Who's Suing Who? a Commentary on Investment Bankers and the Misappropriation Theory

Manning Gilbert Warren III
WHO'S SUING WHO? A COMMENTARY ON INVESTMENT BANKERS AND THE MISAPPROPRIATION THEORY

MANNING GILBERT WARREN III*

I. INTRODUCTION

Industrial espionage appears to have permeated the investment banking industry. Recent enforcement efforts by the Securities and Exchange Commission (SEC)\(^1\) and resulting criminal convictions\(^2\) have revealed publicly that the problem is not isolated or episodic but is endemic.\(^3\) The evil uncovered goes far beyond the classic insider trading context, in which a corporate insider uses nonpublic positive or negative financial news about a company, "inside information,"\(^4\) to make trading profits in that company's securities. The

---

\* Professor of Law, University of Alabama School of Law. B.A., University of Alabama, 1970; J.D., George Washington University, 1973. The author gratefully acknowledges the research assistance of Catherine K. Anderson and Sherri L. Tucker in the preparation of this article.


4. Generally, the term "inside information" refers to "information which comes from within the corporation or affects the price of corporate stock because of its reflection of a corporation's expected earnings or assets." Brudney, Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws, 93 HARV. L. REV. 322, 329 (1979). See also Karmel, Market Information: Insider Trading, 195 N.Y.L.J. 1 (June 19, 1986) (stating
that inside information refers to events or circumstances known to corporate management which may be expected to change materially the market price of the company stock. Under rule 10b-5, a federal cause of action arises for the misuse of material nonpublic information by a corporate insider for personal gain. See, e.g., SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848-49 (2d Cir. 1968) (citing In re Cady Roberts & Co., 40 S.E.C. 907, 912 (1961)), cert. denied, 394 U.S. 976 (1969).

A variation of the classical insider trading case occurs when the corporate insider gives material, nonpublic information to an outsider and the "tippee" then trades without disclosing the information. The Supreme Court addressed this situation in Dirks v. SEC, 463 U.S. 646 (1983). Secrist, an officer of Equity Funding of America, informed Dirks, an investment analyst, that Equity Funding's assets were fraudulently overstated. Id. at 649. Dirks investigated the matter and passed the information on to his clients who sold their holdings in Equity Funding. Id. The SEC censured Dirks for violation of rule 10b-5. Id. at 650-52. Referring to its decision in Chiarella v. United States, 445 U.S. 222 (1980), the Supreme Court noted that the duty to disclose or abstain from trading arises from a fiduciary relationship, not from the mere possession of material, nonpublic information. 463 U.S. at 657. The Court reasoned that a "tippee" must assume the insider's fiduciary duty to shareholders when the insider's disclosure is deemed improper. Id. at 660. The Court ruled that an insider's disclosure is improper "when the insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee and the tippee knows or should know that there has been a breach." Id. Concluding that Secrist properly disclosed the information, the Supreme Court held that Dirks had no duty to abstain from the use of the information. Id. at 667. See Comment, Inside Information and Outside Traders: Corporate Recovery of the Outsider's Unfair Gain, 73 CALIF. L. REV. 483, 498-99 (1985) (arguing that the constructive insider concept extends rule 10b-5 liability only to a limited group of outsiders).

In the Dirks opinion, the Supreme Court commented that one who legitimately receives confidential information from the corporation may become a "constructive insider" and, therefore, owe a fiduciary duty to the shareholders of the disclosing corporation. 463 U.S. at 655 n.14. The court stated that the duty is based not only upon the receipt of the information but also upon the "special confidential relationship" entered into to conduct corporate business. While the "constructive insider" rule may extend the reach of rule 10b-5 beyond corporate officers, it fails to operate in the Chiarella context in which the outsiders were trading on material, nonpublic information. Chiarella's duty to the shareholders of the acquiring corporation was not breached when he engaged in securities transactions with the shareholders of the target corporation. See infra notes 54-65 and accompanying text.

Several state courts have addressed the issue whether an insider trading on nonpublic inside information is liable in a shareholders derivative action for breach of common-law fiduciary duties to the corporation. In Diamond v. Oreamuno, 24 N.Y.2d 494, 248 N.E.2d 910, 912, 301 N.Y.S.2d 78, 81 (1969), the New York Court of Appeals held that, under common-law agency principles, a corporate insider was liable to the corporation for trading on material, nonpublic information. See also In re ORFA Sec. Litig., No. 86-1121, slip op. (D.N.J. Feb. 10, 1987) (available on LEXIS, Fedsec library, Courts file) (holding that New Jersey law provides a derivative cause of action against a corporate officer who sells his corporation's stock on the basis of inside information); Brophy v. Cities Services Co., 31 Del. Ch. 241, 70 A.2d 5 (1949) (holding that Delaware law provides a cause of action against an employee for purchases of stock in advance of the corporation's stock repurchase program). But see Freeman v. Decio, 584 F.2d 186, 192 (7th Cir. 1978) (holding that Indiana law does not provide a derivative cause of action for an insider's activities because the corporation has not been injured); Schein v. Chasen, 478 F.2d 817 (2d Cir. 1973), vacated sub nom. Lehman Bros. v. Schein, 416 U.S.
employees, who in breach of their client’s confidences sell, exchange, and reap trading profits on nonpublic, “outside information” relating to the marketplace initiatives of their clients.

Most of the public attention regarding this conduct has focused upon the SEC’s enforcement proceedings, which have produced unprecedented civil penalties, disgorgements of profits, and injunctions, as well as the Justice Department’s criminal prosecutions. One federal prosecutor has bluntly referred to the investment bankers involved in this wave of trading scandals as “thieves.” He stated: “[T]hey steal information and then they fence it. It’s no different than if they were stealing ice skates.” As a result of the flurry of criminal prosecutions, Congress is once again focusing intensely on the need to regulate takeovers and insider trading more rigorously and to increase the SEC’s enforcement resources. How-


9. See supra note 2.


11. Id.

ever, the concerns to be addressed in this commentary are those not of the public at large, but of a new breed of private litigant: the corporate client whose confidences have been betrayed by its investment banker. More specifically, does that client have a private cause of action for securities fraud under the SEC's rule 10b-5 for any damages sustained?

This commentary will begin by summarizing a recent complaint filed in federal court to serve as a factual predicate for the analysis. Then, a number of preliminary observations will be set forth that amplify the factual predicate in order to provide a clearer context for the discussion. Several of the hurdles presented by the limitations on the scope of rule 10b-5 and the prerequisites for a private cause of action will be considered. The commentary concludes that legislative reform is necessary to provide private litigants with effective recourse under the federal securities laws for damages based on misappropriation of nonpublic information.

II. THE FACTUAL PREDICATE


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

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of
thereunder, section 14(e) of the 1934 Act and rule 14e-3 promulgated thereunder, section 1964(c) of the Racketeer Influenced and Corrupt Organizations Act (RICO), common law fraud, negligence, intentional interference with contractual relations, breach of contract, breach of fiduciary duty, and statutory fraud and deceit under New York law. Because the analysis will focus on the

such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15. 17 C.F.R. § 240.10b-5 (1986). Rule 10b-5 provides:

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

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

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

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

16. 15 U.S.C. § 78n (1982). Section 14(e) of the 1934 Act provides a general prohibition against "any fraudulent, deceptive, or manipulative acts or practices" in connection with any tender offer. Id. The Supreme Court in Piper v. Chris Craft Industries, 430 U.S. 1 (1976), held that unsuccessful tender offerors have no implied cause of action for damages under § 14(e). Id. at 42. However, the Court reserved the issues of (1) whether the target corporation or its shareholders have standing under § 14(e), and (2) whether the tender offeror has an action in equity for injunctive relief under § 14(e). Id. at 42 n.28, 47 n.33. The Court again interpreted § 14(e) in Schreiber v. Burlington Northern, Inc., 472 U.S. 1 (1985). In Schreiber the Court held that the "manipulative" language contained in § 14(e) requires "conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities." Id. at 12 (citing Ernst & Ernst v. Hochfelder, 425 U.S. 185, 199 (1976)). See generally Loewenstein, Section 14(e) of the Williams Act and the Rule 10b-5 Comparisons, 71 GEO. L.J. 1311 (1983) (concluding that scienter should not be an element of § 14(e) action and that plaintiffs need only prove reliance if necessary to prove causation).

