WORDS FROM ON HIGH ABOUT RULE 10b-5: *CHIARELLA*'S HISTORY, *CENTRAL BANK*'S FUTURE

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A securities law decision by the United States Supreme Court is an extraordinary event, especially when it deals with the centerpiece antifraud requirement, Rule 10b-5.[1] Shortly after the decision is handed down, lawyers react with commentary in the legal and financial press, in memoranda to clients, and on the American Bar Association and continuing legal education circuits. Often, the reaction is a sharp one. The decision, we are told, promises a new doctrinal dawn on the issue in question, a reorientation of established thinking. The text of the majority, concurring, and dissenting opinions are carefully parsed. Commentators give even more attention to the decision's tone and thrust in an attempt to divine the Court's real intent.

Yet however large its shadow, the Supreme Court does extremely little of the adjudicatory work in securities law — perhaps one or two decisions each Term. Adjudication of securities law disputes is a task reserved almost exclusively for the lower courts and, to a lesser extent, SEC administrative proceedings. Accordingly, any prediction of the impact of a Supreme Court decision must mainly be a prediction of how the lower courts will interpret and apply it.[2]

When commentators predict that a Supreme Court decision will have a significant and lasting impact, they seem to assume that lower courts apply such decisions in much the same way as they interpret statutes. Under the orthodox view of statutory interpretation, courts seek

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[1]17 C.F.R. § 240.10b-5 (1995).

[2]On the question of the formal interplay between Supreme Court decisions and lower court decision making, see Evan H. Caminker, *Why Must Inferior Courts Obey Superior Court Precedents?*, 46 STAN. L. REV. 817 (1994) (addressing various arguments supporting differing degrees of autonomy for the lower courts); Michael C. Dorf, *Prediction and the Rule of Law*, 42 UCLA L. REV. 651 (1995) (suggesting that the prediction approach, under which a lower court judge uses conventional materials as well as information about the views of higher court judges as a basis for predicting how those judges will rule, generally undermines the law). To be sure, it may be a rough heuristic at times to say that because many of the recent appointees to the lower court benches have the same political ideology as the majority of the Supreme Court, the Supreme Court's "intent" is a good predictor of lower court attitudes.

to determine legislative "intent," determining what the enacting legislature would do if asked to decide the matter in question, and then adhere obediently to that intent.[3] I believe that the analogy between statutory interpretation and the interpretation of Supreme Court precedent is indeed a useful one, not previously explored in any systematic way by legal scholars. Yet, simply drawing this analogy says something significant. Scholars have shown what common experience has long suggested: that there is no rigor or uniformity to the process of statutory interpretation in the courts.[4] The canons of construction are used freely, but unpredictably. Consistent orthodoxy is an illusion; the courts have a mind of their own.

This is also true with Supreme Court opinions. To be sure, there are intentionalist lower court judges who faithfully carry out the Supreme Court's intent by extrapolation. They revel in the Court's dicta as well as its holding. There are also textualists who look narrowly at the language of the Court's opinion, extending that and nothing more.[5] But there are also — and I suspect many — lower court judges who are willing to engage in revisionism. These judges prefer to engage in more

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[3]For a modern statement of this traditionalist view, see Richard A. Posner, *Statutory Interpretation — In the Classroom and in the Courtroom*, 50 U. CHI. L. REV. 800 (1983) (analyzing statutory interpretation processes and suggesting that statutory interpretation should be approached as a process of imaginative reconstruction).

[4]The classic critique is Karl N. Llewellyn, *Remarks on the Theory of Appellate Decision and the Rules or Canons About How Statutes Are to be Construed*, 3 VAND. L. REV. 395 (1950) (examining how "correct," unchallengeable rules of statutory interpretation lead in variant directions). From among the many recent studies of statutory interpretation detailing the indeterminacy, see William N. Eskridge, Jr. & Philip P. Frickey, *Quasi-Constitutional Law: Clear Statement Rules as Constitutional Lawmaking*, 45 VAND. L. REV. 593 (1992) (arguing that the manner in which the Supreme Court applies traditional substantive canons of statutory interpretation reflects underlying ideology, and testing the hypothesis by comparing statutory interpretation by the Burger Court and the Rehnquist Court); Cass R. Sunstein, *Interpreting Statutes in the Regulatory State*, 103 HARV. L. REV. 405 (1989) (suggesting that statutory interpretation involves application of "background norms" and that many disputes over statutory meaning are disagreements over the appropriate norms, and proposing a series of interpretive principles).

[5]The difficulties inherent in textualism in statutory construction is likely replicated in textualist extensions of Supreme Court decisions; there is little reason to be confident, as a practical matter, that text conforms to intent. *See generally* William N. Eskridge, Jr., *The New Textualism*, 37 UCLA L. REV. 621 (1990) (noting that in the textualist view, once the Court has ascertained the plain meaning of a statute, consideration of legislative history becomes irrelevant; identifying problems associated with that extreme approach; and endorsing a reassessment of the proper role of legislative history in statutory interpretation); Nicholas S. Zeppos, *Justice Scalia's Textualism: The "New" New Legal Process*, 12 CARDOZO L. REV. 1597 (1991) (analyzing Justice Scalia's textualist theory and contrasting it with the "purposive" approach to statutory interpretation).

creative interpretation of a Supreme Court opinion,[6] subtly revising its meaning to conform to their own sense of preferred policy and result. They know that the Court is unlikely to revisit the question soon and, when and if it does, it will probably have a different membership. In fact, the Court itself often follows its own precedent with questionable fidelity and considerable creativity. As Justice O'Connor recently stated, judges "'know how to mouth the correct legal rules with ironic solemnity while avoiding those rules' logical consequences.'"[7]

My hypothesis here is a simple one. We should concede that predicting the impact of a Supreme Court decision in the lower courts is difficult. "First returns" in the form of sharpened newspaper quotes and client memos are likely to be misleading. But a helpful clue for prediction exists in the notion of legal equilibria.[8] If the state of the law was generally well-settled or steadily moving in a particular direction prior to the Court's decision, any departure from that status quo or trend will be met with resistance in the lower courts. Unless the Supreme Court's decision either (a) was particularly persuasive or (b) reflects a significant break in political consensus that the lower courts find especially resonant, then dynamic interpreters will cause a gradual reversion back to the status quo or trend.

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[6]On such creativity in statutory interpretation, see GUIDO CALABRESI, A COMMON LAW FOR THE AGE OF STATUTES (1982) (urging judges to assume power to update statutes that have lost consistency with the "legal landscape"); William N. Eskridge, Jr., *Dynamic Statutory Interpretation*, 135 U. PA. L. REV. 1479 (1987) (exploring the thesis that statutes should be interpreted dynamically). For an illustration from banking law, see Donald C. Langevoort, *Statutory Obsolescence and the Judicial Process: The Revisionist Role of the Courts in Federal Banking Regulation*, 85 MICH. L. REV. 672 (1987) (tracing the evolution in statutory interpretation of the Glass-Steagall Act and the McFadden Act of 1927).

[7]TXO Prod. Corp. v. Alliance Resources Corp., 113 S. Ct. 2711, 2742 (1993) (O'Connor, J., dissenting) (quoting Garnes v. Fleming Landfill, Inc., 413 S.E.2d 897, 907 (W. Va. 1991)). *See generally* Walter F. Murphy, *Lower Court Checks on Supreme Court Power*, 53 AM. POL. SCI. REV. 1017 (1959) (noting that when lower courts apply Supreme Court policy, judges may engage in material modification); Caminker, *supra* note 2, at 818-19 (citing examples of lower court judges who have refused to accept a passive enforcement role). Much room for revisionism, of course, lies in the distinction between holding and dicta. *See* Kent Greenawalt, *Reflections on Holding and Dictum*, 39 J. LEGAL EDUC. 431 (1989) (exploring the distinctions between holding and dictum and discussing the degree of constraint a holding imposes on lower court decisions); Frederick Schauer, *Precedent*, 39 STAN. L. REV. 571 (1987) (examining the effect of precedential constraint and the reasons why such constraint is justified).

[8]I borrow this term from the study by Professors Eskridge and Frickey of the "game theoretic" dynamics of judicial decision making and its relationship to statutory interpretation. *See* William N. Eskridge, Jr. & Philip P. Frickey, *The Supreme Court 1993 Term, Foreword: Law as Equilibrium*, 108 HARV. L. REV. 27 (1994) (proposing that law is an equilibrium, and competing institutions force any temporary displacement back toward the stable position).

The first possibility is increasingly unlikely these days. For reasons that are perfectly understandable, the Supreme Court speaks with very little expertise, and hence relatively less subject-matter authority, on intricate matters of federal regulation such as securities law.[9] Since the retirement of Justice Powell, no current member of the Court can be said to be schooled as a "corporate lawyer" as that term is understood substantively. Quite apart from the feelings they have about the particular outcomes, scholars and learned practitioners are giving the Court's securities law opinions low grades for logic, clarity, and usefulness in future cases.[10] The second possibility, the political shift explanation, is more plausible and can indeed often have a useful explanatory power.[11] But I suspect that this is still the exception rather than the rule.[12]

Simply to claim that the process of dynamic revisionism causes gradual reversion is not all that insightful, although practitioners would do well to remember it when reacting sharply to future Supreme Court opinions. In this article, I want to illustrate this claim. Moreover, I want to suggest a predictable pitfall in the process of dynamic revisionism.

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[9]In addition to securities law, bankruptcy, taxation, and environmental law are examples of areas of the law that are complicated by intricate federal regulation. Obviously, the increased caseload of the Court takes away the time the Justices have to consider any single case, however complicated it is factually and legally. Under these circumstances, logic and coherence can easily slip. For a study of the inconsistencies in the Court's use of legislative history in securities law decisions, see Randall W. Quinn, *The Supreme Court's Use of Legislative History in Interpreting the Federal Securities Laws*, 22 SEC. REG. L.J. 262 (1994) (arguing that the Supreme Court should resist abandoning or restricting the use of legislative history in interpreting federal securities laws).

[10]For a brief sampling of criticisms going to the quality of reasoning, see Richard A. Booth, *The Scope of Section 12(2) After* Gustafson, INSIGHTS, July 1995, at 8 (discussing the construction of § 12(2) of the Securities Act of 1933); Marc I. Steinberg, *The Ramifications of Recent U.S. Supreme Court Decisions on Federal and State Securities Regulation*, 70 NOTRE DAME L. REV. 489 (1995) (criticizing the Supreme Court's reasoning in Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 114 S. Ct. 1439 (1994)); James D. Gordon III, *Interplanetary Intelligence About Promissory Notes as Securities*, 69 TEX. L. REV. 383 (1990) (discussing the definition of a security).

[11]Elsewhere, I have suggested that this may have occurred in the federal law relating to takeover defenses. *See* Donald C. Langevoort, *The Supreme Court and the Politics of Corporate Takeovers: A Comment on* CTS Corp. v. Dynamics Corp. of America, 101 HARV. L. REV. 96 (1987) (exploring the nature and significance of the Supreme Court's perspective on regulation of corporate takeovers, in particular, the role of Justice Powell).

