharing confidences . . . ; or (3) Whenever a person receives or obtains material, nonpublic information from his or her spouse, parent, child, or sibling . . . .[110]

The third non-exclusive basis, regarding familial relationships, supercedes the Second Circuit's decision in *Chestman*.

B. Rule 14e-3

In 1980, less than six months after the *Chiarella* decision, the SEC used its authority granted by Sections 14(e)[111] and 23(a) of the Exchange Act to enact Rule 14e-3.[112] Rule 14e-3 supercedes *Chiarella* in the context of tender offers.[113] Rule 14e-3 provides that if a bidder "has taken a substantial step or steps to commence, or has commenced, a tender offer" it shall be unlawful for any person to trade in the target's securities if that person "is in possession of material information relating to such tender offer which information he knows or has reason to know is nonpublic and which he knows or has reason to know has been acquired directly or indirectly from" the bidder, the target, or any person acting on behalf of the bidder or target.[114]

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[105] *Id.*

[106] *Id.*

[107] *Id.* at 567–68.

[108] *Chestman*, 947 F.2d at 567–68.

[109] *Id.* at 568.

[110] 17 C.F.R. § 240.10b5-2 (2003).

[111] Section 14(e) of the Exchange Act reads in pertinent part: "The Commission shall, for the purposes of this subsection, by rules and regulations define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative." 15 U.S.C § 78n(e) (1997).

[112] 17 C.F.R. § 240.14e-3 (2003). *See* Exchange Act Release No. 17,120, [1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,646 (Sept. 4, 1980).

[113] Thomas C. Newkirk, Insider Trading—A U.S. Perspective (Speech by SEC Staff) (Sept. 19, 1998).

[114] 17 C.F.R. § 240.14e-3 (2003).

Conspicuously absent from Rule 14e-3 is any fiduciary duty analysis. The Eighth Circuit viewed the SEC as having exceeded its authority by omitting the duty analysis that the Supreme Court had established in *Chiarella*.[115] However, the Supreme Court resolved any concern about the legitimacy of Rule 14e-3 when it approved its use in *O'Hagan*.[116] The Supreme Court observed that "[t]he SEC, cognizant of the proof problem that could enable sophisticated traders to escape responsibility, placed in Rule 14e-3(a) a 'disclose or abstain from trading' command that does not require specific proof of a breach of fiduciary duty."[117] The Supreme Court held that the SEC's decision to omit the fiduciary duty requirement under Rule 14e-3 was rational given the difficulty of establishing a Rule 10b-5 claim in tender offer situations under certain circumstances.[118]

III. TIPPER/TIPPEE LIABILITY BACKGROUND

The previous section summarized the bases for establishing violations of insider trading as they exist today. Even though each basis of insider trading liability requires a different analysis, they all provide for tipper and tippee liability. People with access to material, nonpublic information can be prosecuted for insider trading, even if they personally do not trade, so long as they communicate such information to people who do trade based on that information.[119] However, as long as the tipper does not obtain a personal benefit from making the tip, the tipper and his tippee(s) will avoid liability for insider trading in certain circumstances. Liability in such cases will depend entirely upon whether the tipper and his tippee(s) are prosecuted under the classical theory, the misappropriation theory, or Rule 14e-3. Consequently, tipper/tippee liability under each basis is examined in detail below.

A. Tipper/Tippee Liability under the Classical Theory

The best way to initiate an examination of tipper/tippee liability is to examine its development under the classical theory. The classical theory contains the longest line of tipper/tippee liability cases. Tipper/tippee liability under the classical theory has been thoroughly litigated and thus has relatively defined contours.

The SEC's first express application of tippee liability presumably occurred in *Cady Roberts & Co*.[120] Soon thereafter, the courts recognized the concept of tipper and tippee liability.[121] The Supreme Court's first detailed consideration of tipper/tippee liability under the classical theory took place in *Dirks v. SEC*.[122] In *Dirks*, the Supreme Court established the personal benefit test and the scienter requirement for tippees.[123]

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[115] *See United States v. O'Hagan*, 92 F.3d 612, 627 (8th Cir. 1996), *rev'd*, 521 U.S. 642 (1997).

[116] *United States v. O'Hagan*, 521 U.S. 642, 667 (1997).

[117] *Id.* at 676; *cf. SEC v. Drescher*, [1999–2000 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 90,681, at 93,223 (S.D.N.Y. Oct. 19, 1999) (imposing an implicit fiduciary duty requirement under Rule 14e-3).

[118] *O'Hagan*, 521 U.S. at 668–72.

[119] *See Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228, 237 (2d Cir. 1974).

[120] LOUIS LOSS & JOEL SELIGMAN, FUNDAMENTALS OF SECURITIES REGULATION 800 (3d ed. 1995).

[121] *Id.* at 805.

[122] 463 U.S. 646 (1983).

[123] *Id.*

In *Dirks*, Ronald Secrist, a former employee of Equity Funding American ("EFA"), revealed to Raymond Dirks, an investment analyst, that EFA was being fraudulently managed.[124] The fact that EFA was being fraudulently managed was material, nonpublic information.[125] Secrist's sole motivation in revealing this material, nonpublic information to Dirks was to reveal this fraud.[126] Dirks revealed this information to a number of people, including his own clients, who thereafter sold their Equity Funding Shares.[127] The SEC filed an administrative disciplinary proceeding against Dirks, alleging an insider trading violation.[128] The Administrative Law Judge ("ALJ") found Dirks liable as a tippee and "suspended Dirks from association with any registered broker or dealer for 60 days."[129] Both Dirks and the SEC's Division of Enforcement appealed the ALJ's decision to the full commission.[130] The SEC held Dirks liable, but reduced his sanction to a censure.[131] Dirks sought review in the United States Court of Appeals for the District of Columbia Circuit. The D.C. Circuit affirmed the SEC's decision.[132] The Supreme Court reversed the D.C. Circuit's decision, holding that Dirks was not liable for insider trading.[133] The Supreme Court applied the same fiduciary duty analysis that it had announced in *Chiarella* and found that Secrist had not violated his fiduciary duty to EFA's shareholders.[134] The Supreme Court announced that, absent personal benefit to Secrist as a result of the tip to Dirks, Secrist had not breached his fiduciary duty to the shareholders. The Court held that without a breach by Secrist, Dirks could not be found liable for insider trading.[135] The Court explained that tippee liability is derivative of the tipper's liability; therefore, if the tipper is not liable, the tippee is likewise not liable.[136]