17. 17 C.F.R. § 240.14e-3 (1986). Basically, rule 14e-3 provides that once a "person has taken a substantial step or steps to commence" a tender offer, any other person with nonpublic, material information concerning the tender offer must wait "a reasonable time" after the information is publicly disclosed before engaging in transactions involving the stock of the target company. This rule is often referred to as the "Chiarella Rule" because the SEC promulgated the rule under § 14(e) of the 1934 Act soon after its defeat in Chiarella v. United States, 445 U.S. 222 (1980). See L. Loss, FUNDAMENTALS OF SECURITIES REGULATION 868-69 (1983). Commentators have questioned the SEC's authority to promulgate rule 14e-3 under § 14(e), but, in any event, it successfully provides a means for the SEC to further its enforcement efforts on the basis of the misappropriation theory. See Junewicz, The Appropriate Limits of Section 14(e) of the Securities Exchange Act of 1934, 62 TEX. L. REV. 1171 (1984).


utility of rule 10b-5 to the corporate client seeking recovery from its investment bankers, the summary of the alleged operative facts is limited to those directly related to Litton's rule 10b-5 claims against Lehman and the two named employees.

Litton retained Lehman to provide investment banking advice regarding the proposed acquisition of various companies in the defense electronics industry, including Itek Corporation. At an initial meeting, Litton's representatives met with Lehman's personnel, including Sokolow, an employee in Lehman's mergers and acquisitions department. Litton disclosed its acquisition interests, and Lehman presented a number of tactical alternatives and recommendations. Subsequently, Litton decided to acquire Itek and commenced open market purchases of Itek common stock. Pursuant to Lehman's advice, Litton developed a three-step acquisition plan: (1) to purchase up to 4.9% of Itek's common stock in the open market, (2) to negotiate a friendly acquisition of Itek's common stock, involving a tender offer, and (3) to merge Itek with a wholly-owned Litton subsidiary.

Shortly thereafter, Lehman and Litton entered into a letter agreement, labeled "confidential," setting forth the services to be provided by Lehman in connection with the proposed acquisition, Lehman's compensation schedule, and Litton's duty not to disclose any of Lehman's advice to third parties. Litton asserts that all disclosures of information to Lehman during their relationship were pursuant to an express agreement by Lehman that Lehman and its employees would maintain strict confidentiality.

The complaint avers an immediate breach of this duty by Sokolow and, secondarily, by Lehman, as his employer. Sokolow disclosed Lehman's acquisition plan to Levine, who was also employed in Lehman's mergers and acquisitions department. The sine qua non for Sokolow's disclosure, according to the complaint, was that Levine would commence trading in Itek common stock while Litton's acquisition plan remained nonpublic and would reward Sokolow.

20. Id. at ¶¶ 19, 20.
21. Id. at ¶¶ 8, 21.
22. Id. at ¶ 22.
23. Id. at ¶ 23.
24. Id. at ¶¶ 22, 24.
25. Id. at ¶¶ 24-26.
26. Id. at ¶ 26.
27. Id. at ¶ 28.
28. Id. at ¶ 100.
29. Id. at ¶ 28.
low with a share of the trading profits realized. To effectuate his trades, Levine used a Bahamian corporation and its securities brokerage accounts in New York, and he allegedly tipped a number of persons, creating a chain reaction of tipper-tippee disclosures and resultant trading based on Litton's nonpublic acquisition plan. This trading activity, according to Litton, caused the price of Itek's common stock on the New York Stock Exchange to rise sharply, reaching and maintaining an artificially inflated level.

Despite the upswing in the price of Itek common stock, Litton held to its acquisition plan. It was able to negotiate a friendly acquisition agreement with Itek representatives, and successfully conducted a cash tender offer at a price per share representing a substantial premium over the market price. After the tender offer was publicly announced, Levine and certain other defendants sold their Itek stock for a substantial profit. Although Litton concluded its acquisition plan, causing Itek to be merged with a Litton subsidiary, it seeks damages in the amount of $30 million from Lehman and the other defendants. The crux of its damages claim is that Sokolow's wrongful disclosure of the acquisition plan and the resultant trading by various tippees significantly affected the cash tender offer price negotiated with Itek by artificially inflating the market prices.

The factual predicate for Litton's rule 10b-5 claims is but a variant of a pattern reflected in a number of pending or threatened lawsuits. The facts can be more succinctly stated by symbolic

30. Id.
31. Id. at ¶¶ 11, 30.
32. Id. at ¶¶ 28-33.
33. Id. at ¶ 34.
34. Id. at ¶¶ 37, 38.
35. Id. at ¶¶ 39, 40.
36. Id. at ¶ 116.
37. Id. at ¶¶ 34, 35. As a result of their outsider trading, both Sokolow and Levine were enjoined from further brokerage activities in an SEC enforcement action. In addition, both men were convicted of securities fraud. United States v. Sokolow, 18 Sec. Reg. & L. Rep. (BNA) 1642 (S.D.N.Y. Nov. 16, 1986); SEC v. Levine, 18 Sec. Reg. & L. Rep. (BNA) 709 (S.D.N.Y. May 12, 1986).
38. See, e.g., FMC Corp. v. Ivan F. Boesky; Boesky & Kinder Partners, L.P.; Ivan F. Boesky & Co., L.P.; IFB Managing Partnership, L.P.; Cambrian & General Securities, p.l.c.; Beverly Hills Hotel Corp.; Farnsworth & Hastings Ltd.; Northview Corporation; Seemala Partners, L.P.; Seemala Corp.; Ivan F. Boesky Corp.; Goldman, Sachs & Co.; David S. Brown; Shearson Lehman Bros., Inc.; Ira B. Sokolow; Drexel Burnham Lambert, Inc., and Dennis B. Levine, No. 86 C 9879 (N.D. Ill. filed Dec. 18, 1986). (The complaint, alleging that FMC retained Goldman Sachs & Co. as its investment banking firm in connection with a recapitalization of the company and that the defendants misappropriated related confidential information and used it to purchase or manipulate the
reiteration. An acquiring corporation (A) retains an investment banker (B), whose employee-insiders (BI) assist A's employee-insiders (AI) in developing a confidential scheme to purchase all or a controlling block of the securities of a target corporation (T) from T's shareholders (TS). In an assumed breach of state law contractual and fiduciary duties to A and B, BI proceeds to purchase securities from TS in the open market prior to any public announcement of A's acquisition plan and without any disclosure of A's plan to TS. Similarly, although perhaps not simultaneously with BI's purchases, A purchases shares from TS without disclosure of its plan. None of A's securities are purchased by A or BI from A's shareholders (AS). Because BI's trading increases the demand and trading volume in T's securities, the price of those securities presumably increases, thereby making A's plan more costly. A then seeks to hold BI and their employer B liable for the misappropriation and wrongful use of its nonpublic acquisition plan and claims as damages not the amount of BI's trading profits, but the amount of the alleged increase in the cost paid by A to effectuate the plan. Although other remedies in tort and contract under state law are asserted and may be available, A claims that its damages are recoverable under rule 10b-5 because BI wrongfully misappropriated A's nonpublic information in connection with the purchase of securities.