[12]Some support for this comes from Delaware corporation law, which has shown its own rhythmic capacity. *See* Elliott J. Weiss & Lawrence J. White, *Of Econometrics and Indeterminacy: A Study of Investors' Reactions to "Changes" in Corporate Law*, 75 CAL. L. REV. 551 (1987) (analyzing investors' reactions to seven major Delaware corporate law decisions and finding no significant market reaction).

The lower federal courts are no more expert in securities regulation than the Supreme Court. Their attempts to realign the Court's holding and dicta with the pre-existing status quo or trend are likely to be awkward and short sighted. If revisionism occurs, there is likely to be as much or more confusion than there was before the Court spoke. The return to equilibrium will be a wobbly, and potentially self-destructive, journey.

My case study is from the law of insider trading. In 1980, the Supreme Court decided *Chiarella v. United States*,[13] a restrictive decision designed to give more order and predictability to a body of law the Court viewed as vague and unstable. *Chiarella* was subsequently strengthened by the Court three years later, in its sister holding of *Dirks v. SEC*.[14] In the next decade and a half, however, the lower courts have effectively restored nearly all of the coverage and most of the residual uncertainty seemingly lost in the aftermath of *Chiarella* and *Dirks*, largely through the invention of a new theory of liability, the misappropriation theory. At the same time, the particular form that revisionism took was inherently unstable, as we have surprisingly seen in the Fourth Circuit's 1995 decision, *United States v. Bryan*.[15] I will explore the road from *Chiarella* to *Bryan*, and in the process offer some thoughts on where it should continue.

Next, I will discuss a recent Supreme Court decision, *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*,[16] wherein the Court rejected a private cause of action for aiding and abetting liability under Rule 10b-5.[17] *Central Bank* is only a little more than a year old and only now beginning to be subject to lower court interpretation (albeit in the relatively unusual setting of intense Congressional activity in its very subject area). I will venture the guess that *Central Bank* is a good candidate for lower court revisionism, although a political shift explanation for continued close adherence to its underlying intent cannot be dismissed. Here again, I will suggest some ways that revisionism can occur without the troublesome doctrinal wobble that we have seen in the law of insider trading.

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[13]445 U.S. 222 (1980) (holding that failing to disclose material information prior to transacting in securities does not constitute fraud under § 10(b) unless a duty to disclose exists).

[14]463 U.S. 646 (1983) (discussing tippee liability under Rule 10b-5 and holding that a recipient of inside information does not acquire a duty to disclose or abstain from trading by receiving the tip but may assume an insider's fiduciary duty if the tippee knows or should know that the insider has breached his fiduciary duty by disclosing the information).

[15]58 F.3d 933 (4th Cir. 1995) (rejecting the misappropriation theory of liability for securities fraud under § 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5).

[16]114 S. Ct. 1439 (1994).

[17]*Id.* at 1455.

I. INSIDER TRADING AFTER *CHIARELLA*: FROM DISCLOSURE TO MISAPPROPRIATION

The history of insider trading regulation under the federal securities laws is a well-worn story, and it does not need a detailed retelling here.[18] However, the fact that there is a broad-based prohibition at all, absent any legislative initiative whatsoever, deserves some brief pause. At common law, high-level insiders were frequently barred from exploiting informational advantages when trading with shareholders.[19] This prohibition was maintained under a variety of theories, usually under the headings of fraud or state corporation law.[20] When insiders solicited shareholders to buy or sell, or otherwise negotiated face-to-face preceding the transaction, a court could plausibly argue that the shareholder was actually deceived, expecting a higher level of fair dealing from company officials. More likely, however, it was that these decisions were premised on a notion that disclosure obligations in these kinds of business transactions should be based on something more than a Darwinian *caveat emptor*. Managers work for the corporation, and the shareholders are, for want of a better term, its owners. Managers would be unjustly enriched if they were permitted to profit from information belonging to another that they had no personal right to exploit.[21]

The resulting obligation was sometimes characterized as fiduciary in nature; but this is not perfectly apt. Particularly in the context of the publicly-traded issuer, the fiduciary duty is owed to the corporation, not to its shareholders as such. It is much more sensible to place this early

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[18]For a detailed discussion of liability under the federal securities laws, see IX LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION (3d ed. 1991). My own recounting is Donald C. Langevoort, *Insider Trading and the Fiduciary Principle: A Post-*Chiarella *Restatement*, 70 CAL. L. REV. 1 (1982).

[19]*See* Strong v. Repide, 213 U.S. 419 (1909) (holding that under certain circumstances, a director of a corporation has a duty to disclose his knowledge of factors affecting share value to a shareholder from whom he seeks to purchase); Oliver v. Oliver, 45 S.E. 232 (Ga. 1903) (holding that the sale of stock from a shareholder to a director may be rescinded where the director conceals material facts as to the value of the stock).

[20]A line of authority (not entirely unbroken) gave corporations the ability to recoup profits from their insiders as a matter of the law of fiduciary duty. *Compare*, Brophy v. Cities Serv. Co., 70 A.2d 5 (Del. Ch. 1949) (stating that public policy will not permit an employee in a position of trust to his employer to abuse the relationship to his profit, and denying a motion to dismiss where the relief sought was the return of profits made as a result of inside information) *with* Freeman v. Decio, 584 F.2d 186 (7th Cir. 1978) (affirming that Indiana law does not recognize a right in a corporation to recover profits from insider trading).

[21]*See* Langevoort, *supra* note 18, at 6-7 (explaining that the general disclosure duty placed on corporate officers and directors when dealing with shareholders was primarily based on principles of unjust enrichment).

to mid-twentieth century development in the framework of the more general erosion of *caveat emptor* that has unmistakably occurred in American law. Today, law books are filled with decisions imposing an affirmative disclosure obligation on people engaged in business negotiations.[22] The precise line has not yet been clarified,[23] but it is moving toward a duty to divulge material information that is the product of a superior informational advantage unless a property-like claim of a *right* to possession of the information can be made. Before the information can be concealed from an unsuspecting party, the person possessing the information must show that it is his or hers, usually the product of some skill, diligence, or expertise.[24] The common law insider trading cases fit perfectly within this trend, for insiders cannot make a property-like claim to information that belongs to the corporation.

Beginning in the early 1960s, this same trend in the law made its way into the jurisprudence of the federal securities laws. In the *In re Cady, Roberts & Co.* decision, the SEC articulated an abstain or disclose obligation on corporate insiders and their associates.[25] This obligation rested explicitly on the unfairness of allowing one having exclusive access to information that is not his or her own to profit in securities trading.[26] This same philosophy influenced the first major judicial

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[22]For an excellent collection and analysis, see Nicola W. Palmieri, *Good Faith Disclosures Required During Precontractual Negotiations*, 24 SETON HALL L. REV. 70 (1993) (citing evidence supporting the thesis that the doctrine of *caveat emptor* has lost much of its efficacy in arm's-length commercial transactions). The classic early study of this shift in American law is Page W. Keeton, *Fraud—Concealment and Non-Disclosure*, 15 TEX. L. REV. 1 (1936) (proposing a standard for determining when a duty of disclosure exists). The most common authority for the current duty of disclosure is the RESTATEMENT (SECOND) OF TORTS § 551 (1977).

[23]*See* Deborah A. DeMott, *Do You Have the Right to Remain Silent?: Duties of Disclosure in Business Transactions*, 19 DEL. J. CORP. L. 65 (1994) (arguing that cases involving duty of disclosure issues are not resolved consistently by current legal doctrine).

[24]The standard economic-oriented exposition of this privilege is Anthony T. Kronman, *Mistake, Disclosure, Information, and the Law of Contracts*, 7 J. LEG. STUD. 1 (1978) (arguing that where one has engaged in a deliberate search for socially useful information, he acquires what is, in essence, a property right which permits him to deal with others without disclosing the information); *see also* Randy E. Barnett, *Rational Bargaining Theory and Contract: Default Rules, Hypothetical Consent, the Duty to Disclose, and Fraud*, 15 HARV. J.L. & PUB. POL'Y 783 (1992) (suggesting that the refusal of one contracting party to disclose information to the other is not fraudulent when the information relates to supply or demand for the resources which are the subject of the contract).

[25]40 S.E.C. 907, 911 (1961). The Supreme Court endorsed and adopted the *Cady, Roberts* obligation in *Chiarella*. *See Chiarella*, 445 U.S. at 227-29.

[26]*Cady, Roberts*, 40 S.E.C. at 912.

endorsement of insider trading liability under Rule 10b-5 in *SEC v. Texas Gulf Sulphur Co.*[27]

The impulse to join the common law trend was obviously a strong one, strong enough that both the SEC and the courts simply ignored a fundamental conceptual question. How is it that insider trading in an anonymous stock market causes anyone to rely on misinformation?[28] Reliance (actual or presumed) is an essential element of deception, which in turn is crucial to a finding of fraud under Rule 10b-5. Yet, when an insider or tippee secretly trades, no reliable representation whatsoever goes out to the market. For precisely this reason, the court in the one common law fraud case that involved a disclosure duty in open-market trading rejected the existence of such a duty.[29] Doctrinal purity, however, gave way to a desire to make Rule 10b-5 cohere with the general movement in the law and create an effective federal weapon against unfair exploitation of informational advantages in securities trading.

A fairness-based disclosure duty was the law until 1980. In that year, the Supreme Court decided *Chiarella* and rejected fairness as the organizing principle for insider trading regulation. The Court held that notice and predictability were high values that required a more determinate doctrinal structure. Disingenuously citing state law to support a rule that had long since ceased to apply, the Court held that a duty of disclosure to the marketplace would not arise absent a pre-existing fiduciary relationship between buyer and seller.[30] While such a relationship would exist in many conventional insider trading situations, the Court's new rule clearly and deliberately cut back the reach of Rule 10b-5 as a general weapon against unfair information advantages. Three years later, in *Dirks*, the Court reaffirmed its rhetoric and approach, confining tipper-tippee liability within the fiduciary-based framework.[31]

Chiarella, then, was plainly a retrenchment decision, running against a broad based trend in both federal and state law. The Court's

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[27]401 F.2d 833 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969).

[28]This point was made in William H. Painter, *Inside Information: Growing Pains for the Development of Federal Corporation Law Under Rule 10b-5*, 65 COLUM. L. REV. 1361, 1370-71 (1965).

[29]*See* Goodwin v. Agassiz, 186 N.E. 659, 661 (Mass. 1933) (noting that a director would be in a difficult position if he could not trade shares of his corporation on the stock exchange without seeking out the purchaser and disclosing all he knows affecting the real or speculative value of the shares).

[30]The Court's opinion reads as if the *Restatement (Second) of Torts* supports its restriction of the duty to disclose to fiduciary relationships. *See Chiarella*, 445 U.S. at 228. In fact, as Justice Blackmun's dissent discusses, the *Restatement (Second) of Torts* (and the common law generally) support a broader duty to disclose. *Id.* at 247-48.