The Supreme Court established the personal benefit test because it observed that not all communication of material, nonpublic information by insiders should be prosecuted as insider trading.[137] Rather, an insider should incur insider trading liability only when he communicates material, nonpublic information for an improper purpose.[138] The determination of whether a disclosure is an improper disclosure "depends in large part on the purpose of the disclosure."[139] The Supreme Court recognized that the "purpose of the securities laws was to

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[124] *Id.* at 648.
[125] *Id.*
[126] *Id.*
[127] *Id.* at 649.
[128] *Dirks v. SEC*, 681 F.2d 824, 832–33 (D.C. Cir. 1982).
[129] *Id.* at 833.
[130] *Id.*
[131] *Id.*
[132] *Id.*
[133] *Dirks*, 463 U.S. at 667.
[134] *Id.* at 662.
[135] *Id.* at 667.
[136] *Id.* at 662.
[137] *Id.*
[138] *Id.*
[139] *Dirks*, 463 U.S. at 662.

eliminate 'use of inside information for personal advantage.'"[140] Consequently, if the inside information is not used for a personal advantage, then it is not used for an improper purpose.

Dirks illustrates two instances where the Supreme Court will not find an improper purpose in the communication of material, nonpublic information. Recognizing the valuable service that investment analysts provide by ferreting out fraud, the Supreme Court did not want to inhibit this socially valuable activity by subjecting them to liability.[141] For this reason, the Supreme Court found that Secrist had not communicated material, nonpublic information to Dirks for an improper purpose.[142] The Supreme Court also gave as an example a situation where an officer of a company discusses the company's operations to investment analysts.[143] The Supreme Court observed that the company's officer should not be found liable for insider trading if he inadvertently relayed material, nonpublic information to the investment analysts.[144] The unique facts of *Dirks* and the Supreme Court's example are both instances of an insider communicating material, nonpublic information, but not for an improper purpose.

A tipper discloses material, nonpublic information for an improper purpose if he obtains a benefit from making a tip.[145] The Supreme Court identified three types of personal benefit that a tipper may receive from making a tip: (1) a pecuniary benefit; (2) a reputational benefit; and (3) a benefit from making a gift.[146] Examples of pecuniary benefits include kickbacks and profit-sharing arrangements.[147] A reputational benefit may arise when a corporate officer offers material, nonpublic information to an analyst in hopes that the analyst will report about him favorably.[148] The personal benefit most often relied upon to meet the personal benefit test is the benefit a tipper receives from making a gift.[149] One commentator has described this form of benefit as a catchall, including all situations when the tip constitutes a misuse of corporate information by the insider.[150]

After *Dirks*, the House Committee on Energy and Commerce ("Committee") became concerned that the lower courts might construe the *Dirks* decision too broadly.[151] Consequently, the Committee instructed the SEC to periodically report on lower courts' interpretation of *Dirks*.[152] In 1985, the SEC reported to the Committee that "the decision has

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[140] *Id.* (quoting *In re Cady, Roberts & Co.*, Release No. 34-6668, 40 S.E.C. 907, 912 n.15 (1961)).
[141] *Id.*
[142] *Id.* at 666.
[143] *Id.* at 662.
[144] *Id.*
[145] *Dirks*, 463 U.S. at 662.
[146] *Id.* at 663–64.
[147] LANGEVOORT, *supra* note 73, at 103, § 4.03.
[148] *Id.*
[149] *Id.* at 104.
[150] *Id.* at 103.
[151] INSIDER TRADING SANCTIONS ACT OF 1984, H.R. REP. NO. 98-355, at 14–15 (1983), *reprinted in* 1984 U.S.C.C.A.N. 2274, 2287–88.
[152] *Id.* at 15.

not adversely affected, to a significant degree, the Commission's enforcement program against insider trading."[153]

The personal benefit test has been interpreted so broadly that the SEC and plaintiffs usually have no difficulty establishing personal benefit. *SEC v. Switzer*[154] is one of only a few decisions after *Dirks* where the prosecution could not meet the personal benefit test.[155] Switzer, the then-coach of the University of Oklahoma's football team, while sunbathing, overheard a corporate officer discussing with his wife his company's plans to commence a tender offer for another company.[156] The corporate officer was not aware that Switzer had overheard this discussion.[157] Switzer traded on this material, nonpublic information.[158] The SEC prosecuted Switzer, but he successfully defended himself by establishing that the personal benefit test could not be met.[159] Unique fact patterns such as those in *Dirks* and *Switzer* illustrate the narrow situations in which the personal benefit test cannot be met. For the most part, it is not difficult to establish a personal benefit.

B. Tipper/Tippee Liability under the Misappropriation Theory

When considering the misappropriation theory, courts do not approach tipper/tippee liability issues with the same level of consistency as they do under the classical theory. Courts are split on whether the prosecution must satisfy the personal benefit test under the misappropriation theory. The following paragraphs examine this development.