III. PRELIMINARY OBSERVATIONS

In undertaking an analysis of whether a private cause of action under rule 10b-5 is available to A, a number of observations about the factual predicate may be useful in clarifying the position of the parties.

(1) Both A and BI were buyers of T's securities and, hence, were never on different sides of any transactions in those securities.

(2) Assuming BI owed state law contractual and fiduciary du-
ties to A and B, BI did not disclose to A an intention to breach any of those duties.

(3) The parties, A, B, and BI, were all fully aware of A’s non-public acquisition plan.\textsuperscript{39}

(4) A does not claim that any misrepresentation or omission by BI was material or relied upon by A or otherwise caused A to purchase T’s securities.

(5) Both A and BI failed to disclose A’s nonpublic acquisition plan to TS at the time of their respective pre-announcement purchases of T’s securities, and A does not assert that it or BI breached any duty of disclosure to TS.

(6) Public disclosure by A, B, or BI of the acquisition plan prior to A’s amicable agreement with T would have impeded A’s plan or resulted in significantly higher costs to A.

(7) Despite any increases in the market price of T’s securities, A purchased T’s securities at the higher price plus a premium.

(8) Despite any increases in the market price of T’s securities, T’s employee-insiders may not have agreed to cooperate with A on the basis of any price lower than that ultimately paid by A.

(9) Assuming BI’s purchases increased the price of T’s securities and, accordingly, increased the price ultimately paid by A, benefits of the increased price accrued to TS at the time the acquisition plan was consummated.\textsuperscript{40}

\textsuperscript{39} No reference is made in the Litton Complaint to “materiality” or “reliance,” two critical elements of a rule 10b-5 private cause of action. See infra notes 52-102 and accompanying text. See generally Helman, Rule 10b-5 Omissions Cases and the Investment Decision, 51 Fordham L. Rev. 399 (1982) (advising careful analysis of the plaintiff’s investment decision in rule 10b-5 cases).

\textsuperscript{40} The assumption that the misappropriator’s purchases bear a causal connection to price increases in a target corporation’s securities is a difficult one. One writer has stated that “the purchase of a target’s shares in advance of a takeover ... bids up the price of the target’s shares and thereby makes the corporate action more expensive. This reduces the value of the takeover to the firm.” Carlton & Fischel, supra note 4, at 884. However, a recent study by the SEC’s Office of the Chief Economist concludes that pre-bid trading for target stock “is not necessarily an accurate indicator of insider trading.” See Stock Trading Before the Announcement of Tender Offers: Insider Trading or Market Anticipation?, Study by the SEC’s Office of the Chief Economist, at 1 (released Mar. 10, 1987) [hereinafter Staff Study]. Rather, the study identified three influences—“media speculation,” a bidder’s “foothold acquisition” in the target company, and whether the bid is friendly or hostile—that could make the pre-bid activity not attributable to insider trading. Id. at 2-3.

It is beyond the scope of this article to address whether the increased costs of the tender offer resulting from improper trading are among the types of recoverable damages in a private cause of action under rule 10b-5. In any event, a plaintiff must show a causal connection between the deception and the damages claimed to have been suffered. See, e.g., Schreiber v. Burlington Northern, Inc., 472 U.S. 1, 13 (1985) (“since the
T's shareholders who sold to A, BI, or others prior to the public disclosure of A's acquisition plan received fewer benefits of the price increase in T's securities.

To the extent proprietary interests in the nonpublic acquisition plan existed pending public disclosure, they were held by both A and B as co-creators of the nonpublic information, as evidenced by their confidential letter agreement.\(^4\)

B's liability under rule 10b-5, which ultimately would be borne by B's shareholders, is dependent on BI's liability, whether B's liability is based on aiding and abetting, controlling person,\(^4^2\) deceptive and misleading acts alleged by the petitioner all occurred with reference to the making of the second tender offer—when the injuries suffered by petitioner had already been sustained—these acts bear no possible causal relationship to petitioner's alleged injuries'.\(^4^1\)

41. See Macey, From Fairness to Contract: The New Direction of the Rules Against Insider Trading, 13 Hofstra L. Rev. 9, 27, 30-39 (1984) ("The right to prohibit another from trading on the basis of inside information must stem from a notion that information is a form of property interest.").

42. Once the primary liability of the wrongdoer is established under rule 10b-5, the wrongdoer's employer may be subject to secondary liability as an aider and abettor. To establish aiding and abetting liability, the plaintiff must prove: (1) the existence of an independent securities law violation committed by the primary wrongdoer; (2) the aider and abettor had actual knowledge of the wrongful act; and (3) the aider and abettor substantially assisted the wrongdoer in effectuating the violation. See Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 38, 44-47 (2d Cir.), cert. denied, 439 U.S. 1039 (1978); Kerbs v. Fall River Indus., 502 F.2d 731, 740 (10th Cir. 1974). See generally 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); Note, Liability for Aiding and Abetting Violations of Rule 10b-5: The Recklessness Standard in Civil Damages Actions, 62 Tex. L. Rev. 1087 (1984) (arguing that existing conflict among the circuits should be resolved in favor of unrestricted application of recklessness standard to parties who aid and abet rule 10b-5 violators); Note, The Private Action Against a Securities Fraud Aider and Abettor: Silent and Inactive Conduct, 29 Vand. L. Rev. 1233 (1976) (examining origins of aiding and abetting liability and developing theory of liability based on passive conduct).

43. Section 20(a) of the 1934 Act extends liability for the acts of one person to another, who, through stock ownership, agency, or agreement, "controls" that person. 15 U.S.C. § 78t(a) (1982). The SEC, in rule 12b-2, has defined the term "control" to mean "the possession, direct or indirect, of the power to direct . . . the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise." 17 C.F.R. § 240.12b-2 (1986). A controlling person may escape liability under § 20(a) by showing that it has "acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action." 15 U.S.C. § 78t(a) (1982). See also Comment, Secondary Liability of Controlling Persons Under the Securities Acts: Toward an Improved Analysis, 126 U. Pa. L. Rev. 1345 (1978).