[31]*Dirks*, 463 U.S. at 659-61.

intent to reject this trend was unmistakable. Not surprisingly, the commentary immediately following the decision, loudly (with both glee and doom) trumpeted the demise of broad-based insider trading liability.

What happened then? With very few exceptions, lower courts construed *Chiarella* and *Dirks* as narrowly as possible. Movement occurred in three separate directions. First, courts applied the fiduciary obligation broadly. In one case, for example, a court declared a person a "temporary insider" after he received information from a friend who asked if his company would be interested in providing financing for a joint venture, even though his reaction to the overture was to reject it.[32] As to the law of tippers and tippees, lower courts showed a consistent willingness to fiduciarize any person who came into possession of information that he or she knew — or should have known — came from someone who was misusing it.[33] Virtually the only protection afforded to anyone who traded on information coming from within the issuer was a situation where the recipient simply got lucky: a finder's keeper sort of holding.[34]

The SEC also responded. A few months after *Chiarella*, the Commission adopted a tender offer insider trading rule that essentially rejected the Supreme Court's predictability and notice intent and completely jettisoned any fiduciary duty requirement for a duty of abstention.[35] The Second Circuit, sitting en banc, was the first court to review and accept the validity of Rule 14e-3(a).[36] The Commission's primary justification of the rule was that it was promulgated under section 14(e) of the Exchange Act, not section 10(b).[37] The Commission pointed to a small bit of legislative history to justify different treatment under a statutory grant of authority that had otherwise universally been construed as in *pari materia* with the provision the Supreme Court construed.[38] The lower courts have consistently upheld Rule 14e-3 against challenge.[39]

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[32]SEC v. Lund, 570 F. Supp. 1397, 1403 (C.D. Cal. 1983). *Lund* was modified slightly in SEC v. Ingram, 694 F. Supp. 1437, 1440 (C.D. Cal. 1988), which is still an expansionist decision.

[33]*See, e.g.*, SEC v. Musella, 678 F. Supp. 1060 (S.D.N.Y. 1988) (finding that remote tippees who did not know the tipper nor the first-tier tippees engaged in insider trading).

[34]*See, e.g.*, SEC v. Switzer, 590 F. Supp. 756 (W.D. Okla. 1984) (acting on inside information that was inadvertently overheard at a track meet does not violate Rule 10b-5).

[35]*See* 17 C.F.R. § 240.14e-3 (1995) (regulating transactions in securities on the basis of material, nonpublic information in the context of tender offers).

[36]*See* United States v. Chestman, 947 F.2d 551 (2d Cir. 1991) (en banc), *cert. denied*, 503 U.S. 1004 (1992).

[37]*Id.* at 558-60.

[38]*Id.* at 559.

[39]The Second Circuit's decision in *Chestman* is the most important in this line of cases.

But the most important form of dynamic interpretation of *Chiarella* has occurred in the rise of the so-called misappropriation theory of liability.[40] Shortly after *Chiarella*, the Second Circuit decided *United States v. Newman*,[41] a case involving a trading ring of investment bankers and their associates. In many instances, the profitable trading occurred in stocks where the banker's client was the acquiring corporation of merger and takeover targets.[42] The primary insider trading situation was covered by neither: (1) the newly-reformulated abstain or disclose rule because of the lack of a fiduciary nexus running to marketplace traders, nor (2) Rule 14e-3 because of the lack of a tender offer or because the activity predated the rule. The theory that prosecutors pursued was one that had been previously raised before the Supreme Court, but which the Court refused to consider solely because of concerns about timeliness.[43] The prosecution proposed that a person who is entrusted with material nonpublic information by an employer or other principal defrauds that source if he or she secretly misappropriates it for personal gain by trading in the securities markets.[44] The *Newman* court accepted the viability of this new theory of liability.[45] Until 1995, the *Newman*'s court endorsement of the misappropriation theory was followed by every court of appeals that had considered the question.[46]

See also SEC v. Peters, 978 F.2d 1162, 1167 (10th Cir. 1992) (upholding the validity of the rule based on its design to prevent fraudulent trading on insider information in the tender offer context).

[40]There is substantial literature on the misappropriation theory. *See generally* DONALD C. LANGEVOORT, INSIDER TRADING: REGULATION, ENFORCEMENT AND PREVENTION, ch. 6 (1991); Barbara Bader Aldave, *The Misappropriation Theory:* Carpenter *and its Aftermath*, 49 OHIO ST. L.J. 373 (1988); Steven R. Salbu, *The Misappropriation Theory of Insider Trading: A Legal, Economic, and Ethical Analysis*, 15 HARV. J.L. & PUB. POL'Y 223 (1992).

[41]664 F.2d 12 (2d Cir. 1981), *cert. denied*, 464 U.S. 863 (1983).

[42]*Id.* at 15-16.

[43]*See Chiarella*, 445 U.S. at 236-37. The concurring opinion by Justice Stevens expressed some sympathy for this theory. *See id.* at 237-38 (Stevens, J., concurring).

[44]*Newman*, 664 F.2d at 15-16.

[45]*Id.* at 16.

[46]*See* SEC v. Cherif, 933 F.2d 403 (7th Cir. 1991) (adopting and applying the misappropriation theory in a case where a former employee forged a letter granting him continued access to confidential property and information which he wrongfully appropriated and used in trading), *cert. denied*, 502 U.S. 1071 (1992); SEC v. Clark, 915 F.2d 439 (9th Cir. 1990) (adopting the misappropriation theory in a "garden-variety" case where an officer of a corporation purchased stock in a company he knew his company was planning to purchase); *cf.* Rothberg v. Rosenbloom, 771 F.2d 818 (3d Cir. 1985) (indirectly endorsing the misappropriation theory). On the other hand, the Supreme Court, by an equally divided Court, affirmed the Second Circuit's extension of the misappropriation theory in a case involving a reporter for the *Wall Street Journal*. United States v. Carpenter, 484 U.S. 19 (1987), *aff'g* 791 F.2d 1024 (2d Cir. 1986). The Court's indecision (not articulated in the opinion because of

The expansion offered by the misappropriation theory was immense. The required fiduciary linkage between buyer and seller on which the *Chiarella* analysis was premised was broken. Thus, one did not have to trade in one's own company's stock (or be a tippee of an insider of the issuer) to violate Rule 10b-5. One only had to have received information from another and have used it in violation of an expectation of trust and confidence. Consistent with the pattern we have identified, the judicial and SEC decisions under the misappropriation theory have been quite liberal. The courts, for example, have indicated that misappropriation occurs when one trades while in possession of information belonging to another. It is not necessary for prosecutors to show that the information was the reason for trading, lest too many traders profit from disingenuous excuses.[47] Materiality has been construed differently, and probably more broadly, than under the *Chiarella* approach.[48] Not only investment bankers but lawyers,[49] reporters,[50] government officials,[51] psychiatrists,[52] friends, and family members[53] have all fallen within its coverage.[54] Most importantly,

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the split vote) could have been based on doubts about the theory per se, or its application to the particular problem of journalists.

[47]*See* United States v. Teicher, 987 F.2d 112, 120-21 (2d Cir. 1993) (rejecting the argument that "a violation of Rule 10b-5 requires an actual causal connection between the misappropriated information and the trading"). Following this, the SEC has brought a number of proceedings where there was a plausible claim that the defendant would have traded anyway, regardless of the inside information. *E.g.*, SEC v. Baker, Litig. Rel. 13850 (S.D.N.Y. Oct. 27, 1993), 55 SEC Docket 958-59 (1993) (alleging that although the defendant planned to sell certain stock for six months, he violated insider trading laws by timing the sale based on confidential inside information).

[48]*See, e.g.*, United States v. Elliott, 711 F. Supp. 425, 432-33 (N.D. Ill. 1989) (adopting the view that the materiality standard from typical Rule 10b-5 cases does not apply in misappropriation cases).

[49]*See id.* at 433.

[50]United States v. Carpenter, 791 F.2d 1024 (2d Cir. 1986), *aff'd*, 484 U.S. 19 (1987).

[51]*E.g.*, SEC v. Acree, No. 92-0862, 1992 WL 427369 (D.D.C. Nov. 10, 1992) (consent by a former office of the Comptroller of the Currency official).

[52]SEC v. Willis, 737 F. Supp. 269 (S.D.N.Y. 1990).

[53]*Compare Chestman*, 947 F.2d at 568 (kinship does not establish a per se fiduciary relationship) *with* SEC v. Reed, 601 F. Supp. 685, 715-18 (S.D.N.Y.) (may prove the existence of a confidential relationship between father and son on the facts of the case), *rev'd*, 773 F.2d 477 (2d Cir. 1985). After *Chestman*, the SEC has regularly invoked the misappropriation theory in comparable circumstances, reading the Second Circuit's decision largely as a pleadings and proof matter. *See, e.g.*, SEC v. Saul, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,088 (N.D. Ill. July 10, 1991) (denying defendants' motion for summary judgment based on circumstantial evidence of insider trading).

[54]*See generally* Thomas W. Briggs, *Insider Trading and the Prospective Investor After the* Chestman *Decision*, 20 SEC. REG. L.J. 296 (1992) (discussing four available theories that courts may apply against an investor in an insider trading case following *Chestman*).

perhaps, the standards for tipper-tippee liability enunciated in *Dirks* have been relaxed considerably for purposes of the misappropriation theory. According to some courts, it is not necessary to show that the tipper intended to benefit personally by tipping.[55] The Second Circuit has gone so far as to suggest that it may not be necessary for the tipper to be aware that securities trading will result from passing on the information.[56]

In fact, the misappropriation theory has all but preempted the abstain or disclose standard restrained in *Chiarella* and *Dirks*. It takes but a little thought to notice that there are virtually no abstain or disclose cases that cannot also be brought as misappropriation cases. To this extent, *Chiarella* and *Dirks* have been rendered far less significant than once thought.

To be sure, this evolution in the lower courts does not directly reject the teachings of the Supreme Court. The Court itself explicitly left open the misappropriation theory (and at least one Justice expressed some support for it),[57] creating an obvious invitation for its development. But, in this area, it is difficult to detect any explicit attempt at fidelity to the Court's emphasis on notice and predictability as justification for restriction. With one exception, the closely divided en banc decision of the Second Circuit in *United States v. Chestman*,[58] lower courts have restored an analytical structure that emphasizes the way the information is obtained and used rather than any disclosure obligation based on pre-existing relationships. That, as the case law shows us, is quite a murky standard.