1. Courts Holding That Proof of Personal Benefit Is Not Required Under the Misappropriation Theory

Some courts simply omit the personal benefit test when evaluating tipper/tippee liability under the misappropriation theory. However, at least two district courts have explicitly held that the personal benefit test is inapplicable under the misappropriation theory.[160] In *SEC v. Willis*[161] and *SEC v. Musella*,[162] the Southern District Court of New York held that proof of personal benefit was not required under the misappropriation theory.[163] The district courts in these two decisions did not explain the basis for their conclusion that personal benefit was not a required element. Rather, the district courts simply made a conclusory statement to that

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[153] LANGEVOORT, *supra* note 73, at 103 (citing *Report of the Securities and Exchange Commission to the House Committee on Energy and Commerce on Dirks v. Securities and Exchange Commission*, Aug. 23, 1985, at 46).

[154] 590 F. Supp. 756 (W.D. Okla. 1984).

[155] LANGEVOORT, *supra* note 73, at 103.

[156] *Switzer*, 590 F. Supp. at 762.

[157] *Id.*

[158] *Id.* at 763.

[159] *Id.* at 766.

[160] *United States v. Libera*, 989 F.2d 596 (2d Cir. 1993); *SEC v. Maio*, 51 F.3d 623 (7th Cir. 1995); *United States v. Mylett*, 97 F.3d 663 (2d Cir. 1996).

[161] 777 F. Supp. 1165 (S.D.N.Y. 1991).

[162] 748 F. Supp. 1028 (S.D.N.Y. 1989).

[163] *Willis*, 777 F. Supp. at 1172 n.7; *Musella*, 748 F. Supp. at 1038 n.4.

effect and held that even if personal benefit were required under the misappropriation theory, it would have been met.[164]

No appellate court has explicitly held that the personal benefit test is inapplicable under the misappropriation theory. However, in *SEC v. Sargent*, the First Circuit observed that "the Second Circuit strongly implied, . . . in dicta, that there was no need to make an affirmative showing of benefit in cases of misappropriation."[165] The First Circuit based this conclusion on the Second Circuit's opinion in *SEC v. Libera*,[166] where the Second Circuit commented on the elements for establishing tipper/tippee liability. In *Libera*, the Second Circuit remarked:

> [T]he misappropriation theory requires the establishment of two elements: (i) a breach by the tipper of a duty owed to the owner of the nonpublic information; and (ii) the tippee's knowledge that the tipper had breached the duty. We believe these two elements, without more, are sufficient for tippee liability. The tipper's knowledge that he or she was breaching a duty to the owner of confidential information suffices to establish the tipper's expectation that the breach will lead to some kind of a misuse of the information. This is so because it may be presumed that the tippee's interest in the information is, in contemporary jargon, not for nothing.[167]

The First Circuit construed this phrase as an indication that the "Second Circuit would probably not require a showing of benefit to the tipper for tipper (or tippee) liability, but would create a presumption of section 10(b) and Rule 10b-5 liability if there was misappropriation followed by a tip."[168] The First Circuit did not state whether it agreed or disagreed with the Second Circuit's position because it found that the SEC had presented enough evidence in the present case that would have made this issue moot.[169] In *Sargent*, the First Circuit found that even if the SEC were required to prove that the tipper benefited from his tip to the tippee, the SEC would have been able to do so.[170]

2. *Courts Holding That Proof of Personal Benefit Is Required Under the Misappropriation Theory*

On the other hand, a number of courts have held that proof of personal benefit is a required element to prove tipper/tippee liability under the misappropriation theory.[171] The most significant opinion is the Eleventh Circuit's opinion in *SEC v. Yun*. This is the only case

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164 *Willis*, 777 F. Supp. at 1172 n.7; *Musella*, 748 F. Supp. at 1038 n.4.

165 *SEC v. Sargent*, 229 F.3d 68, 77 (1st Cir. 2000).

166 989 F.2d 596 (2d Cir. 1993).

167 *Id.* at 600.

168 *Sargent*, 229 F.3d at 77.

169 *Id.*

170 *Id.*

171 *See SEC v. Yun*, 327 F.3d 1263, 1269–70 (11th Cir. 2003); *SEC v. Gonzalez de Castilla*, 184 F. Supp. 2d 365, 375 (S.D.N.Y. 2002); *Stevens v. O'Brien Envtl. Energy, Inc.*, [1999 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 90,475, at 92,241 (E.D. Pa. May 10, 1999). *See also SEC v. Lambert*, 38 F. Supp. 2d 1348, 1351–52 (S.D. Fla. 1999) (assuming that the personal benefit test is part of the evaluation to determine tippee liability under the misappropriation theory).

where an appellate court has directly addressed whether the misappropriation theory should incorporate the personal benefit test.

In *SEC v. Yun*, David Yun was the president of Scholastic Book Fairs, Inc., a subsidiary of Scholastic Corporation.[172] In January 1997, the chief financial officer of Scholastic Corporation told Mr. Yun that Scholastic Corporation intended to make a negative earnings announcement before the end of the quarter.[173] Mr. Yun knew that this was confidential information.[174]

At about the same time that Mr. Yun learned this material, nonpublic information, he was negotiating a post-nuptial division of assets with his wife, Donna Yun.[175] Mr. Yun owned Scholastic Corporation options, so he discussed his ownership of these options with Mrs. Yun.[176] During their negotiations, Mr. Yun explained that although Scholastic Corporation shares were currently trading at $65 a share, he valued each option at $55 on the asset statement because Scholastic Corporation was going to make a negative earnings announcement on February 20, 1997.[177] Mr. Yun told her not to disclose this information to anyone; Mrs. Yun promised to keep this information confidential.[178]