Currently, a split exists among the circuits as to whether § 20(a) would be the exclusive remedy for a plaintiff seeking to impute liability to an investment banking firm for the misdeeds of its employees. A majority of courts view "controlling person" liability and respondeat superior as concurrent theories for imputing liability. See, e.g., Commerford v. Olson, [Current Developments] Fed. Sec. L. Rep. (CCH) ¶ 92,809 (8th Cir. July 2, 1986); In re Atlantic Fin. Management, Inc., 784 F.2d 29 (1st Cir. 1986), cert. denied, 107
or respondeat superior theories.44

S. Ct. 2469 (1987); Henricksen v. Henricksen, 640 F.2d 880 (7th Cir. 1980), cert. denied, 449 U.S. 1097 (1981); Paul F. Newton & Co. v. Texas Commerce Bank, 630 F.2d 1111 (5th Cir. 1980); Marbury Management, Inc. v. Kohn, 629 F.2d 705 (2d Cir.), cert. denied, 449 U.S. 1011 (1980); Kerbs v. Fall River Indus., 502 F.2d 731 (10th Cir. 1974); Johns Hopkins Univ. v. Hutton, 422 F.2d 1124 (4th Cir. 1970); Armstrong, Jones & Co. v. SEC, 421 F.2d 359 (6th Cir. 1970); But see Sharp v. Coopers & Lybrand, 649 F.2d 175 (3d Cir. 1981); Christoffel v. E. F. Hutton & Co., 588 F.2d 665 (9th Cir. 1978). For further discussion, see Fitzpatrick & Carman, Respondeat Superior and the Federal Securities Laws: A Round Peg in a Square Hole, 12 HOFSTRA L. REV. 1 (1983); Fishel, Secondary Liability Under Section 10(b) of the Securities Act of 1934, 69 CALIF. L. REV. 80 (1981); Note, Rule 10b-5 and Vicarious Liability Based on Respondeat Superior, 69 CALIF. L. REV. 1513 (1981). See also Brodsky, Controlling-Person Liability—A Conflict, 186 N.Y.L.J. 1 (July 15, 1981); Brodsky, Brokerage Firm's Liability, 185 N.Y.L.J. 1 (Jan. 21, 1981). The majority view is based primarily upon the rationale that the absence of respondeat superior liability in securities cases could considerably change existing liability assumptions. See Marbury Management, Inc. v. Kohn, 629 F.2d 705, 716 (2d Cir.), cert. denied, 449 U.S. 1011 (1980) ("there is no warrant for believing that section 20(a) was intended to narrow the remedies of the customers of brokerage houses or to create a novel defense in cases otherwise governed by traditional agency principles").

44. In contrast to "controlling person" liability, the common-law doctrine of respondeat superior views the good faith of the principal or other controlling person as irrelevant to the issue of liability. See Musewicz, Vicarious Employer Liability and Section 10(b): In Defense of the Common Law, 50 GEO. WASH. L. REV. 754 (1982); Note, Application of Common Law Agency Principles to Actions Under the Securities Acts: Strict Liability for Employers, 32 MERCER L. REV. 1283, 1292 (1981). Under respondeat superior principles, an employer is liable for all acts an employee committed "within the scope of employment." RESTATEMENT (SECOND) OF AGENCY § 228 (1958) (defining "scope of employment"); P. Mecham, Outline of the Law of Agency § 366 (4th ed. 1952). Accordingly, scope of employment is the key element in establishing respondeat superior liability. The phrase includes conduct of the type the employee was employed to perform actuated by an intent to serve the master. RESTATEMENT (SECOND) OF AGENCY § 228 (1958). The fact that an employee acted for personal gain, however, does not necessarily cause the acts to be outside the scope of employment. Brill, The Liability of an Employer for the Wilful Torts of His Servants, 45 CHI.-KENT L. REV. 1, 10 (1968). Lord McNaghten in Lloyd v. Grace, Smith & Co., A.C. 716 (1912), All E.R. Reprints 51 (1911-13), adopted this rule, stating: "A principal must be liable for the fraud of his agent committed in the course of the agent's employment and not beyond the scope of his agency, whether the fraud be committed for the principal's benefit or not." All E.R. Rep. at 57. The United States Supreme Court adopted this rule in Gleason v. Seaboard Air Line Ry., 278 U.S. 349 (1929). In Gleason the railroad company was found liable for the payment of a draft against a bill of lading which was forged by the railroad's agent. The Court overturned Friedlander v. Texas & Pacific Ry., 130 U.S. 416 (1899), and held that the "liability of the principal for the false statement or other misconduct of the agent acting within the scope of his authority is unaffected by his secret purpose or motives." 278 U.S. at 356. The rule has been widely applied. See, e.g., Hydrolevel Corp. v. American Soc'y of Mechanical Eng'rs, 635 F.2d 118, 125 (2d Cir. 1980) (stating that the Gleason rule "has not been questioned" and induces "greater care to prevent misconduct by agents occupying especially sensitive or responsible positions that invite reliance"); Ricketts v. Pennsylvania Ry., 153 F.2d 757, 759 (2d Cir. 1946) ("[i]t is now settled... that an agent does not cease to be acting within the scope of his authority when he is engaged in a fraud upon a third person"); Kean v. National City Bank, 294 F. 214, 224 (6th Cir. 1923) ("The principal [may be charged] with the knowledge of the agent, where the agent is acting within the scope of
Not all of the foregoing observations, or others that could also be stated, may prove determinative in any judicial resolution. Taken together with the factual predicate, however, a clearer basis for analysis is presented.

IV. THE APPLICABILITY OF RULE 10b-5

Most would agree that BI's conduct is reprehensible—morally, legally, and economically. The Supreme Court has observed that this type of trading may "even where permitted by law . . . fall below ethical standards of conduct."45 This assumes without discussion the availability of appropriate remedies under state law, whether the conduct is characterized as a breach of confidence46 or fiduciary duty by an agent to a principal,47 as conversion,48 as misappropriation of a trade secret49 or confidential business information,50 or as
a breach of an employment contract. Even those who generally would view trading on nonpublic information as an acceptable part of an executive compensation package have condemned such non-consensual trading activity as economically inefficient.

However, despite the admonition that federal securities law should be read "flexibly to effectuate its remedial purposes," not all wrongful conduct somehow associated with securities is proscribed by section 10(b) and rule 10b-5. Even when proscribed by the substantive scope of these provisions, additional restrictions on the implied private cause of action may pretermit a private litigant's recovery. Accordingly, it first must be determined whether BI's conduct falls within the scope of coverage under rule 10b-5, as delimited by section 10(b). Then, a determination must be made whether A has standing to pursue its action, and, if so, whether it can establish the requisite elements of a prima facie case.

A. The Scope of Rule 10b-5

The Supreme Court has not addressed the precise issue whether rule 10b-5 is applicable to a person who, in breach of fiduciary duties, misappropriates confidential information from one

---

51. See F. Gurry, supra note 46, at 94-122. The author states that a business secret "is information which a firm generates about its own activities." In a business relationship, the information is provided only for the purposes of a particular business relationship. Thus, one is liable for a breach of confidence when the information is used in breach of an obligation.


53. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 200 (1976). The Court explained that a private cause of action under § 10(b) and rule 10b-5 requires a showing of "intentional or willful conduct designed to deceive or defraud investors." Id. at 199. See also Reiss v. Pan Am. World Airways, 711 F.2d 11, 14 (2d Cir. 1983) ("[T]he must be proof that the nondisclosure was intended to mislead.").
party to make trading profits in the securities of another. The issue was excluded in specific language from the Supreme Court’s decision in *Chiarella v. United States*, the only case thus far presented to it involving an outsider trading on outside information. In *Chiarella* an employee (BI) of a financial printing firm (B) utilized confidential information provided by the firm’s clients (A) to reap trading profits in the securities of companies (T) those clients planned to acquire. BI was indicted and convicted for violations of section 10(b) and rule 10b-5. On appeal the SEC asserted two arguments: (1) BI’s misappropriation and use of confidential information from A operated as a rule 10b-5 fraud against A, and (2) BI’s purchases based on information misappropriated from A operated as a rule 10b-5 fraud against TS, the shareholders of T who sold during the subject period. Because the first misappropriation argument had not been submitted to the jury at trial, the Court addressed only the second argument.

In rejecting the notion that BI committed 10b-5 fraud against TS, the Court reasoned that BI’s silence or nondisclosure would satisfy the “deception” requirement imposed by section 10(b) and rule 10b-5 only if BI was subject to a duty to disclose. This duty, according to the Court, must arise from a fiduciary relationship of trust and confidence between the parties to a transaction.