Why have the lower courts engaged in such a significant post-*Chiarella* reconstruction of the law of insider trading? There are two reasons, combining in their explanatory power. One reason is that *Chiarella* and *Dirks* are simply not very persuasive. They rely on forced views of the common law antecedents of disclosure obligations under the law of fraud. Despite the emphasis on notice and predictability, the tests adopted in these cases were far more fuzzy and subjective in application

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[55]*See* 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.), *cert. denied*, 498 U.S. 816 (1990). *See generally* Donald C. Langevoort, *The Demise of* Dirks: *Shifting Standards for Tipper-Tippee Liability*, INSIGHTS, June 1994, at 23 (arguing that the demise of *Dirks* and the misappropriation theory of liability provides an opportunity for needed statutory reform). This issue is left unclear in the most recent court of appeals decision on the subject, SEC v. Maio, 51 F.3d 623 (7th Cir. 1995).

[56]*See* United States v. Libera, 989 F.2d 596, 600 (2d Cir.), *cert. denied*, 114 S. Ct. 467 (1993).

[57]*Chiarella*, 445 U.S. at 238 (Stevens, J., concurring).

[58]947 F.2d 551 (2d Cir. 1991), *cert. denied*, 503 U.S. 1004 (1992).

than the Court promised in its opinions. Precisely who owes a fiduciary duty to the issuer or its shareholders, or who is passing on information for personal benefit to another, are highly indeterminate and legalistic questions, especially from the standpoint of one possessing inside information and wanting to tip or trade.[59] It is understandable that courts lose faith in the promised objectivity of the Court's standards.

The other issue central to my hypothesis is that *Chiarella* and *Dirks* broke an equilibrium that the federal and state judiciary had come to accept concerning the affirmative duty to disclose in business transactions. The Court had tried to move the law backwards, toward *caveat emptor*. The most notable aspect of the misappropriation theory is its affinity to the idea that people may not profit from secret information that cannot be said to be their's and to which they have no rightful claim. By embracing the misappropriation theory, the equilibrium was essentially restored.

Since the adoption of the misappropriation theory in *Newman* and its progeny, there have been two successive landmarks in its intellectual history. One is its attempted restatement and defense by Judge Winter in an often-cited concurring opinion in the *Chestman* case.[60] In scholarly detail, Judge Winter traced the history of insider trading regulation under Rule 10b-5 through the adoption of the misappropriation theory.[61] Borrowing heavily from the writings of his judicial colleague (professor, at the time of the writings) Frank Easterbrook,[62] Winter justified insider trading liability as a means of protecting business property.[63] Allowing trading threatens that property interest because trading can draw public attention to the issuer and thus foil its desire for confidentiality.[64] Winter reasoned that the misappropriation theory is well-fitted to this property protection goal.[65]

There are two problems with Winter's analysis. One is its forced view of the history of insider trading law. Nowhere in Winter's

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[59]The *Dirks* standard, for example, includes reputational and gift-giving feelings as proscribed forms of personal benefit. This is hardly easy to predict from the standpoint of the tippee. Indeed, the SEC has pursued cases against investment analysts, the precise group the *Dirks* Court wanted to protect. *See* LANGEVOORT, *supra* note 40, § 11.02 (discussing the unique issues involving investment analysts and insider trading liability).

[60]*See Chestman*, 947 F.2d at 575-78 (Winter, J., concurring).

[61]*See id.*

[62]*See* Frank H. Easterbrook, *Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information*, 1981 SUP. CT. REV. 309.

[63]*Chestman*, 947 F.2d at 576-78 (Winter, J., concurring).

[64]*Id.*

[65]*Id.* at 578.

justification is there any explanation for why uninformed traders should be seen as the victims of a fraud. The *source* is the victim. Yet one cannot read the case law from *Cady, Roberts* through *Chiarella* without seeing that the dominating concern was in neutralizing the insider's informational advantage vis-à-vis the person on the other end of the trade. Under prevailing law, recovery in both private actions (via subsequent distributions) and SEC disgorgement proceedings goes to those other traders, not the source of the information.[66] The business property rationale may be a plausible normative justification to those otherwise unpersuaded by the fairness rationale for insider trading liability,[67] but it is a descriptive misfit.

The other troubling feature about the property theory was recognized, but dismissed, by Judge Winter. In one sense, insider trading is a federalism concern, but, historically, the protection of corporate property and confidentiality has been the province of state law. The securities laws are disclosure-forcing, not secret-protecting.[68] In noting this, Winter put his finger on one of the two intellectual soft spots of the misappropriation theory. How is it that the protection of a property interest — especially when it takes the form of such interests as journalistic reputation or the sanctity of physician-patient or husband-wife conversations — falls within the zone of interests protected by the federal securities laws?[69] Winter's brief response was simply that the law was too far "down this road" for this concern to persist.[70]

Perhaps so for Judge Winter. But that concern was enough to drive the third watershed event in the history of the misappropriation theory, its outright rejection in the summer of 1995 by the Fourth Circuit

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[66]Pursuant to § 20A of the Securities Exchange Act of 1934, contemporaneous traders may recover and share the insider's profits unless the SEC has already obtained disgorgement. 15 U.S.C. § 78t-1(b)(1), (2) (1994). *See generally* Rory C. Flynn, *SEC Distribution Plans in Insider Trading Cases*, 48 BUS. LAW. 107, 120-27 (1992) (summarizing the distribution of disgorgement funds among investors). When the SEC obtains disgorgement, it regularly distributes it to "injured" traders. *Id.* at 122-23.

[67]*See generally* Jonathan R. Macey, *From Fairness to Contract: The New Direction of the Rules Against Insider Trading*, 13 HOFSTRA L. REV. 9 (1984) (discussing the theoretical underpinnings of the property rights analysis involving insider trading).

[68]*See Chestman*, 947 F.2d at 572-78 (Winter, J., concurring).

[69]This insight was by no means original to Judge Winter, having been made soon after the misappropriation theory first surfaced. *See* Langevoort, *supra* note 18, at 46-48. The courts have been quite explicit in requiring injury (or threatened injury) to the source of the information but then accepting non-securities related harms as sufficient. *See* LANGEVOORT, *supra* note 40, § 6.05.

[70]*Chestman*, 947 F.2d at 578.

in *United States v. Bryan*[71] for precisely the reasons identified (but dismissed) by Judge Winter. *Bryan* involved a criminal prosecution of a former director of the West Virginia lottery, who bought stock in a company that manufactures video lottery gaming equipment based on knowledge that the state would be expanding into the video lottery business.[72] The court affirmed his conviction on mail and wire fraud grounds, closely following the analysis of the Supreme Court in *United States v. Carpenter*, but reversed the conviction based on violations of Rule 10b-5 under the misappropriation theory.[73] Though holding specifically that the misappropriation theory was not viable in the context of this particular case, since neither the official nor the state were engaged in investment-related activity, the court's attack on the theory generally was truly vehement and pervasive.[74]

In its effort to restore notice and predictability to the law of insider trading — an explicit return to *Chiarella*'s original intent — the *Bryan* court honed in on two analytical weaknesses in the misappropriation theory. One involved deception.[75] The Supreme Court has held that Rule 10b-5 deals with deception, not simple breaches of fiduciary duty.[76] Yet the deception identified in *Newman* and its successors is little more than secret faithlessness to the trust expected by the source of the information. That does seem very close to conjoining deception and fiduciary breach.

The other is Judge Winter's point. The *Bryan* court opined that basing a criminal conviction on the misappropriation of government information by a state official makes little sense within the confines of Rule 10b-5.[77] The absence of an interest of the sort protected by the securities laws in the relationship between Bryan and the State of West Virginia makes it improper to extend the reach of the Rule that far.[78] For this rule of restriction, the court cited the *Central Bank* decision,[79] to which we shall turn shortly.

The points made by the court in *Bryan* are powerful ones, though they are not without rejoinders.[80] As to deception, the distinction

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[71]58 F.3d 933, 949-50 (4th Cir. 1995).

[72]*Id.* at 936-39.

[73]*Id.* at 961.

[74]The Fourth Circuit followed its *Bryan* decision in a subsequent companion case, United States v. ReBrook, 58 F.3d 961 (4th Cir. 1995).

[75]*Bryan*, 58 F.3d at 944.

[76]*See* Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 473 (1977).

[77]*Bryan*, 58 F.3d at 944.

[78]*Id.* at 952.

[79]*Id.* at 945.

[80]Aside from its basic points (each of which have some merit), the *Bryan* opinion

between fiduciary breaches and *secret* fiduciary breaches has elsewhere been accepted.[81] Deception is often non-verbal;[82] by its terms, Rule 10b-5 prohibits much more than spoken or written misstatements and omissions. More importantly, the long history of treating such breaches as fraud under the mail and wire fraud statutes suggests that, on this point alone, a stable theory of deception arising from misappropriation can be articulated and justified.

As to the "zone of interests" point, which the court considered a "fundamental limitation,"[83] there is congressional recognition of the misappropriation theory in the Insider Trading and Securities Fraud Enforcement Act of 1988.[84] Various provisions of that legislation and its history indicate that Congress considered the misappropriation of inside information to be included within the "zone of interests" of the federal securities laws.[85] One example is the creation of section 20A of the

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plainly overreaches in numerous places. *See infra* note 89. Perhaps the least persuasive aspect of the opinion is its recounting of the supposedly "harrowing" history of the theory's use in the Second Circuit. *Bryan*, 58 F.3d at 953. In particular, the court misreads (or twists beyond recognition) the holding in Moss v. Morgan Stanley Inc., 553 F. Supp. 1347 (S.D.N.Y.), *aff'd*, 719 F.2d 5 (2d Cir. 1983), *cert. denied*, 465 U.S. 1025 (1984). Fairly read, *Newman* established that the fraud in a misappropriation is the implicit deception of the source. It is not a case of disclosure except in the sense that had the defendant disclosed to the source, there would have been no deception; the fraud would not have been a secret. Having established this, the "in connection with" requirement is satisfied by the defendant's trading. *Moss* then extends this logically: in a case based on misappropriation, other marketplace traders have no standing to sue. Any word-choice tensions among the decisions are highly inconsequential. Similarly, the *Chestman* decision can hardly be read as a questioning or rejection of the misappropriation theory; to the contrary, it is a pruning of it to keep it manageable and functional. Contrary to *Bryan*'s suggestion, *Chestman* shows that the courts are inclined to assure that the misappropriation theory is not excessively indeterminate and open-ended.

[81]*E.g.*, Goldberg v. Meridor, 567 F.2d 209 (2d Cir. 1977), *cert. denied*, 434 U.S. 1069 (1978). *See generally* Ralph C. Ferrara & Marc I. Steinberg, *A Reappraisal of* Santa Fe: *Rule 10b-5 and the New Federalism*, 129 U. PA. L. REV. 263 (1980) (examining *Santa Fe* and its progeny from a federalist perspective).

[82]*See* VII LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 3525-28 (3d ed. 1990).

[83]*Bryan*, 58 F.3d at 959. In fact, a reading of the court's opinion suggests that its concern about the presence of deception was really part and parcel of the broader "zone of interests" point. *See id.* at 945-46.

[84]Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, 102 Stat. 4677 (codified as amended in scattered sections of 15 U.S.C.).