Despite her promise to her husband, Mrs. Yun did not keep this information confidential.[179] Instead, she disclosed this confidential information to Jerry Burch, one of her co-workers.[180] Mrs. Yun and Burch were real estate agents that worked together and shared the same office.[181] On February 18, Mrs. Yun was in their office talking to her attorney over the phone about the post-nuptial division of her and her husband's assets.[182] While she was speaking to her attorney, Burch entered their office to retrieve certain documents.[183] While Burch was in the office, he overheard Mrs. Yun as she explained to her attorney that Mr. Yun was expecting Scholastic Corporation's stock to decline after an upcoming earnings announcement.[184] After work that day, Mrs. Yun and Burch attended a cocktail party.[185] During the cocktail party, Mrs. Yun allegedly disclosed additional information to Burch regarding Scholastic Corporation's upcoming negative earnings announcement.[186]

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[172] *Yun*, 327 F.3d at 1267.
[173] *Id.*
[174] *Id.*
[175] *Id.*
[176] *Id.*
[177] *Id.*
[178] *Yun*, 327 F.3d at 1267.
[179] *Id.* at 1268.
[180] *Id.*
[181] *Id.*
[182] *Id.*
[183] *Id.*
[184] *Yun*, 327 F.3d at 1268.
[185] *Id.*
[186] *Id.*

On February 19 or 20, Burch purchased Scholastic Corporation put options.[187] Immediately after Scholastic Corporation made the negative earnings announcements on February 20, Burch sold his Scholastic Corporation puts and realized a profit of $269,000.[188] Within hours, the SEC began investigating whether Burch was liable for insider trading.[189] The SEC ultimately filed a claim against Mrs. Yun and Burch, asserting insider trading liability under the misappropriation theory.[190] The SEC's complaint alleged that Mrs. Yun breached her duty of trust and confidence to her husband by disclosing material, nonpublic information to Burch.[191] The SEC further alleged that Burch was liable as a tippee for trading on the material, nonpublic information.[192]

Ironically, the SEC's initial pleadings suggested that, in order to establish tipper/tippee liability under the misappropriation theory, it was necessary to prove that Mrs. Yun derived a personal benefit.[193] The SEC quickly changed its position and persuaded the district court that it was not necessary for the SEC to prove that Mrs. Yun benefited from her disclosure to Burch.[194] The district court accepted the SEC's position and omitted any mention of the personal benefit test when it instructed the jury on the essential elements of insider trading under the misappropriation theory.[195] The jury found Mrs. Yun and Burch liable for insider trading under the misappropriation theory.[196] The district court entered judgment against Mrs. Yun and Burch, "holding them jointly liable for $269,000, the profits generated by the prohibited trading," and for other damages and penalties.[197] The Eleventh Circuit vacated the district court's judgment and remanded the case for a new trial, holding that the SEC was required to establish that Mrs. Yun benefited from her tip to Burch.[198]

On appeal, the SEC made several arguments to support its position. First, the SEC argued, in essence, that because the Supreme Court established the personal benefit test in a case that only involved the classical theory, the Supreme Court did not intend to incorporate that test into the misappropriation theory.[199] To support this argument, the SEC highlighted the distinction between the duty owed under the classical theory and the duty owed under the misappropriation theory.[200] In response to the SEC's argument, the Eleventh Circuit drew on the Supreme Court's statement in *O'Hagan* that the courts "should attempt to synthesize,

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[187] *Id.*
[188] *Id.*
[189] *Id.*
[190] *Yun*, 327 F.3d at 1268–70.
[191] *Id.* at 1270.
[192] *Id.*
[193] *Id.* at 1274.
[194] *Id.* at 1281.
[195] *Id.*
[196] *Yun*, 327 F.3d at 1267.
[197] *Id.*
[198] *Id.* at 1282.
[199] Brief for Appellee at 40–42, *SEC v. Yun*, 327 F.3d 1263 (11th Cir. 2003) (No. 01-14490) [hereinafter Brief for Appellee].
[200] *Id.*

rather than polarize, insider trading law."[201] Instead of focusing on the differences between the classical theory and the misappropriation theory, the Eleventh Circuit focused on their similarities.[202] For instance, the Eleventh Circuit noted that under either theory, "the tippee is under notice that he has received confidential information through an improper breach of loyalty and confidentiality."[203] In addition, "the harm to the securities market from such trading would not differ depending on whether the tippee received the confidential information from an insider or an outsider; the integrity of, and investor confidence in, the securities markets are undermined by either method of insider trading."[204] The Eleventh Circuit concluded that it "makes 'scant sense' to impose liability more readily on a tipping outsider who breaches a duty to a source of information than on a tipping insider who breaches a duty to corporate shareholders."[205]

Overall, the Eleventh Circuit persuasively countered the SEC's contention that the Supreme Court in *Dirks* only intended the personal benefit test to apply under the classical theory of insider trading. However, the Eleventh Circuit could have further justified its conclusion. The Supreme Court issued the *Dirks* opinion in 1983.[206] Meanwhile, the Supreme Court did not even approve of the misappropriation theory until its 1997 decision in *O'Hagan*.[207] Consequently, it was unreasonable for the SEC to expect that the Supreme Court would have had the foresight to formulate the personal benefit test to comport with the tipper/tippee analysis of an insider trading theory that the Supreme Court did not even recognize until fourteen years later.

In its appellee brief, the SEC attempted to take advantage of the Supreme Court's reference to Section 395 of the Restatement (Second) of Agency in *O'Hagan*.[208] The Supreme Court referred to Section 395 in *O'Hagan* to support its proposition that a misappropriating trader has an obligation to disclose material, nonpublic information before trading.[209] The Supreme Court did not expressly include Section 395 as a component of the duty to abstain or disclose under the misappropriation theory. Instead, the Supreme Court apparently cited Section 395 as an illustration of the duty to disclose confidential information. Nonetheless, the SEC seized upon certain phrases in comment a to Section 395 to support its position.