55. *Id.* at 236. The Court noted that the government’s brief offered an alternative theory to support Chiarella’s conviction:

> It argues that petitioner breached a duty to the acquiring corporation when he acted upon information that he obtained by virtue of his position as an employee of a printer employed by the corporation. The breach of this duty is said to support a conviction under § 10(b) for fraud perpetrated upon both the acquiring corporation and the seller.

We need not decide whether this theory has merit for it was not submitted to the jury. *Id.* at 235-36. The Court concluded that it would not uphold the conviction simply on the jury’s determination that Chiarella’s nondisclosure of material, nonpublic information in transactions with the shareholders of the target corporation operated as a fraud upon the shareholders. *Id.* at 236.

56. *Id.* at 224.
57. *Id.* at 225.
58. *Id.*
59. *Id.* at 236. The Court has reiterated its reservation of the issue whether rule 10b-5 liability may be predicated solely on the misappropriation and use of material, nonpublic information, irrespective of any duty to disclose. *See* Bateman Eichler, Hill Richards, Inc. v. Berner, 472 U.S. 299, 312 n.21 (1985).
60. 445 U.S. at 237 n.21.
61. *Id.* at 232-33.
was found.\textsuperscript{62} BI was not an insider of T, was not an agent of T or TS, and otherwise had no fiduciary duties to T or TS. Thus, the Court found no duty to disclose and, accordingly, no deception and no fraud under rule 10b-5.\textsuperscript{63} The Court's reasoning applies with equal force to A, who also purchased securities from TS without disclosing the nonpublic information regarding the acquisition plan.\textsuperscript{64} The Court refused, absent supporting evidence of congressional intent, to recognize "a general duty between all participants in market transactions to forego action based on material nonpublic information."\textsuperscript{65}

The Court's conclusion was based in substantial part on its prior holding in \textit{Santa Fe Industries v. Green},\textsuperscript{66} which dealt with the

\begin{footnotesize}
\begin{enumerate}
\item \textit{Id.} Justice Powell explained:
\[\text{[T]he element required to make silence fraudulent—a duty to disclose—is absent in this case. No duty could arise from petitioner's relationship with the sellers of the target company's securities, for petitioner had no prior dealings with them. He was not their agent, he was not a fiduciary, he was not a person in whom the sellers had placed their trust and confidence. He was, in fact, a complete stranger who dealt with the sellers only through impersonal market transactions.}\]

\item \textit{Id.} The Second Circuit, in the context of a private action under rule 10b-5, has held that, once a duty to disclose is established, that duty runs even to strangers in impersonal market transactions. Furthermore, the mere breach of this duty satisfies the causal connection requirement. \textit{See Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228, 237 (2d Cir. 1974) ("[D]efendants owed a duty...[to disclose] not only to the purchasers of the actual shares sold by defendants...but to all persons who during the same period purchased Douglas stock in the open market without knowledge of the material inside information....")}. \textit{See also Wilson v. Comtech Telecommunications Corp., 648 F.2d 88, 99 (2d Cir. 1981) ("[D]uty of disclosure is owed only to those investors trading contemporaneously with the insiders."); Elkind v. Liggett & Meyers, Inc., 635 F.2d 156, 169 (2d Cir. 1980) (same position).}

\item The Sixth Circuit has refused to impose civil liability in the context of impersonal market transactions. Since the insider did not induce the stranger to sell, the court has found the causal connection lacking. \textit{See Fridrich v. Bradford, 542 F.2d 307, 318 (6th Cir. 1976) ("[D]efendants' act of trading with third persons was not causally connected with any claimed loss by plaintiffs who traded on the impersonal market and who were otherwise unaffected by the wrongful acts.").}\textit{ See also Moss v. Morgan Stanley, 719 F.2d 5 (2d Cir.), cert. denied, 429 U.S. 1053 (1983); Laventhal v. General Dynamics Corp., 704 F.2d 407 (8th Cir. 1983); Walton v. Morgan Stanley, 623 F.2d 796 (2d Cir. 1980) (cited with approval in Dirks v. SEC, 463 U.S. 646, 662 n.22 (1983)).}

\item 445 U.S. at 235.

\item \textit{Id.} at 231 n.14. The Court noted with approval the Second Circuit's decision in \textit{General Time Corp. v. Talley Indus., 403 F.2d 159 (2d Cir. 1968), cert. denied, 393 U.S. 1026 (1969)}, determined that, absent a fiduciary relationship to the sellers, a tender offeror did not violate § 10(b) when it made pre-announcement purchases of the target company's securities. This holding, according to the Court, was consistent with its \textit{Chiarella} analysis. 445 U.S. at 231 n.14.

\item \textit{Id.} at 233.

\item 430 U.S. 462 (1977). For a discussion of the implications of the Court's holding
\end{enumerate}
\end{footnotesize}
converse principle. While Chiarella held a material nondisclosure insufficient absent a fiduciary duty to speak, Santa Fe held the breach of a fiduciary duty insufficient absent a material nondisclosure. The Court in Santa Fe was confronted with the issue whether a breach of fiduciary duty of fairness that involved the purchase of securities in a merger was within the scope of rule 10b-5. Rule 10b-5 fraud, the Court concluded, simply did not embrace "all breaches of fiduciary duty in connection with a securities transaction." The federalization of state law fiduciary duty could not be premised on the language of section 10(b) or rule 10b-5, in light of congressional intent that focused not on fairness but on disclosure.

The Court’s decisions in Chiarella and Santa Fe, read together, support conclusions that (1) neither A nor BI had a fiduciary duty to TS and, hence, nondisclosure to TS does not violate rule 10b-5, and (2) BI’s breach of its fiduciary duty to A, without a material nondisclosure to A, does not violate rule 10b-5. BI’s nondisclosure to A did not pertain directly to T’s securities or to A’s nonpublic acquisition plan—both A and BI obviously possessed that information—but rather to BI’s failure to disclose the intent to breach, and the breach itself, of the fiduciary duty owed by BI to A and B. In a nondisclosure analysis, the issue becomes whether a failure to disclose a breach of fiduciary duty is within the scope of rule 10b-5.

The view has been expressed that failure to disclose a breach of a fiduciary duty is simply insufficient under Santa Fe to constitute a violation of section 10(b). If one disagrees, the possibilities for


67. 430 U.S. at 479-80.
68. Id. at 470-71.
69. Id. at 472.
70. Id. at 477-80.
71. See Biesenbach v. Guenther, 588 F.2d 400 (3d Cir. 1978). In Biesenbach the minority shareholders alleged that directors of the corporation breached their fiduciary duties in connection with loans they made to the corporation. Id. at 401. The terms of the loans were designed to give the directors control of the corporation through repayment in the corporation’s securities. Id. The plaintiffs contended that the failure to disclose this breach of fiduciary duty was a misrepresentation or omission sufficient to constitute a violation of rule 10b-5. Id. at 402. The Third Circuit, in rejecting this claim, stated: “In effect, appellants are stating that the failure to disclose the breach of fiduciary duty was a misrepresentation or omission sufficient to constitute a violation of the Act. We refuse to adopt this approach which would clearly circumvent the Supreme Court’s holding in Santa Fe.” Id. The court concluded that “the unclean heart” was not actionable under rule 10b-5, whether disclosed or not. Id.
circumvention of Santa Fe's holding would render it meaningless. To come within the scope of rule 10b-5, a plaintiff would need only to amend the complaint for breach of fiduciary duty by adding an averment that the breach was not disclosed. Even if the scope of rule 10b-5 is broadly construed, despite Santa Fe's restrictions, to include nondisclosure of a breach of fiduciary duty, the materiality of this nondisclosure is at least questionable under the prevailing definition established in TSC Industries v. Northway, Inc.\(^7\) To paraphrase this issue, would BI's disclosure in advance of the breach have significantly affected a reasonable investor's decision to purchase T's securities?\(^7\) Given the observations that A effected much larger purchases without public disclosure of its plan and continued to pursue its plan despite substantial escalation in the market price of T's securities, this is doubtful. As a reasonable investor, A in all likelihood presumed that takeover rumors and resultant trading would inevitably occur following its "window" purchases,\(^7\) with consequential increases in the price of T's securities.\(^6\) Reference should be made to the preliminary observation that A does not as-