[85]See H.R. REP. NO. 910, 100th Cong., 2d Sess. 7-14 (1988), *reprinted in* 1988 U.S.C.C.A.N. 6043-6048, for the congressional discussion regarding the need to improve procedural and remedial methods for the prevention of insider trading. The Energy and Commerce Committee commented favorably on the misappropriation theory and stated that the misappropriation of information is the "type of security fraud [that] should be encompassed within Section 10(b) and Rule 10b-5." *Id.* at 10, *reprinted in* 1988 U.S.C.C.A.N. at 6047. *See*

Exchange Act[86] which effectively overruled the restrictive remedial aspect of one misappropriation case, *Moss v. Morgan Stanley Inc.*[87] Although Congress stated that it did not intend to address the substantive law of insider trading, the 1988 legislation, and its precursor in 1984,[88] stand as recognition that prohibiting the misappropriation of inside information is consistent with, and perhaps even essential to, the remedial goals of insider trading regulation.[89] Additionally, it is nonsense to suggest that state law interests are seriously implicated or state law remedies suffice in cases such as these.[90] The only system for the monitoring of stock market trading and the detection of insider trading exists as a matter of federal securities regulation.

What path will the law take now that *Bryan* has taken aim at the misappropriation theory? That is hard to predict, especially since the matter seems particularly ripe for Supreme Court review now that there is a distinct conflict in the circuits on a high visibility issue. One might say that the Court's hostility to expansive readings of the securities laws over the past few years bodes ill for the misappropriation theory,[91] but we should remember that this hostility has been directed largely at potentially abusive private actions. My theory suggests that courts addressing the issue will tend toward the jurisprudential equilibrium, which I still believe

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generally LANGEVOORT, *supra* note 40, § 6.02, at 6-7 to 6-8 (discussing the congressional responses to the misappropriation theory).

[86]Securities Exchange Act of 1934, 15 U.S.C. § 78t-1(a) (1994). Section 78t-1(a) gives standing to contemporaneous traders to recover for all forms of insider trading. 15 U.S.C. § 78t-1(a).

[87]719 F.2d 5 (2d Cir. 1983), *cert. denied*, 465 U.S. 1025 (1984). In *Moss*, the court held that absent a relationship of trust and confidence between two parties, one party cannot sue the other for insider trading violations. *Id.* at 12-15.

[88]Insider Trading Sanctions Act of 1984, Pub. L. No. 98-376, 98 Stat. 1264 (codified as amended in scattered sections of 15 U.S.C.).

[89]*See Clark*, 915 F.2d at 453; *Carpenter*, 791 F.2d at 1030-31. The *Bryan* court cited the Supreme Court's recent *Central Bank* decision, discussed *infra*, for the proposition that narrow textualist interpretation of § 10(b) is appropriate in a case like this involving a scope question, suggesting perhaps that reliance on legislative history, etc., would thus not be appropriate. *See Bryan*, 58 F.3d at 945. That is surely wrong. In *Central Bank*, the Court made clear that scope questions such as "who" can be liable, as opposed to what constitutes a violation, require textualist treatment. *Central Bank*, 114 S. Ct. at 1146-50. Whatever one thinks of the distinction, the question of whether misappropriation is a fraud within the meaning of § 10(b) is not a scope question.

[90]In contrast to *Santa Fe*, there is no serious reason to suspect that federalization of fiduciary duties with respect to stock market trading would somehow clash with a well-developed body of state law. In this sense, the federalism concern here differs considerably from that raised by the mismanagement cases.

[91]*See* Susan Jenkins, *Lawyers Debate Future of Misappropriation Theory After* Bryan, 27 Sec. Reg. & L. Rep. (BNA) 1331-32 (1995).

is toward barring the exploitation of misappropriated information. Whether the Supreme Court addresses the question or leaves it to the lower courts to work out on their own, I would guess (and hope) that the misappropriation theory will be left standing in some form or another.[92]

There are three routes to travel in this direction. One, of course, is simply to side with *Newman*, emphasizing the points that the *Bryan* court gave inadequate attention. We should remember that the law of insider trading began with the courts simply ignoring serious conceptual questions about how and why open-market insider trading is fraudulent, rather than merely abusive. With all the *Bryan* court's stated concern about the open-endedness of the misappropriation theory, one can find few if any cases where the trader was not fully aware that they were using the information wrongfully, violating another's expectation of confidentiality. Additionally, striking down the theory would leave a large gap in the enforcement arsenal.[93]

Another route is compromise.[94] Though *Bryan*'s dicta is strong, its specific holding is narrower: the misappropriation approach is only invalid when we cannot identify some securities-related interest in the relationship between source and trader.[95] The court suggests at some points that the victim must be a purchaser or seller, but at other times employs some broader approach.[96] Were this zone of interests approach to be followed, the scope of the misappropriation would be narrowed but perhaps not excessively (at least if there is no absolute requirement that the victim be a trader). One could, for example, claim sufficient connection in cases involving business executives, controlling persons and families, investment bankers, and the financial press — each of whom

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[92]Because the Supreme Court considers the issue just once, there is no reason to be as confident in the equilibrium hypothesis as one would be with respect to a larger universe of opportunities to address the question. Still — like the concept of "reversion to mean" — it is probably mildly useful in probabilistic terms.

[93]*See* Jenkins, *supra* note 91, at 1331. Perhaps disingenuously, the *Bryan* court and some commentators have suggested that the loss of the misappropriation theory would be trivial. Quite to the contrary, there are numerous "core" insider trading cases, including those involving trading in junk bonds, trading by investment bankers in advance of merger transactions on information received from the bidder, trading by government officials, that would seemingly be lost without it. Such matters as the *Business Week* and *Wall Street Journal* "Heard on the Street" scandal depended on it as well. Nor is there any reason to expect that state law remedies would suffice. The detection of insider trading is difficult, accomplished successfully only by the computerized monitoring systems established by the self-regulatory organizations under the supervision of the SEC.

[94]In my writings, I have for some time considered this a point of possible compromise. *See* LANGEVOORT, *supra* note 40, § 6.05[3].

[95]*Bryan*, 58 F.3d at 959.

[96]*Id.* at 947-49.

plays an important role in the financial markets, implicating its integrity in the general enterprise of securities regulation. If this route were followed, I suspect that we would see a gradual expansion of the concept of investment-related activity, back again toward equilibrium.

The third possibility is my preference. In his dissenting opinion in *Chiarella*, Chief Justice Burger articulated a very different misappropriation theory, which the Court also left open because it had not been charged to the jury.[97] In his view, there should be a duty to disclose misappropriated information *to other marketplace traders*.[98] Although the former Chief Justice is often miscited as the author of the current misappropriation theory,[99] his test was deliberately not pursued in *Newman*. It was considered too confusing to present to the jury in tandem with the fraud on the source theory and quickly faded from legal attention after the conventional misappropriation theory became firmly established. But I suspect that this theory quite accurately captures the equilibrium more than anything else. Misappropriation is a fraud on other traders, keeping it legitimately within the zone normally associated with Rule 10b-5. We impose the duty to disclose for precisely the same reason that the common law has been moving in the same direction for nearly a century; people have no right to profit from information that they have stolen from others.

Moving in this direction requires some revisionism, but there is ample cover. The most compelling is the express private right of action for marketplace traders who are victims of insider trading, created by Congress to overrule a decision that precluded such recovery in misappropriation cases.[100] That is, for all intents and purposes, an implicit legislative codification of Chief Justice Burger's approach.[101]

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[97]*Chiarella*, 445 U.S. at 240 (Burger, C.J., dissenting).

[98]*Id.*

[99]Justice Stevens' concurring opinion is the true source of the conventional misappropriation theory. *Id.* at 237-38. The Burger approach surfaced briefly in the Second Circuit's *Carpenter* decision. *See Carpenter*, 791 F.2d at 1034 (suggesting a duty to disclose to the market). However, it was inconsistent with the basic holding of that Circuit in an earlier case. *See Moss*, 719 F.2d at 16 (adopting the Supreme Court's reasoning in *Chiarella* that a duty to disclose under § 10(b) does not arise from the mere possession of nonpublic market information).

[100]*See supra* note 86 and accompanying text.

[101]*See* LANGEVOORT, *supra* note 40, § 9.03[1] (addressing marketplace traders' rights to recover under the misappropriation theory and indicating that § 20A codifies Justice Burger's dissent in *Chiarella*); Lawrence E. Mitchell, *The Jurisprudence of the Misappropriation Theory and the New Insider Trading Legislation: From Fairness to Efficiency and Back*, 52 ALB. L. REV. 775, 777-78 (1988) (discussing the Insider Trading and Securities Fraud Enforcement Act of 1988).

There is also dicta in *Dirks* to seize upon.[102] And functionally, one can distinguish *Chiarella* as a case where the Court's primary concern was in eliminating a parity of information (or pure fairness) approach to insider trading liability. Requiring a breach of fiduciary duty, as the misappropriation theory does, eliminates all but the most hypersensitive concern that the rule would operate to chill legitimate investment activity; it requires a meaningful finding of independent wrongdoing, and the courts have not been thoughtless in supervising and applying it.[103]

All this assumes, of course, that there has not been a political shift toward greater tolerance of insider trading. There is no doubt that the judicial expansionism of the 1980s was abetted by the high political visibility of the Boesky and related scandals, which have now mostly faded. But I see little evidence of a sea change. The politics of private litigation under the securities laws has little connection to insider trading, where private actions are largely surplusage. Intellectually, the law and economics movement that seriously questioned insider trading regulation in the late 1960s through the early 80s,[104] which plainly affected the *Chiarella* and *Dirks* Courts, has shifted so that the propriety of some stringent form of insider trading regulation is widely accepted even among very conservative thinkers.[105] There is far less support for a broad freedom to trade. The economics-oriented theorists still tend to justify

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[102]For whatever reasons, the Court in *Dirks* took the time to note that Dirks did not "misappropriate or illegally obtain" the information. *Dirks*, 463 U.S. at 665. *See also* Bateman Eichler, Hill Richards, Inc. v. Berner, 472 U.S. 299, 313 nn.22-23 (1985) (citing the *Dirks* dicta and portions of the legislative history of the Insider Trading Sanctions Act of 1984 that expressed Congress' support of the misappropriation theory).

[103]The *Bryan* court's hypersensitivity goes overboard when it notes with concern — without quite explaining why — that the misappropriation theory is not logically limited to breaches of fiduciary duty and might be expanded to cover the straightforward theft of information. *See Bryan*, 58 F.3d at 944-45. This is quite true, see LANGEVOORT, *supra* note 40, § 6.08, but hardly cause for alarm.

[104]*See generally* HENRY G. MANNE, INSIDER TRADING AND THE STOCK MARKET (1966) (defending insider trading and questioning the effectiveness of rules against it); Michael P. Dooley, *Enforcement of Insider Trading Restrictions*, 66 VA. L. REV. 1, 55 (1980) (noting that, despite arguments to the contrary, insider trading does little actual harm to investors).