For instance, in its brief, the SEC referred to a portion of comment a, which reads as follows: "The agent also has a duty not to use information acquired by him as agent . . . for any purpose likely to cause his principal *harm* or to interfere with his business . . . ."[210] Based on Section 395, the SEC claimed that a tipper's unauthorized disclosure of material, nonpublic

201 *Yun*, 327 F.3d at 1276 (citing *United States v. O'Hagan*, 521 U.S. 642, 652 (1997)).
202 *Id.*
203 *Id.*
204 *Id.*
205 *Id.* at 1277.
206 *Dirks v. SEC*, 463 U.S. 646 (1983).
207 *United States v. O'Hagan*, 521 U.S. 642 (1997).
208 Brief for Appellee, *supra* note 199, at 42–46.
209 *O'Hagan*, 521 U.S. at 654–55.
210 RESTATEMENT (SECOND) OF AGENCY § 395 cmt. a (1958).

information that harms the principal constitutes a breach whether or not the misappropriating tipper benefits from the unauthorized disclosure.[211]

The Eleventh Circuit flatly rejected the SEC's explanation.[212] The Eleventh Circuit accepted the notion that the corporation's shareholders are harmed when a corporate insider breaches his duty of disclosure to the shareholders.[213] But under the classical theory, even if the corporation's shareholders are harmed, the corporate insider who breached his duty of disclosure is not liable for tipping unless he benefited from the disclosure of the material, nonpublic information.[214] Hearkening back to the principle that the courts "should attempt to synthesize, rather than polarize, insider trading law," the Eleventh Circuit held that tippers should be treated the same under either the classical theory or the misappropriation theory.[215] Thus, in order to prove tipper/tippee liability, the plaintiff must show that the tipper personally benefited, regardless of which theory is utilized.[216]

In further support of imposing a requirement under the misappropriation theory that a plaintiff prove a tipper's intent to benefit, the Eleventh Circuit also noted that in *O'Hagan*, the Supreme Court held "§ 10(b) is not an all purpose breach of fiduciary ban."[217] The Eleventh Circuit proceeded from this statement to the implication that a tipper is not liable for insider trading if the tipper "had no intent to trade or manipulate the market."[218] This implication could have significant consequences. The Eleventh Circuit's statement that a tipper is not subject to liability if the tipper "had no intent to trade or manipulate the market" broadens the scope of those shielded from tipper/tippee liability. For instance, a tipper could benefit from disclosing nonpublic, material information in breach of a duty of trust and confidence and still escape tipper liability because he "had no intent to trade or manipulate the market." It will be interesting to see if tipper/tippee defendants attempt to utilize this expanded protection in the future.

The Eleventh Circuit advanced additional arguments to support its holding that a plaintiff must prove a tipper's intent to benefit under the misappropriation theory. The Supreme Court in *O'Hagan* observed that: "A fiduciary who pretends loyalty to the principal while secretly converting the principal's information for *personal gain* dupes or defrauds the principal."[219] According to the Eleventh Circuit, the language in *O'Hagan* "explicitly states or implicitly assumes that a misappropriator must gain personally from his trading on the confidential information."[220]

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[211] *SEC v. Yun*, 327 F.3d 1263, 1277 (11th Cir. 2003).
[212] *Id.* at 1277–78.
[213] *Id*. at 1277.
[214] *Id.*
[215] *Id*. at 1277–78.
[216] *Id.*
[217] *Yun*, 327 F.3d at 1278 (quoting *United States v. O'Hagan*, 521 U.S. 642, 655 (1997)).
[218] *Id.* at 1278 n.34.
[219] *Id.* at 1279 (quoting *O'Hagan*, 521 U.S. at 653–54).
[220] *Id.*

In conclusion, the Eleventh Circuit explained that the "the need for an identical approach to determining tipper and tippee liability under the two theories becomes evident when one realizes that nearly all violations under the classical theory of insider trading can be alternatively characterized as misappropriations."[221] As the Eleventh Circuit acknowledged, this is perhaps the most important reason for the requirement that a plaintiff must prove a tipper's intent to benefit under the misappropriation theory. Otherwise, plaintiffs could circumvent the *Dirks* decision and always avoid the burden of satisfying the personal benefit test.

The Eleventh Circuit's opinion in *SEC v. Yun* examined numerous justifications for requiring proof of personal benefit in order to establish tipper/tippee liability under the misappropriation theory. However, at least one district court has identified additional justifications for the holding in *Yun*. In *Stevens v. O'Brien Environmental Energy, Inc.*, the United States District Court for the Eastern District of Pennsylvania held that the personal benefit test should be utilized under the misappropriation theory for the same reasons enunciated in *Dirks*.[222] The district court rationalized that the personal benefit test was necessary to insulate people from insider trading liability if they disclose material, nonpublic information either inadvertently or with the intention of revealing a fraud.[223] As explained in more detail below, the justifications addressed in *Stevens* are probably the most important reasons to require the use of the personal benefit test in all tipper/tippee claims brought under the misappropriation theory.

C. Tipper/Tippee Liability under Rule 14e-3

Tipper/tippee liability is a common law development and therefore is not explicitly provided for in either Section 10(b) or Rule 10b-5. However, Section 14(e) and Rule 14e-3 establish tipper/tippee liability in the tender offer context. Rule 14e-3(d) provides that it is unlawful for the bidder or target to "communicate material, nonpublic information relating to a tender offer to any other person under circumstances in which it is reasonably foreseeable that such communication is likely to result" in trading in violation of Rule 14e-3.[224] Rule 14e-3(d) specifically addresses tipper/tippee liability, but fails to address whether proof of personal benefit is required.