\(^7\) The term "material" is not defined in the 1934 Act, but has been defined by the SEC in rule 12b-2:

The term "material," when used to qualify a requirement for the furnishing of information as to any subject, limits the information required to those matters to which there is a substantial likelihood that a reasonable investor would attach importance in determining whether to buy or sell the securities registered.


74. See id. at 449. The Court, in the context of a proxy solicitation, phrased the materiality standard as follows:

[A]n omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote. . . . It does not require proof of a substantial likelihood that disclosure of the omitted fact would have caused the reasonable investor to change his vote. What the standard does contemplate is a showing of a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder. Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by a reasonable investor as having significantly altered the "total mix" of information made available.

Id. Compare the SEC's definition, supra note 72.

75. See 15 U.S.C. § 78m(d)(1) (1982); 17 C.F.R. § 240.13d-1 (1986). Section 13(d) of the 1934 Act provides for a 10-day window after a person acquires beneficial ownership of a five percent threshold of a target's stock to disclose his intentions to the target, to the securities exchange on which the stock is traded, and to the SEC. See L. Loss, supra note 17, at 573-74. The Senate is currently considering a bill to amend § 13(d) that would reduce the window period to five days and the threshold to two percent. Simon Proposes Bill to Limit 13(d) Window, Prohibit Greenmail, 19 Sec. Reg. & L. Rep. (BNA) 219 (Feb. 13, 1987).

76. See Staff Study, supra note 40, at 1-2.
sert that BI's nondisclosure was material or otherwise affected A's decision to purchase T's securities. On the other hand, if BI's intent had been disclosed prior to the breach, A or B, perhaps with the SEC's assistance, may have been able to dissuade BI from the course of action taken. In any event, the issue of "materiality" is clearly a potential roadblock to A in its efforts to show that BI's conduct falls within the proscriptions of rule 10b-5.

It has been argued that BI's conduct may come within the scope of rule 10b-5 pursuant to a theory based upon the misappropriation of confidential information, rather than upon the failure to disclose a material fact. But any misappropriation theory must rest on an act of deception as to a material fact. This conclusion, reached in an unbroken line of Supreme Court decisions interpreting rule 10b-5, cannot be debated seriously. If there was no duty to disclose to TS under Chiarella, then the only duty to disclose ran to A and B. In other words, A and B stood in a position to be deceived by BI and were in fact deceived by BI's failure to disclose an intended breach of fiduciary duty. However, Chief Justice Burger and Justices Brennan, Blackmun, and Marshall indicated either in concurring or dissenting opinions in Chiarella that misappropriation was theft, and securities trading using stolen information worked the requisite deception. Justices Blackmun and Marshall went even further, stating that even if Chiarella's intentions had been disclosed to and blessed by those to whom he owed fiduciary duties, his conduct would have violated rule 10b-5. Justice Stevens suggested in his concurring opinion that at least an arguable case could be posited in support of the misappropriation theory without conflicting with the majority opinion in Chiarella.

The construction of the argument alluded to by Justice Stevens would necessarily incorporate a tenet that the act of misappropriation, regardless of any disclosure obligation, is equivalent to the requisite deception. While it is true that theft may be accomplished by deception, it is also true that not all theft is deceptive. If the theft were fully disclosed to A and B prior to actual use of the

78. See Chiarella, 445 U.S. at 239 (Brennan, J., concurring); id. at 245, (Burger, C.J., dissenting); id. at 245-46 (Blackmun and Marshall, J.J., concurring).
79. Id. at 246.
80. Id. at 237, 238 (Stevens, J., concurring).
81. Id.
confidential information by BI, it is difficult to pinpoint the deception. If BI actually had stolen T's securities from A and B in an armed robbery, criminal theft would have occurred but not the deceptive conduct proscribed by section 10(b). No evidence of congressional intent exists in the language or history of section 10(b) to support this extension in scope of rule 10b-5.\(^\text{82}\) Under Chiarella, absent any duty to TS, actionable deception must rest on BI's nondisclosure to A and B.

In addition to the issue whether BI's conduct was tantamount to a fraudulent nondisclosure of a material fact, another issue substantially more burdensome is whether BI's nondisclosure to A was "in connection with the purchase or sale of any security," as required by rule 10b-5.\(^\text{83}\) This "in connection with" requirement is pertinent both to the scope of rule 10b-5 generally\(^\text{84}\) and to the plaintiff's standing to bring a private cause of action.\(^\text{85}\)

To establish the requisite connection with the fraud, a determination must be made concerning which purchases or sales are to be connected. As previously observed, both A and BI made purchases of T's securities, which, of course, also involved corresponding sales

\(^{82}\) See Ernst & Ernst v. Hochfelder, 425 U.S. 185, 194-206 (1976) (discussing legislative history of § 10(b)).

\(^{83}\) 17 C.F.R. § 240.10b-5(c) (1986). For the full text of this regulation, see supra note 15.

\(^{84}\) See, e.g., Liberty Nat'l Ins. Holding Co. v. Charter Co., 734 F.2d 545, 555 (11th Cir. 1984) ("The case law reveals that in order for this element ["in connection with"] to be satisfied there must be some causal relationship between the alleged deception and some consequent purchase or sale. Courts have spoken of this connection in terms of reliance and causation."); Tully v. Mott Supermarkets, Inc., 540 F.2d 187, 194 (3d Cir. 1976) ("'in connection with the purchase or sale' of any security, contemplates a causal connection between the alleged fraud and the purchase or sale of stock").

\(^{85}\) See, e.g., Bochicchio v. Smith Barney, Harris Upham & Co., 647 F. Supp. 1426, 1430 (S.D.N.Y. 1986) (dismissing securities investor's claim against investment firm for alleged misuse of securities trading accounts for failure to state a claim because the "in connection with the purchase or sale of securities" requirement was not satisfied); Citron v. Rollins Env. Servs., Inc., [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,115 (D. Del. 1986) (holding that a corporation lacks standing to assert a § 10(b) claim because the corporation was neither a purchaser nor seller); Baker v. Wheat First Sec., [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,111 (S.D.W. Va. 1986) (holding that a broker-dealer is not subject to federal securities fraud liability merely for forging a letter to authorize the transfer of funds from an investor's account; the transfer of funds is not "connected with the purchase or sale of securities" and, thus, the investors do not have standing); Davidge v. White, 377 F. Supp. 1084, 1086-87 (S.D.N.Y. 1974) (holding that a trustee lacks standing to bring a § 10(b) action for a company to recover profits illegally made by a company director in possession of nonpublic information because neither the trustee nor the company were purchasers or sellers in the director's transactions). See also Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975). See infra notes 96-120 and accompanying text.
of T's securities by TS. Because, under Chiarella, TS was not deceived, TS's sales should be excluded from consideration. Because BI was not deceived, BI's purchases should be excluded as well. Attention must then be directed to A's purchases of T's securities. A major difficulty in connecting BI's deception of A with A's purchases is that the deception itself did not pertain to the intrinsic characteristics of the securities purchased by A, to their investment value, or to the elements of the actual securities transactions between A and TS. The deception pertained solely to BI's intent to breach fiduciary obligations to A and B by misusing information about A's market strategies in purchasing T's securities. It is unclear whether this constitutes a sufficient nexus between BI's deception and A's purchase of securities. Although lower court authority is available, this issue cannot be resolved satisfactorily by reference to Supreme Court precedent. The Supreme Court addressed the "in connection with" requirement, although not definitively, in Superintendent of Insurance v. Bankers Life and Casualty Co. Because that case involved a private cause of action, it is more appropriately considered in the ensuing discussion of A's standing to sue under rule 10b-5.