[105]*See generally* ROBERT CHARLES CLARK, CORPORATE LAW 274-75 (1986) (suggesting that insider trading will increase the price of capital and ultimately will chill and reduce participation in the stock market); James D. Cox, *Insider Trading and Contracting: A Critical Response to the "Chicago School,"* 1986 DUKE L.J. 628, 642-59 (examining arguments against insider trading regulations and dismissing each of them); Easterbrook, *supra* note 62, at 309-39 (presenting a series of arguments, mostly economic, for and against insider trading); Saul Levmore, *Securities and Secrets: Insider Trading and the Law of Contracts*, 68 VA. L. REV. 117 (1982) (applying the roles of silence and disclosure in contract law to an assessment of fairness and efficiency in securities regulation); Macey, *supra* note 67, at 60-61 (discussing the Insider Trading Sanctions Act of 1984).

regulation in property-based terms, as Judge Winter's concurrence shows.[106] Yet rigorously argued fairness based theories are also reascendent.[107] Behavioral economists are producing an impressive body of evidence to support the intuition on which *Cady, Roberts* and *Texas Gulf Sulphur* were based — that perceptions of fair dealing do have a distinct effect on the willingness of people to engage in forms of economic activity like investment.[108] No matter what one's ideological bent, punishing the "information thief" should be an appealing goal. The equilibrium thus becomes more attractive than ever, not less.

II. *CENTRAL BANK* AND SECONDARY LIABILITY

Until 1994, liability under Rule 10b-5 was firmly supplemented by a set of theories of secondary liability that gave fairly broad scope to the question of who is liable for fraud in connection with the purchase or sale of a security. Most important was the doctrine of aiding and abetting which created joint and several responsibility for persons who intentionally gave substantial assistance to another in the commission of securities fraud.[109] Courts disagreed as to what constituted aiding and abetting. For instance, could inaction or providing basic professional services be substantial assistance? Was reckless disregard sufficient to satisfy the intent requirement? Despite these uncertainties, there was uniform agreement that under the right circumstances liability would follow in either a private right of action or an SEC enforcement proceeding. Hundreds of lower court cases, over three decades, fell along this line.

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[105]See *supra* text accompanying notes 60-70 for a critical discussion of Judge Winter's concurrence.

[107]*See, e.g.*, Kim Lane Schepple, *"It's Just Not Right": The Ethics of Insider Trading*, LAW & CONTEMP. PROBS., Summer 1993, at 123.

[108]*See, e.g.*, George Leowenstein et al., *Self-Serving Assessments of Fairness and Pre-Trial Bargaining*, 22 J. LEGAL STUD. 135 (1993) (examining the effect of fairness in the settlement process). *See also* Matthew Rabin, *Incorporating Fairness Into Game Theory and Economics*, 83 AM. ECON. REV. 1281 (1993) (examining different aspects of fairness in economic bargaining).

[109]*See generally* IX LOSS & SELIGMAN, *supra* note 18, at 4479-88 (summarizing liability in civil securities litigation for aiding and abetting); Alan R. Bromberg & Lewis D. Lowenfels, *Aiding and Abetting Securities Fraud: A Critical Examination*, 52 ALB. L. REV. 637 (1988) (examining the validity of aiding and abetting as a private right of action and the use of the theory in SEC and criminal proceedings); David S. Ruder, *Multiple Defendants in Securities Law Fraud Cases: Aiding and Abetting, Conspiracy, in* Pari Delicto, *Indemnification, and Contribution*, 120 U. PA. L. REV. 597 (1972) (discussing liability for aiding and abetting and for conspiracy).

Then came *Central Bank*.[110] The Supreme Court held that lower courts were all wrong; no private right of action exists for aiding and abetting.[111] The Court's reasoning was a mixture of textualist statutory interpretation and policy analysis — the former made quite awkward, as in all Rule 10b-5 cases, by the fact that there is no evidence that in 1934 Congress contemplated a private right of action under the Rule.[112] It is a judge-made invention, and references to legislative intent in 1933 and 1934 have a truly imaginary character (imagination that can reflect all sorts of ideological biases). In terms of interpretation, the Court stated that in determining the scope of section 10(b)'s grant of rulemaking authority — as opposed to saying what the section or Rule means — text-based literalism is the exclusive method of interpretation.[113] The failure of Congress to provide for liability for persons other than those who use or employ a manipulative or deceptive device or contrivance precludes the imposition of liability on such persons.[114] Other tools of statutory construction, such as resorting to legislative history, purpose, contemporaneous understandings, etc., are to be used only in determining the Rule's meaning once its scope has been delimited.[115] For good measure, however, the Court went on to show to its satisfaction that such tools would not change the outcome in any event.[116] Special emphasis was given to the possibility of litigation abuse inherent in a broad scope to private liability under Rule 10b-5.[117]

I find *Central Bank* remarkably similar to *Chiarella* in a number of respects. It operates as a significant and even more dramatic departure

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[110]114 S. Ct. 1439 (1994). For some of the major commentaries on *Central Bank*, see HAROLD S. BLOOMENTHAL ET AL., EMERGING TRENDS IN SECURITIES LAW § 1.01 (1994-95 ed.); Thomas O. Gorman, *Who's Afraid of 10b-5?: The Scope of a Section 10(b) Cause of Action After* Central Bank of Denver, 22 SEC. REG. L.J. 247 (1994); James D. Redwood, *Toward a More Enlightened Securities Jurisprudence in the Supreme Court?: Don't Bank on it Anytime Soon*, 32 HOUS. L. REV. 3 (1995); Steinberg, *supra* note 10; *Symposium on the Central Bank Decision: The Demise of Aiding and Abetting?*, 49 BUS. LAW. 1429 (1994) (including articles by well-known authorities Joel Seligman and David Ruder). See also the various views (including those of the author) expressed in *Abandonment of the Private Right of Action for Aiding and Abetting Securities Fraud/Staff Report on Private Securities Litigation*, Hearing Before the Subcommittee on Securities of the Senate Committee on Banking, Housing, and Urban Affairs, 103d Cong., 2d Sess. (S. Hrg. 103-759, May 12, 1994).

[111]*Central Bank*, 114 S. Ct. at 1455.

[112]*See* Steve Thel, *The Original Conception of Section 10(b) of the Securities Exchange Act*, 42 STAN. L. REV. 385, 432-33 n.209 (1990).

[113]*Central Bank*, 114 S. Ct. at 1447-48.

[114]*Id.* at 1448.

[115]*Id.*

[116]*See id.* at 1448-49.

[117]*Central Bank*, 114 S. Ct. at 1454.

from prior lower court precedent. Additionally, its reasoning lacks persuasive force in a number of respects. One can find ample cases in the history of the Supreme Court where standard tools of statutory construction have been employed on scope-type questions.[118] Moreover, it is far from clear that there is a meaningful distinction between the question of scope and the question of meaning. For instance, why are we not construing (albeit liberally) the words "use" or "employ" if we hold that those who provide substantial assistance to a fraud should be held liable? The decision also glosses over instances of congressional activity that seem more or less premised on the assumption of aiding and abetting liability under Rule 10b-5.[119]

More important from our perspective, however, is *Central Bank*'s dissonance. There was a rejection of a long and unbroken line of cases under Rule 10b-5 recognizing aiding and abetting. The equilibrium in the law generally has been steadily moving toward recognition that those who play a substantial role in a harm are subject to liability.[120] We see it in criminal law (a federal statute making aiding and abetting a federal law violation a crime),[121] as well as in the law of torts, agency, and trusts under state law. At the state and federal level, doctrines employing some form of participant liability have expanded, not contracted. It seems that, in general, judges are prepared to sanction those who consciously abet serious wrongdoing in legitimately prosecuted actions.[122]

If such an equilibrium exists, then we would predict that *Central Bank* may share the same fate as *Chiarella* — lower court revisionism that, while officially giving due respect to the Court's decision, quietly nudges the law back toward the status quo. I believe that this is indeed

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[118]*See* Alan R. Bromberg, *Aiding and Abetting: Sudden Death and Possible Resurrection*, 27 REV. SEC. & COMMODITIES REG. 133, 136 n.28 (1994); Steinberg, *supra* note 10, at 494-96.

[119]For instance, Congress' decision in 1984 and 1988 regarding treatment of aiding and abetting an insider trading violation. *See* LANGEVOORT, *supra* note 40, § 8.02[2][c].

[120]This is a "gatekeeper" construct commonly employed as a regulatory strategy. *See generally* Reinier H. Kraakman, *Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy*, 2 J.L. ECON. & ORG. 53, 53 (1986) (defining and discussing gatekeeper liability as "liability imposed on private parties who are able to disrupt misconduct by withholding their cooperation from wrongdoers").

[121]18 U.S.C. § 2 (1994) (providing that any person who aids, abets, or otherwise assists in the commission of a federal crime is punishable as a principal).

[122]The policy analysis in *Central Bank* itself seems directed largely at the potential for groundless actions. More moderate decisions taking the same view have tended to control this by tightening the pleading or substantive rules, rather than eliminating the theory altogether. This impulse is likely to continue: there clearly has been a political shift in the view of private litigation under the securities laws.

beginning to happen. Before we consider the roads that the lower courts may take, however, we must attend to a crucial difference between the two Supreme Court decisions. *Chiarella* quickly lost both its intellectual and political base as the insider trading scandals of the 1980s exploded. As we have seen, congressional legislation was far from complementary of the Court's decision and even the law and economics scholars began to line up in favor of prohibition. In contrast, *Central Bank* rode a wave of anti-private litigation attitudes that has not yet broken and is now being legitimized in legislation. Even before *Central Bank* was decided, the lower courts were pruning the standards for aiding and abetting liability.[123] A sea change of judicial sentiment of the sort that plainly did not occur in the law of insider trading is more plausibly present here.

But I would not be so sure. Concerns about speculative private litigation have long existed,[124] yet the impulse to impose liability when an actor does seem to have played a significant role in a fraud or other harm has remained a strong characteristic of the law generally. The lower courts have been quite sensitive to litigation abuse but have chosen to control it through heightened pleading requirements and other modifications rather than outright rejection. In fact, congressional litigation reform may offer a reason for some courts to stop feeling so much pressure to prune via the principal mechanism at their disposal, substantive doctrinal curtailment, and revert toward the prior equilibrium.

Assuming that reversion will occur, prediction becomes a matter of how. There are two doctrines that have substantial promise for expansion to balance the loss of aiding and abetting and related scope doctrines — primary liability and vicarious liability.

A. *Primary Liability*

Toward the end of Justice Kennedy's opinion, the Court made the obvious disclaimer; nothing in its decision was meant to define what the scope of primary liability is under Rule 10b-5.[125] That, presumably, would come later through more normal interpretive methodology. Referring to a law review article by Daniel Fischel,[126] on which it had

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[123]*See* Donald C. Langevoort, *Where Were the Lawyers? A Behavioral Inquiry into Lawyers' Responsibility for Clients' Fraud*, 46 VAND. L. REV. 75, 86-89 (1993) (discussing lawyer liability under an aiding and abetting theory).