In 1987, the district court in *Burlington Industries, Inc. v. Edelman* borrowed from cases interpreting Rule 10b-5 and held that proof of personal benefit was necessary to establish tipper/tippee liability under Rule 14e-3.[225] The district court arrived at this conclusion by first holding that Rule 14e-3 creates a duty of disclosure requiring corporate insiders to either "disclose the insider information or abstain from trading in the stock in the corporation."[226]

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[221] *Id.*

[222] *Stevens v. O'Brien Envtl. Energy, Inc.*, [1999 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 90,475, at 92,243 (E.D. Pa. May 10, 1999).

[223] *Id.*

[224] 17 C.F.R. § 240.14e-3 (2003).

[225] *Burlington Indus., Inc. v. Edelman*, 666 F. Supp. 799, 813–14 (M.D.N.C. 1987) (citing *Dirks v. SEC*, 463 U.S. 646, 662 (1983)).

[226] *Id.* at 814.

The corollary to the abstain or disclose rule was that the "insider has a duty not to disclose (tip) inside information to third parties for the purpose of gaining a personal benefit."[227]

Although the analysis in *Burlington Industries* is applicable in Rule 10b-5 cases, it clearly is not applicable in Rule 14e-3 cases. As discussed above, the Supreme Court held in *O'Hagan* that Rule 14e-3 does not require proof of a breach of fiduciary duty.[228] Pursuant to the Supreme Court's decision in *O'Hagan*, the district court's analysis in *Burlington Industries* is no longer adequate to support the proposition that proof of personal benefit is necessary to establish tipper/tippee liability under Rule 14e-3.

In *SEC v. Sekhri*, another district court appeared to imply that the plaintiff or prosecution must prove that the tipper received a personal benefit in order to establish tipper/tippee liability under Rule 14e-3.[229] However, it is not clear whether the district court intentionally or accidentally imposed such a requirement.

At least one district court has explicitly held that the personal benefit test is not applicable to claims asserted under Rule 14e-3.[230] Other courts simply omit the use of the personal benefit test in tipper/tippee liability claims under Rule 14e-3 without stating whether it should or should not ever be applied in such instances.[231] Unfortunately, the district courts in all of these cases fail to examine the rationales for or against the use of the personal benefit test in Rule 14e-3 cases.

IV. RECOMMENDATIONS

A. The Misappropriation Theory Should Incorporate the Personal Benefit Test

In *Dirks*, the Supreme Court explained the rationale for the personal benefit test in the context of the classical theory. Any reason for not incorporating the personal benefit test under

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227 *Id.*

228 *See United States v. O'Hagan*, 521 U.S. 642, 652 (1997).

229 *See SEC v. Sekhri*, [2002 Transfer Binder] Fed. Sec. L. Rep. ¶ 91,963, at 90,580 (S.D.N.Y. July 22, 2002). The district court's opinion in *Sekhri* reads in part:

> A tippee is liable under Sections 10(b) and 14(c) [sic] and the SEC's implementing rules where an insider transmits the information to him or her and 'receives a direct or indirect personal benefit from the disclosure, such as a pecuniary gain or a reputational benefit that will translate into future earnings . . . [or] when an insider makes a gift of confidential information to a trading relative or friend.'

Id. (quoting *Dirks v. SEC*, 463 U.S. 646, 663–64 (1983)). In the above sentence, the court inadvertently referred to Section "14(c)" and its implementing rule when it intended to refer to 14(e) and its implementing rule, Rule 14e-3. Section 14(c) is entitled: "Information to holders of record prior to annual or other meeting." Nowhere in *SEC v. Sekhri* does the court address this topic. Moreover, Section 14(c) does not have any implementing rules. On the other hand, the court repeatedly makes reference to Section 14(e) and its implementing rule, Rule 14e-3. Consequently, it is clear that the court inadvertently referred to section 14(c).

230 *See SEC v. Downe*, 969 F. Supp. 149, 153 (S.D.N.Y. 1997).

231 *See, e.g.*, *Hollywood Casino Corp. v. Simmons*, Fed. Sec. L. Rep. ¶ 91,958 (N.D. Tex. July 18, 2002); *SEC v. Gonzalez de Castilla*, 184 F. Supp. 2d 365 (S.D.N.Y. 2002).

the misappropriation theory must hinge on the differences between the classical theory and the misappropriation theory. The differences between these two theories are highlighted in the following paragraph.

Both the classical theory and the misappropriation theory similarly impose a duty to abstain or disclose.[232] However, the nature of the duty to abstain or disclose is significantly different for each theory. Under the classical theory, the fiduciary duty is owed to the shareholders.[233] The fiduciary duty under the misappropriation theory is owed to the source of the information.[234] In addition, the type of information that must be disclosed under either theory to avoid prosecution for insider trading is different. Under the classical theory, an insider who chooses to trade on material, nonpublic information must first disclose the information to his company's shareholders to avoid liability.[235] On the other hand, under the misappropriation theory, an individual who chooses to trade on material, nonpublic information must first disclose to his source that he intends to use the information for trading.[236]

Any explanation for abandoning the personal benefit test under the misappropriation theory must rest on the above two distinguishing factors. However, any argument based on either of these two distinctions is unavailing. In *SEC v. Yun*, the Eleventh Circuit identified a number of reasons why the personal benefit test is applicable under either theory despite the differences between the two.[237] Remarkably, the Eleventh Circuit did not buttress its decision in *Yun* by referring to the rationale for the personal benefit test enunciated by the Supreme Court in *Dirks*. Despite the differences between the classical theory and the misappropriation theory, the rationale for the personal benefit test under the classical theory is equally applicable under the misappropriation theory. The Eleventh Circuit's and the Supreme Court's rationales are examined in greater detail below.

1. The Eleventh Circuit's Rationale in SEC v. Yun

As discussed above, the Eleventh Circuit's opinion in *SEC v. Yun* is the only appellate court decision that has expressly addressed whether proof of personal benefit to the tipper is

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232 *O'Hagan*, 521 U.S. at 652 (citing *Chiarella v. United States*, 445 U.S. 222, 228 (1980)).