The SEC, encouraged by the concurring and dissenting opinions in Chiarella, has pursued its misappropriation theories with a vengeance. The United States Court of Appeals for the Second Circuit has found the argument especially persuasive, at least in criminal and administrative enforcement proceedings. One of its decisions, United States v. Newman, exemplifies the position developed by the court. The Newman facts can be restated using the symbolic references to the parties previously established in the factual predicate for this commentary. During a five year period BI misappropriated confidential merger and takeover information from A and B and made substantial trading profits in the securities concerned. In prosecuting BI for criminal violations of section 10(b) and rule 10b-5, the government (G) premised BI's duty to disclose

86. See Tully v. Mott Supermarkets, Inc., 540 F.2d 187, 194 (3d Cir. 1976) ("'in connection with the purchase or sale' of any security contemplates a causal connection between the alleged fraud and the purchase or sale of stock").
89. See infra notes 96-120 and accompanying text.
91. Id. at 15.
not upon a duty to TS but upon a duty to A and B.\textsuperscript{92} Subscribing to Chief Justice Burger's dissent in \textit{Chiarella}, the court concluded that BI's conduct was actionable deception of A and B.\textsuperscript{93} Unfortunately, the court did not distinguish between BI's \textit{nondisclosure} to A and B and BI's theft of the subject information. It is unclear whether the court viewed the \textit{theft} as the requisite deception or, instead, whether it viewed BI's nondisclosure of the breach as deceptive. The latter is at least suggested by the court's use of the term "deceitful misappropriation."\textsuperscript{94}

Concerned only with the scope of rule 10b-5 and not with the standing issue which arises in private litigation, the \textit{Newman} court rather summarily concluded that BI's fraud was "in connection with" the purchase of a security.\textsuperscript{95} Interestingly, the nexus found by the court was not a causal one related to purchases by A. Instead, an arrow was drawn from BI's fraud to BI's purchase of a security. Restated, the court held that it was a criminal violation of section 10(b) and rule 10b-5 for BI to defraud A and B in connection with BI's purchase of a security from TS, despite the \textit{Chiarella} view that TS was not at all deceived. If one completes this \textit{reductio ad absurdum}, the question might arise whether BI defrauded himself. This underscores the question, "Who's suing who?" In \textit{Newman} it was G against BI.\textsuperscript{96} Fortunately, the Second Circuit has not applied a similar rationale in private actions under rule 10b-5.

\textsuperscript{92} \textit{Id.} at 15-16.
\textsuperscript{93} \textit{Id.} at 17. The Second Circuit stated:

\begin{quote}
By sulllying the reputations of Courtois' and Antoniu's employers [B] as safe repositories of client confidences, appellee and his cohorts [BI] defrauded those employers as surely as if they took their money. . . . Appellee and his cohorts [BI] also wronged Morgan Stanley's and Kuhn Loeb's clients [A], whose takeover plans were keyed to target company stock prices fixed by market forces, not artificially inflated through purchases by purloiners of confidential information.
\end{quote}

\textit{Id.}

\textsuperscript{94} \textit{See id.} at 18.

\textsuperscript{95} \textit{Id.}

\textsuperscript{96} \textit{Id.} at 14. Relying extensively on \textit{Newman}, one court has noted that the government may be the only proper plaintiff in a suit using the misappropriation theory:

\begin{quote}
Because of the judicially-created standing requirement limiting private rule 10b-5 damage claims to purchasers or sellers of securities, the extension of liability under section 10(b) and Rule 10b-5 made possible by the misappropriation theory will be useful only for actions instituted by government agencies. . . . Prudent exercise of these governmental agencies' inherent prosecutorial discretion no doubt will limit even further the actions brought under the misappropriation theory.
\end{quote}

B. Standing to Sue Under Rule 10b-5

A significant impasse to A's private cause of action is the specialized standing requirement imposed by rule 10b-5. In Birnbaum v. Newport Steel Corp., the Second Circuit established the rule that only a defrauded purchaser or seller of securities has standing to bring an implied private right of action under rule 10b-5. In its view, the language of the rule, which proscribes "fraud or deceit upon any person, in connection with the purchase or sale of any security," means "any person" who was defrauded in connection with that person's purchase or sale of a security. This construction finds support in the SEC's stated purpose for the rule's adoption, to close "a loophole in the protections against fraud...prohibiting [any person] from buying securities if they engage in fraud in their purchase." The Second Circuit concluded that section 10(b) was directed solely at that type of misrepresentation or fraudulent practice usually associated with the sale or purchase of securities, and was not directed at "fraudulent mismanagement" or "a breach of fiduciary duty by corporate insiders...using their position to profit in the sale or exchange of corporate securities." The Supreme Court subsequently adopted Birnbaum's purchaser-seller rule in Blue Chip Stamps v. Manor Drugstores.

The Birnbaum rule, as adopted in Blue Chip Stamps, should not be construed simplistically as only requiring that a plaintiff be a purchaser or seller of securities, regardless of whether the deception relates to those securities. It also requires a nexus between the fraud and the purchase or sale of the securities. Previously in this commentary, the only nexus identified in the factual predicate, albeit tenuous, was between BI's deception of A and B and A's purchases of T's securities. The Second Circuit in Newman, a criminal action, stretched the "in connection with" language to find a nexus between BI's deception and BI's purchases of T's securities. However, the Second Circuit in Birnbaum, a private action, ruled that the nexus must be between the defrauded plaintiff and that plaintiff's purchase or sale of a security. Much of the confu-

97. 193 F.2d 461 (2d Cir. 1952).
98. Id. at 464.
99. Id. at 463.
101. 193 F.2d at 464.
103. 664 F.2d 12, 18 (2d Cir. 1981).
104. 193 F.2d at 464.
sion may be attributable to the Supreme Court's opinion in *Superintendent of Insurance*. In that case the Supreme Court was confronted with a rule 10b-5 private action in which an insurance company, a seller of securities, "was duped into believing that it, the seller, would receive the proceeds" from the sale. Although the insiders misappropriating those proceeds were not buyers or sellers of the subject securities, the Court found a sufficient nexus between the fraud and the issuer's sale of securities. The deception pertained to the consideration to be paid for the securities, a significant element of the seller's securities transaction. Thus, the insiders' deception of the seller included not only a nondisclosure of their breach of fiduciary duties, but also a misrepresentation of a material fact constituting an essential element of the sale. This clearly contrasts with BI's nondisclosure of an intent to breach a fiduciary duty, unaccompanied by any misrepresentation or nondisclosure relating to the subject securities. It is this distinction that marks the line between the state law of fiduciary duty and the federal law of rule 10b-5. Unfortunately, the Second Circuit in *Newman* and similar cases has seized upon Justice Douglas' reference in *Superintendent of Insurance* to deceptive conduct "touching" the sale of securities. The use of the term "touching," according to Professor Loss, may be more attributable to Justice Douglas' literary style than to some expansive construction of the "in connection with" requirement.