[124]It was a significant feature, for example, of the Supreme Court's decision in Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 740 (1975).

[125]*Central Bank*, 114 S. Ct. at 1455.

[126]Daniel R. Fischel, *Secondary Liability Under Section 10(b) of the Securities Act of 1934*, 69 CAL. L. REV. 80 (1981).

relied earlier in the opinion, the Court did suggest that lawyers, accountants, and others usually treated as aiders and abetters could still be liable if their involvement was such that they could fairly be said to have directly *or indirectly* made or employed a manipulative device or contrivance.[127] The law review article offers the examples of an accountant certifying financial statements and a false opinion letter prepared by a lawyer to further an illegal securities scheme.[128]

As numerous commentators have pointed out, there is much elasticity in the concept of a primary violation, especially when one pauses over the word "indirectly" in both the rule and the underlying statutory authorization.[129] The interesting question is how much of traditional aiding and abetting could be restored by courts inclined to revert to equilibrium. There is no doubt that when a person prepares disclosure materials for investors under his or her own name and all the other requirements for liability are met, primary liability results. This is the Fischel standard.[130] The test emphasizes direct contact with investors in such a way that the alleged violator's involvement is public and hence something that separately can be relied upon by investors.[131] In fact, a fair number of aiding and abetting cases naturally fall into this category.[132]

There is little sense, however, in limiting fraud liability to those whose involvement is public and direct. The vast bulk of securities law makes clear that behind the scenes involvement in fraudulent *disclosure* (or actionable nondisclosure), as opposed to mere participation in the fraud, by no means absolves the participant from culpability.[133] The very nature of securities fraud often involves obscuring the source and interests of its authors. People can have a significant influence on how fraudulent disclosure is packaged, and hence how effective it is, without being identifiable to the victim. Nothing in any moderate reading of *Central Bank* precludes imposing liability on key participants.

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[127]*Central Bank*, 114 S. Ct. at 1455.

[128]*See* Fischel, *supra* note 126, at 110-11.

[129]*See supra* note 110 (citing authorities).

[130]*See* Fischel, *supra* note 126, at 102-03.

[131]*Id.*

[132]*See* Akin v. Q-L Inv. Inc., 959 F.2d 521, 526 (5th Cir. 1992); Arthur Young & Co. v. Reves, 937 F.2d 1310, 1332 (8th Cir. 1991). For a post-*Central Bank* example, see Kline v. First Western Gov't Sec., Inc., 24 F.3d 480, 486-88 (3d Cir.), *cert. denied*, 115 S. Ct. 613 (1994).

[133]This is inherent in the notion of "group pleading"—holding the management control group presumptively liable for corporate misstatements. *E.g.*, Wool v. Tandem Computers Inc., 818 F.2d 1433, 1440 (9th Cir. 1987). This form of pleading survives *Central Bank*. *See In re* Glenfed, Inc. Sec. Litig., 60 F.3d 591, 592-93 (9th Cir. 1995).

What, then, should the test be? One concept that is more an invitation to confusion than anything else, although one sees it in some of the few cases dealing with the primary-secondary distinction before *Central Bank*, is that of "duty." The aiding and abetting cases relied heavily on duty. It was used by many courts as a prerequisite to liability based on recklessness as opposed to actual intent, and for liability based on silence rather than affirmative assistance.[134] Sixth Circuit cases also used duty to describe the line between primary and secondary liability.[135] Under Rule 10b-5 generally, however, a duty is typically presumed in cases involving affirmative misrepresentations or half-truths;[136] in other words, the actor is expected to use the requisite degree of care regardless of any pre-existing relationship between the parties so long as the activity is reasonably calculated to affect investors. In this sense, duty blends indistinguishably into the "in connection with" inquiry. Duty's true impact in federal securities law is really only in silence cases, as we saw under the law of insider trading. In fact, reading the Sixth Circuit cases shows that the courts saw duty in the broad "in connection with" (and hence not all that helpful) context.[137] The risk, unfortunately, is that some courts will approach duty in its more usual sense — that of a *pre-existing* relationship — and restrict primary liability to those situations where investors had some reason to expect the particular defendant to act properly toward them because of this relationship. There were, in fact, a number of aiding and abetting cases that seemingly used duty in this much narrower fashion.[138]

If duty is not particularly helpful, we should turn to other possibilities. In a recent article, Thomas Riesenberg has suggested limiting primary liability to those who actually make the misstatement (presumably the publicly identified source) and those who act as that source's "agent or spokesperson."[139] This test borrows from the law

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[134]*See, e.g.*, Abell v. Potomac Ins. Co., 858 F.2d 1104 (5th Cir. 1988).

[135]*E.g.*, Molecular Tech. Corp. v. Valentine, 925 F.2d 910, 917 (6th Cir. 1991) (violating a duty to disclose, either by failing to provide information or revealing information in a misleading way, will result in primary liability); *cf.* SEC v. Washington County Util. Dist., 676 F.2d 218, 223 (6th Cir. 1982) (lacking knowledge of information being furnished will result in no duty and, thus, no primary liability).

[136]*See* Deutschman v. Beneficial Corp., 841 F.2d 502, 506 (3d Cir. 1988). Duty as a construct in fraud cases has its source in the controversy of negligent misrepresentation (i.e., by creating a duty of care), something of less significance with respect to intentional frauds.

[137]*See supra* note 135.

[138]One example is Abell v. Potomac Ins. Co., 858 F.2d 1104 (5th Cir. 1988), in which the court held that lawyers who drafted a false disclosure statement were not liable as aiders and abetters because of lack of either duty or "high conscious intent." *Id.* at 1126.

[139]Thomas L. Riesenberg, *Fraud Claims Against Professionals After* Central Bank,

under section 12 of the Securities Act and essentially looks to whether the defendant was so closely associated with the source, and with a financial incentive aligned with the source, that some alter-ego characterization is appropriate. Though perhaps slightly broader than the Fischel standard, this test also rests heavily on public perception. It gives too little weight to significant behind the scenes involvement.

Consistent with my prediction, a much broader approach has begun to appear in some of the cases. The Ninth Circuit has suggested that primary liability can be imposed on those who have a significant role in drafting fraudulent disclosure materials, although the holding is muddied by the fact that the accountant defendants had a fairly visible association with those materials and were, in one instance, directly identified as a source.[140] A district court in California has gone a step further, suggesting that simple involvement or participation in fraudulent disclosure is enough for liability.[141] Some other courts have been less expansive.[142]

If applied broadly, these holdings allow for substantial revisionism. Refined properly, they also make a good deal of sense. Consider a lawyer whose client wants to make a questionable disclosure. The client prepares the first draft. The lawyer then reviews the draft and makes some suggestions that refine the disclosure, still misleading but less likely to draw regulatory attention. Other than solicitousness for the legal profession, there is little justification for absolving the lawyer from responsibility. He or she had an important causal role in the deception itself. Professionals such as lawyers and accountants are frequently influential in the way the disclosure goes out. Whether their role is

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INSIGHTS, Feb. 1995, at 9, 14. With all due respect, Mr. Riesenberg's role as counsel for Ernst & Young, a likely target of many primary liability claims, creates an obvious desire to have the standard be applied narrowly.

[140] *In re* Software Toolworks Inc., 38 F.3d 1078, 1090 n.3 (9th Cir. 1994).

[141] *In re* ZZZZ Best Sec. Litig., 864 F. Supp. 960, 970 (C.D. Cal. 1994). *See also* O'Neil v. Appel, 897 F. Supp. 995, 1000 (W.D. Mich. 1995) (allowing a suit to survive where the defendant issued an unqualified audit opinion which the defendant may have known was false); Adam v. Silicon Valley Bancshares, 884 F. Supp. 1398, 1401 (N.D. Cal. 1995) (holding that a defendant may be held primarily liable for participating significantly in a fraudulent scheme even where the misrepresentations were not directly made by the defendant).

[142] *See In re* Kendall Square Research Corp. Sec. Litig., 868 F. Supp. 26, 28 (D. Mass. 1994) (reviewing and approving statements will not result in liability where the actor did not prepare the documents); Vosgerichian v. Commodore Int'l, 862 F. Supp. 1371, 1377 (E.D. Pa. 1994) (dismissing plaintiff's aiding and abetting claims since aider and abettor liability was abolished by the Supreme Court in *Central Bank*). *See also* SEC v. U.S. Envtl. Inc., 897 F. Supp. 117, 119 (S.D.N.Y. 1995) (holding that "conspiring" to violate the Securities Acts is not a viable theory of liability after *Central Bank*).

limited to first drafter, editor, or commentator, they have an impact on the disclosure's capacity to deceive.

My suggestion is that the notion of participation or involvement in these cases be redefined in terms of proximate causation or a broad notion of "co-authorship." Any person who plays a significant role in the formulation of a disclosure document or other form of publicity that contains a material misstatement or omission should be liable as a primary violator if he or she acted with the requisite degree of scienter and all the other requirements for Rule 10b-5 liability are met. A significant role is one in which the person is invited, expected, or is otherwise in a position to affect the form or content of the disclosure — where the person has the ability to influence its capacity to deceive.[143] This could take the form of drafting, editing, or providing information.

This would not be the exclusive test for primary liability, of course. If there was a pre-existing fiduciary or comparable duty of disclosure, or if the involvement of the defendant was sufficiently visible that it operated as a separate and independent representation to investors (express or implied), then liability would be imposed without regard to co-authorship. Seizing on the language in Rule 10b-5 proscribing "schemes to defraud," primary liability could also be imposed on a person who had no responsibility for the misinformation but who helped formulate or carry out the scheme in a manner suggesting some form of co-conspiracy.[144]

How faithful this relatively broad approach is to *Central Bank's* dicta is debatable. If a judge takes very seriously the Court's concern for professionals and the costs of their services, a narrower approach might show more fidelity to Justice Kennedy's apparent intent. But there are ample ways short of outright protectionism to deal with speculative litigation, especially after the litigation reform legislation. Pleading requirements can be tightened and sanctions can be imposed for excess. If not entirely faithful, this approach is not outright disobedience either.

Such reformulation of primary liability under Rule 10b-5 would not completely return the law to its pre-*Central Bank* status. Among the usual deep pocket defendants, banks would seem to be protected the most since their involvement with the principal wrongdoers is rarely in the

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[143]In essence, this is a concept of "proximate cause," which happens to be a means by which "substantial assistance" was construed under the old law of aiding and abetting. *See* Landy v. FDIC, 486 F.2d 139, 163 (3d Cir. 1973), *cert. denied*, 416 U.S. 960 (1974) (deceiving practices of the party need only touch the exchange of securities). The difference here is that the old cases spoke in terms of the actor being the proximate cause of the fraud; here, more narrowly, it is the proximate cause of the misinformation itself.