233 *Chiarella v. United States*, 445 U.S. 222, 228–30 (1980).

234 *See O'Hagan*, 521 U.S. at 652–53 ("[T]he misappropriation theory outlaws trading on the basis of nonpublic information by a corporate 'outsider' in breach of a duty owed not to a trading party, but to the source of the information.").

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

236 *O'Hagan*, 521 U.S. at 656.

> [F]ull disclosure forecloses liability under the misappropriation theory: Because the deception essential to the misappropriation theory involves feigning fidelity to the source of information, if the fiduciary discloses to the source that he plans to trade on the nonpublic information, there is no "deceptive device" and thus no §10(b) violation—although the fiduciary turned trader may remain liable under state law for breach of a duty of loyalty.

Id.

237 *SEC v. Yun*, 327 F.3d 1263, 1276–77 (11th Cir. 2003).

required to establish tipper/tippee liability under the misappropriation theory. In that opinion, the Eleventh Circuit advanced persuasive justifications for requiring proof of personal benefit under the misappropriation theory.

For instance, the Eleventh Circuit observed that every insider trading case that can be brought under the classical theory may also be brought under the misappropriation theory.[238] Any disclosure of material, nonpublic information by either a corporate insider or a temporary insider is not only a breach of a fiduciary duty owed to the shareholders, but also a breach of a fiduciary duty of trust or confidence owed to the corporation, the temporary insider's employer, or both.[239] If the personal benefit test was omitted from tipper/tippee analysis under the misappropriation theory, plaintiffs could entirely circumvent the *Dirks* decision and avoid the burden of proving personal benefit by prosecuting all insider trading claims under the misappropriation theory.[240] This would adversely affect those who inadvertently disclose nonpublic, material information or who disclose such information to expose fraud. To avoid this result, the Eleventh Circuit appropriately held that plaintiffs are required to prove personal benefit in order to establish tipper/tippee liability under the misappropriation theory.[241]

In *SEC v. Yun*, the SEC based its arguments on the construction of certain phrases in *Dirks* and *O'Hagan*.[242] Consequently, the Eleventh Circuit devoted a significant portion of its opinion to rebutting the SEC's semantic arguments. Although the Eleventh Circuit eloquently countered the SEC's arguments, it could have supported its holding by elaborating on the underlying reason that the Supreme Court established the personal benefit test in *Dirks*. As explained in *Dirks*, an insider should not incur insider trading liability unless he communicates material, nonpublic information for an improper purpose.[243] If a person reveals material, nonpublic information inadvertently or to expose a fraud, that person has not communicated material, nonpublic information for an improper purpose.[244] In *Yun*, the Eleventh Circuit did not even mention this rationale for the personal benefit test. An explanation of this rationale would have made it clear why the personal benefit test should be incorporated into the misappropriation theory.

Instead, the Eleventh Circuit in *SEC v. Yun* appeared to endorse the inclusion of the personal benefit test under the misappropriation theory simply because it was efficient to do so. For instance, the Eleventh Circuit repeatedly referred to the precept that courts "should attempt to synthesize, rather than polarize, insider trading law."[245] The synthesization of insider trading is a sensible objective, but this aim does not capture the underlying rationale for the personal benefit test—to protect people who reveal material, nonpublic information inadvertently or to expose a fraud.

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[238] *Id.* at 1279.
[239] DONALD C. LANGEVOORT, INSIDER TRADING REGULATION, ENFORCEMENT, AND PREVENTION § 6:13 (2002).
[240] *Yun*, 327 F.3d at 1279.
[241] *Id.*
[242] Brief for Appellee, *supra* note 199, at 40–46.
[243] *Dirks v. SEC*, 463 U.S. 646, 671 (1983).
[244] *Id.* at 661–62.
[245] *Yun*, 327 F.3d at 1276–78.

2. *The Supreme Court's Rationale in Dirks v. SEC*

As stated in *Dirks*, the primary rationale for the personal benefit test is to insure that material, nonpublic information is not released for an improper purpose.[246] This rationale is just as applicable in the context of the misappropriation theory as under the classical theory.

An example will illustrate the reason the *Dirks* rationale for the personal benefit test applies equally well under the misappropriation theory. Consider an officer of a Fortune 500 company who is discussing material, nonpublic information regarding the company with his wife. Rule 10(b)5-2 provides that a fiduciary duty exists between them.[247] Furthermore, assume that the husband explained to her that the company was engaging in a massive fraud to inflate the value of its earnings and told her to keep this information confidential. The wife is disgusted by the fraud that her husband's company is perpetrating and communicates this information to some of her friends, who consequently trade in the company's stock. Assume her sole purpose in making the disclosure was to reveal this despicable fraud and that she is neither retaliating against her husband for some reason nor attempting to assist her friends in making a quick buck. Certainly, the same rationale that the Supreme Court developed for the personal benefit test in *Dirks* is applicable in this example. The wife should be encouraged to disclose material, nonpublic information that reveals a fraud in the company because she did not do so with an improper purpose.

However, the above facts may be slightly altered and accordingly lead to an entirely different result. Assume that the wife disclosed the information not only to reveal a fraud in the company, but also to retaliate against her husband or to assist her friends in making a quick profit. In this case, the wife would have disclosed the information to obtain a personal benefit for herself, in addition to revealing a fraud.[248] Therefore, the wife should be liable under the misappropriation theory as a tipper because she disclosed the information for an improper purpose—to obtain a personal benefit.