[144]*See* BLOOMENTHAL ET AL., *supra* note 110, § 1.14.

formulation of disclosure.[145] Lawyers whose involvement was not with the disclosure but with transactional tasks, like contract drafting and general legal advice, would be free as well.[146] Courts would have to look to other sources of law, such as state blue sky law or common law theories, to gather these actors in pendent or ancillary jurisdiction.[147] Precisely how these non-securities law sources might be used takes us too far afield. But the temptation to do so, and thereby restore the equilibrium, will surely be strong.

B. *Vicarious Liability*

For some time, the courts have struggled with the question of the place of employer liability under Rule 10b-5. Section 20(a) of the Securities Exchange Act contains an express provision for controlling person liability that provides a good faith/no inducement defense.[148] But most courts have deemed it non-exclusive and have accepted the availability of *respondeat superior* and comparable agency law doctrines in securities litigation.[149] From a plaintiff's perspective, these have the virtue of being no-fault regimes; the responsibility of the agent is attributed to the principal simply because the activity was within the scope of the agent's authority (with some evidence of intent to benefit the employer).

According to the *Central Bank* dissenters and most commentators, *respondeat superior* and its cognates are no longer available. Because derivative responsibility is clearly a scope question, they say, the failure of the text to provide for them is fatal. There is a substantial difference

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[145]*See* Kahn v. Chase Manhattan Bank, N.A., 90 Civ. 2824 (LLM), 1995 U.S. Dist. LEXIS 11772, at *4 (S.D.N.Y. Aug. 14, 1995) (dismissing a § 10(b) claim against the bank and one employee since allowing one to cash checks with forged endorsements and allowing unauthorized use of accounts does not constitute a "manipulative or deceptive act" as explained in *Central Bank*).

[146]On the other hand, this kind of involvement was receiving substantial protection even before *Central Bank*. *See* Camp v. Dema, 948 F.2d 455, 459 (8th Cir. 1991); Schatz v. Rosenberg, 943 F.2d 485, 492 (4th Cir. 1991), *cert. denied*, 503 U.S. 936 (1992).

[147]*See* Steinberg, *supra* note 10, at 505-07; *see also* Douglas M. Branson, *Collateral Participant Liability Under State Securities Laws*, 19 PEPP. L. REV. 1027, 1028 (1992) (suggesting secondary liability must now be found under state blue sky laws since federal law has narrowed liability).

[148]15 U.S.C. § 78t(a) (1994).

[149]For the most recent of the major cases in this genre, see Hollinger v. Titan Capital Corp., 914 F.2d 1564 (9th Cir. 1990), *cert. denied*, 499 U.S. 976 (1991). *See generally* IX LOSS & SELIGMAN, *supra* note 18, at 4475-78 (explaining that § 20(a) is not to be applied exclusively, rather it should exist in addition to the other remedies set forth in common law or equity).

between the aiding and abetting and *respondeat superior* issues. One might accept the Court's contention that secondary participant liability was not so visible under tort law when Congress enacted section 10(b) that it would be presumed to be part of the legislative expectation with respect to enforcement issues. The same could hardly be said for *respondeat superior*, which is a foundational element of tort law. But if one religiously accepts the text-only rule for scope issues, this is not dispositive. *Respondeat superior* surely is at risk, for it need not be based on any finding that the firm used or employed a deceptive or manipulative device or contrivance.

Here again, however, there is much room for retrenchment. One way, of course, is simply by broadening the scope of section 20(a). But there is another route as well. As a few courts and commentators have taken special note, section 10(b) bars any *person* from violating any rule thereunder, and person is defined explicitly in section 3(a)(9) to include not only natural persons, but corporations and other forms of business organizations.[150] By statutory definition, then, corporations can violate Rule 10b-5, and *some* form of agency law reasoning is necessary to construct an explanation of how and when. I am quite sure that if the courts reject *respondeat superior* as such, we will soon see a blossoming of the law of what constitutes primary wrongdoing by organizational entities. It is worth noting that the most important entity liability case prior to *Central Bank* was from the Third Circuit,[151] the one court that has consistently rejected *respondeat superior*.

A very good argument can be made that any time a natural person commits a fraud on behalf of or as agent for an employer or other principal, that activity should be attributed to the entity as a matter of primary liability. Even a strict regime like criminal law invokes such an approach,[152] making liability turn simply — as did *respondeat superior*

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[150]*See* SEC v. Management Dynamics, Inc., 515 F.2d 801, 812 (2d Cir. 1975) ("Were [controlling person liability provisions] the sole measures of corporate liability . . . the inclusion of corporations under the definitions of 'person' would be not only unnecessary but also misleading."). *See also* BLOOMENTHAL ET AL., *supra* note 110, § 1.09 (discussing entities as primary violators).

[151]Sharp v. Coopers & Lybrand, 649 F.2d 175, 182 n.8 (3d Cir. 1981), *cert. denied*, 455 U.S. 938 (1982).

[152]*See, e.g.*, CIT Corp. v. United States, 150 F.2d 85 (9th Cir. 1945). One should note the possibility of "organizational scienter" based on collective attribution where no one individual has the requisite intent. *See, e.g.*, Caterpillar, Inc. v. Great Am. Ins. Co., 62 F.3d 955 (7th Cir. 1995); *see also* Nordstrom Inc. v. Chubb & Son Inc., 54 F.3d 1424, 1433 (9th Cir. 1995) (controlling persons do not have to directly participate to be held liable). *See generally* Craig L. Griffin, *Corporate Scienter Under the Securities Exchange Act of 1934*, 1989 B.Y.U. L. REV. 1227 (suggesting standards through which the deception requirement of

— on whether the agent was acting within the scope of his or her authority. Whether one calls this *respondeat superior* or not is semantics; the key is that such vicarious liability is essential to give effect to Congress' own definition of person. An interesting case along these lines, and one surely to have new life, is *In re Atlantic Financial Management, Inc.*,[153] a First Circuit decision written by then judge, now Justice, Breyer. In deciding whether the fraud of a company's chairman could be attributed to the company, the court held that the key in a fraud case is whether the words or actions of the individual were clothed in corporate authority, whether actual, implied, inherent, or apparent.[154] In *Atlantic Financial*, apparent authority was sufficiently broad to cover misrepresentations in the corporate name that exceed the scope of actual authority.[155]

So reformulated, there would be relatively few fraud cases covered by the old understanding of *respondeat superior* that could not be recast in terms of direct entity liability. Here, we must draw a careful distinction between fraud and non-communicative torts such as negligence, malpractice, etc. So far as misrepresentations and actionable omissions are concerned, the question becomes whether the individual was speaking *on behalf of* the employer/principal in engaging in the misconduct. If he or she was not so doing, then it is hard to see how the communication was within the scope of the employee's responsibilities. But if he or she was speaking with the authority of the employer[156] (e.g., in such a way that the standing and reputation of the employer might enhance the employee's credibility, or in a way that appears to reflect the entity's information and beliefs as opposed to the employee's own) then direct responsibility is both logical and reasonable. In many such cases, the fraud succeeds because of the organizational wrapping in which the

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§ 10(b) can be imputed to a corporate defendant); William S. Laufer, *Corporate Bodies and Guilty Minds*, 43 EMORY L.J. 647 (1994) (discussing corporate culpability and liability under criminal law).

[153]784 F.2d 29 (1st Cir. 1986), *cert. denied*, 481 U.S. 1072 (1987). *Atlantic Financial* cited the Supreme Court's antitrust decision in ASME v. Hydrolevel Corp., 456 U.S. 556 (1982). *In re Atlantic Fin.*, 784 F.2d at 32. On the apparent authority point, one might take note that Justice Rehnquist was a dissenter in *ASME*. *ASME*, 456 U.S. at 578-79.

[154]*Atlantic Fin.*, 784 F.2d at 31-32.

[155]*Id.* at 32-35.

[156]Or as one court has put it, where the words or actions "are 'intrinsically corporate and bear the imprimatur of the corporation itself.'" Caterpillar, Inc. v. Great Am. Ins. Co., 864 F. Supp. 849, 856 (C.D. Ill. 1994), *modified*, 62 F.3d 955 (7th Cir. 1995) (quoting Naye v. Boyd, [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,979, at 94,807 (W.D. Wash. Oct. 20, 1986)).

employee's words or actions are packaged, and the employer is an intended or apparent beneficiary therefrom.[157]

An authority-based "on behalf of" test for direct entity fraud liability would be a close substitute for what has been termed *respondeat superior* liability, while technically avoiding the scope limitation of the Supreme Court's textualist exegesis. Most *respondeat superior* cases have arisen in the context of brokerage firms, investment banks, and investment management operations. Except in those cases where the individual was on something of a frolic and detour — doing some business on the side — his or her representations would readily be subject to characterization as those of the entity. Take, for example, a lawyer who helps a client reformulate a misleading disclosure document in such a way that passes the primary liability test. It is not a stretch at all to see the lawyer's contributions as attributable to his or her law firm, for the lawyer's authority and influence often derives largely from the firm.[158]

III. CONCLUSION

If my hypothesis is correct, we often overreact to a Supreme Court decision. The very fact that might make it noteworthy — a departure from reasonably settled existing law — should lead us to suspect that its influence might soon deflate. Perhaps the best analogy is to a Socratic dialogue between a teacher and the teacher's students. If the teacher persuades, or the students are already primed to embrace the lesson, the teaching has power. If the students remain resistant, however, the lesson becomes something simply to parrot back at exam time and soon disappears from consciousness as a meaningful force. Prior assumptions still control.

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[157] *See, e.g., id.* at 856.

[158] A harder question involves insider trading. *See* Richard A. Booth, *Vicarious Liability and Securities Fraud*, 22 SEC. REG. L.J. 347 (1995) (arguing that the controlling person provisions of federal securities law should be the exclusive source of vicarious liability). Normally, insider trading is outside the scope of employment, since it is done for personal benefit. *See* Moss v. Morgan Stanley Inc., 553 F. Supp. 1347 (S.D.N.Y. 1983). The employer is often the victim as well. On the other hand, one can imagine a misappropriation case where a team of investment bankers was held out by their employer as reputable and responsible, enabling them to take advantage of the customer's trust. *Cf. Atlantic Fin.*, 784 F.2d at 32 (holding that a corporation can be vicariously liable for the apparently authorized misrepresentations of a high official). When the scheme infects the entire team, the temptation to characterize it as that of the firm may be significant.

Testing and elaboration of the equilibrium hypothesis would take much more in the way of systematic illustration than my two examples allow, of course. But the idea is an intriguing one. Lower courts are abundantly creative, unwilling to be constrained by dicta (and having fairly respectable jurisprudential support for downplaying it[159]). The law of insider trading suggests an almost organic capacity to impose liability for the unfair exploitation of someone else's information, whatever the overarching doctrinal framework. I suspect that well-pled efforts to impose liability on secondary participants in securities fraud will find similar receptivity. In sum, *Chiarella* and *Central Bank* may have done little more than introduce substantial wobble into the law, disorienting it for a while, and tempting the lower courts toward false starts as they try to find their way. On these two issues, this article has sought to offer a roadmap home.

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[159]*See* authorities cited *supra* note 2.