Another hypothetical highlights a slightly different issue. Suppose a corporate officer of the Fortune 500 company seeks psychiatric help and discloses to the psychiatrist, in the course of his treatment, that the company is engaging in a massive fraud to inflate the value of its earnings. Without informing his patient that he would disclose this information for others to trade on, the psychiatrist communicates this information to an investment analyst who instructs his clients to sell their securities in the company. Assume the psychiatrist receives nothing in return but the satisfaction of revealing fraudulent activity in the company.

Like the previous husband-wife hypothetical, the psychiatrist arguably communicated this information for a proper purpose (i.e., to ferret out fraud). That is not to say that the psychiatrist is immune from all liability for ferreting out this fraud. Certainly the psychiatrist should be liable under state law for breach of doctor-patient confidentiality.[249] However, the

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[246] *Dirks*, 463 U.S. at 662.

[247] 17 C.F.R. § 240.10b5-2 (2003).

[248] *Cf. Yun*, 327 F.3d at 1278 n.34.

[249] *See, e.g.*, TEX. OCC. CODE ANN. § 159.009 (Vernon Supp. 2002) ("Injunction; Cause of Action for Unauthorized Release of Confidential Information").

psychiatrist should not suffer additional liability for insider trading if the only purpose for his disclosure was to prevent people from being scammed by the company.

As reflected in *Dirks*, the securities laws only prohibit the disclosure of material, nonpublic information if the disclosure is for an improper purpose.[250] In *O'Hagan*, the Supreme Court recognized that the misappropriation theory is designed to protect the integrity of the securities market.[251] What better way to do this than to allow the wife or the psychiatrist in the above illustrations to disclose material, nonpublic information to reveal fraud? The disclosure of material, nonpublic information by the wife or the psychiatrist is consistent with the misappropriation theory's goal of protecting the integrity of the securities market. Consequently, it is difficult to argue that the personal benefit test would run contrary to the purpose of the misappropriation theory.

B. Rule 14e-3 Should Incorporate the Personal Benefit Test

For the same reasons justifying the application of the personal benefit test under the misappropriation theory, the personal benefit test should be a required element of proof in the context of Rule 14e-3.

At first glance, it may appear problematic to recommend using the personal benefit test in the context of Rule 14e-3. The personal benefit test, as applied in the context of the classical theory and the misappropriation theory, is intertwined with a consideration of whether a breach of a fiduciary duty occurred.[252] In *Dirks*, the Supreme Court did not introduce the personal benefit test as an analysis separate from the determination of whether an insider breached his duty to disclose or abstain. How could the personal benefit test be incorporated into Rule 14e-3 if such rule does not require the breach of a fiduciary duty in order to establish liability for insider trading in a tender offer situation?

Although Rule 14e-3 does not involve a fiduciary duty analysis, the personal benefit test can and should be applied in the context of this rule. Similar to the classical theory and the misappropriation theory, Rule 14e-3 incorporates the disclose or abstain rule.[253] Instead of conceptualizing the personal benefit test as intertwined with the determination of whether a breach of fiduciary duty has occurred, courts should simply apply the personal benefit test under any insider trading theory that is based on the disclose or abstain rule. The same rationale for applying the personal benefit test under the classical theory and the misappropriation theory supports its use in the context of Rule 14e-3. That is, the requirement

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[250] *Dirks*, 463 U.S. at 662.

[251] *United States v. O'Hagan*, 521 U.S. 642, 653 (1997) ("The misappropriation theory is thus designed to 'protec[t] the integrity of the securities markets against abuses by "outsiders" to a corporation who have access to confidential information that will affect th[e] corporation's security price when revealed, but who owe no fiduciary or other duty to that corporation's shareholders.'" (quoting Brief for United States at 14, *United States v. O'Hagan*, 521 U.S. 642 (1997) (No. 96-842)) (alteration in original)).

[252] *Dirks*, 463 U.S. at 662.

[253] Tender Offer Fraud Rule, Exchange Act Release No. 17,120, [1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,646, at 83,453 (Sept. 4, 1980).

of proof of personal benefit insulates people from prosecution under the insider trading laws as long as they do not disclose material, nonpublic information for an improper purpose.

Consider the following hypothetical which is similar to the facts in *O'Hagan*. An attorney owes a duty of trust or confidence to his law firm employer. The law firm is assisting Company A in its tender offer for Company B. However, in the course of his work, the attorney discovers that the law firm is assisting Company A in making a false bid for Company B.[254] The fact that the tender offer is a false bid is material, nonpublic information. Under Rule 14e-3, that attorney may be liable if he revealed this material, nonpublic information to tippees. However, public policy considerations would favor the attorney's prompt dissemination of this information to the public, as long as the attorney did so to reveal a fraud without seeking personal benefit.

The SEC's failure to include the personal benefit test in the language of Rule 14e-3 is a significant omission. Consequently, courts should require proof of the personal benefit test in any Rule 14e-3 action, just as they have done in Rule 10b-5 claims based on the classical theory.

CONCLUSION

Based on the above arguments, courts should utilize the personal benefit test when assessing tipper/tippee liability under either the misappropriation theory or Rule 14e-3. The classical theory, the misappropriation theory, and Rule 14e-3 all incorporate the disclose or abstain rule. Although proving a violation of the disclose or abstain rule under each approach requires different evidence, the rationale for the application of the personal benefit test is the same for each. Tippers that do not reveal material, nonpublic information for an improper purpose should not be prosecuted for insider trading.

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[254] False bids are prohibited by Rule 14e-8. 17 C.F.R. § 240.14e-8 (2003). Rule 14e-8 proscribes announcing a tender offer if the person:

> Is making the announcement of a potential tender offer without the intention to commence the offer within a reasonable time and complete the offer; (b) Intends, directly or indirectly, for the announcement to manipulate the market price of the stock of the bidder or subject company; or (c) Does not have the reasonable belief that the person will have the means to purchase securities to complete the offer.

Id.