The Second Circuit in *Chemical Bank v. Arthur Anderson & Co.*, a private action, refused to accord Justice Douglas' "touching" language the expansive effect the court gave the term in *Newman*. Instead, it agreed with and quoted Professor Loss' interpretation that no expansion of the "in connection with" requirement was intended. In *Chemical Bank* the requisite sale of securities was a parent corporation's pledge of its subsidiary's stock to secure the plaintiff bank's loan to the subsidiary. The requisite deception was the parent corporation's allegedly false financial statements de-

106. 404 U.S. at 9.
107. Id. at 10.
108. Id.
110. Id. at 18. In *Superintendent of Insurance* Justice Douglas stated: "The crux of the present case is that [plaintiff] suffered an injury as a result of deceptive practices touching its sale of securities..." 404 U.S. at 12-13.
111. L. Loss, supra note 17, at 904.
113. Id. at 942.
114. Id. at 943.
livered to the bank prior to consummation of the loan transaction.\textsuperscript{115} Noting that the Supreme Court had side-stepped the issue in \textit{Rubin v. United States},\textsuperscript{116} Judge Friendly stated that misrepresentations or omissions that are involved in a securities transaction but do not pertain to the securities themselves cannot form the basis for a violation of section 10(b) and rule 10b-5.\textsuperscript{117} Judge Friendly's statement regarding the scope of rule 10b-5 is especially instructive:

The purpose of section 10(b) and rule 10b-5 is to protect persons who are deceived in securities transactions—to make sure that buyers of securities get what they think they are getting and that sellers of securities are not tricked into parting with something for a price known to the buyer to be inadequate or for a consideration known to the buyer not to be what it purports to be.\textsuperscript{118}

The nexus between BI's nondisclosure of an intent to breach a fiduciary duty to A and A's purchases of T's securities is even more remote than the connection found inadequate in \textit{Chemical Bank}. The deception not only fails to pertain to the securities themselves, but, unlike \textit{Chemical Bank}, the deception does not form a part of the transaction in which the securities were sold. BI's conduct is analogous to that of an attorney who promises a client that he or she will perform all fiduciary duties faithfully in managing the client's investments while secretly intending to steal the client's securities. In \textit{Pross v. Katz}\textsuperscript{119} the Second Circuit held on these facts that the attorney, who subsequently did steal his client's securities, had not violated rule 10b-5.\textsuperscript{120} The court concluded that to hold otherwise would render \textit{Santa Fe} meaningless and would imprudently extend the reach of rule 10b-5 to cover every conversion of property that involves securities.\textsuperscript{121} A's encounter with the "in connection with"

\textsuperscript{115} Id.
\textsuperscript{116} See 449 U.S. 424 (1981) (holding the pledge of stock for a loan to be an "offer or sale" of securities under § 17(a) of the Securities Act of 1933).
\textsuperscript{117} 726 F.2d at 943-45.
\textsuperscript{118} Id. at 943.
\textsuperscript{119} 784 F.2d 455 (2d Cir. 1986).
\textsuperscript{120} Id. at 458. In this case, Pross, a dentist, purchased securities in a limited partnership interest upon the recommendation of Katz, Pross' attorney, and the real estate developer who controlled the partnership. Id. at 456. Despite alleged promises to "manage Pross' investments faithfully," Katz allegedly took fraudulent steps to divest Pross of his investments. Id. at 456-57. The court held that the breach of a promise faithfully to perform fiduciary duties while secretly intending to breach that duty does not violate rule 10b-5. Id. at 458.
\textsuperscript{121} 784 F.2d at 458. The Second Circuit stated: "The complaint here alleges no more than a conversion of property that happened to involve securities. We are unwill-
requirement should fare no better. Absent a greater nexus between BI's deception and A's purchase, the standing requirement under rule 10b-5 is not satisfied.

C. The Elements of a Private Cause of Action

The failure by A to satisfy the standing requirement is, of course, fatal to its private cause of action under rule 10b-5. It is, therefore, unnecessary to examine at great length whether the factual predicate might otherwise establish a prima facie case. In addition to a showing that the requisite deception occurred in connection with the purchase or sale of a security, other elements include (1) the misrepresentation or omission of a fact, (2) which fact is material, (3) which is made or omitted with scienter or the intent to deceive, (4) which is justifiably relied upon by the plaintiff, (5) and which results in damages to the plaintiff.122 The federal courts have not yet analyzed these elements in the precise context presented by the factual predicate considered in this commentary. However, the Second Circuit has been faced with a private action corollary of Newman, although it involved a different alignment of the parties. Moss v. Morgan Stanley123 does not involve an action brought by A against B and BI but, rather, an action brought by TS against B and BI.124 Nevertheless, Moss provides a useful analogue to A's litigation.

The Newman facts, reconsidered in a private action by the same court in Moss, were substantially similar to the factual predicate addressed in this commentary. Confidential information regarding A's acquisition initiatives, developed by A and B, was misappropriated and used by BI to make trading profits in T's securities.125 In Newman the alignment of the parties was G against BI, and the court concluded that BI was criminally liable under rule 10b-5.126 In Moss the alignment of the parties was TS against B and BI.127 The plaintiff TS sought to represent a class of T's shareholders who had sold

---

122. See also Bochicchio v. Smith Barney, Harris Upham & Co., 647 F. Supp. 1426, 1430 (S.D.N.Y. 1986) ("[T]he conversion of securities, even if it occurs from a brokerage account, does not state a claim under § 10(b).")
124. Id. at 8-9.
125. See id.
126. 664 F.2d at 15.
127. 719 F.2d at 8-9.
securities in the open market contemporaneously with BI's open market purchases.\textsuperscript{128} Guided by Chiarella, the Second Circuit concluded that BI, like Chiarella, had no fiduciary relationship with TS and, consequently, had no duty to disclose.\textsuperscript{129} Absent a duty to disclose, BI's nondisclosure could not satisfy the deception requirement mandated by section 10(b). Efforts by TS to "piggyback" upon the duty owed by BI to A and B met a stonewall. The court concluded: "There is no 'duty in the air' to which any plaintiff can attach his claim."\textsuperscript{130}

Reconciliation of Newman and Moss is an exercise in frustration. In Moss the court could not find the requisite deception. It did not consider the "in connection with the purchase or sale" requirement because there was no deception of TS to connect with any securities transaction. The court's disinclination to provide a windfall recovery to TS solely to discourage BI's tortious conduct against A and B suggests that the court would not have found a sufficient connection.\textsuperscript{131} BI's deception not only failed to deceive TS, but the subject matter of the deception did not pertain to the securities that TS sold. In Newman, on the other hand, the court seemed determined to punish BI for the deception of A and B, without regard to whether the subject matter of the deception pertained to A's or TS's securities transactions. One can only surmise that the result is due to the juxtaposition of policies against windfall damages and in favor of criminal sanctions for deception. Thus, the court may have chosen to read the "in connection with the purchase or sale" phrase of rule 10b-5 more strictly in a private action than in a criminal proceeding, in which the mere "touching" of any securities transaction seems to be enough. Interestingly, the Second Circuit in Newman seeks to protect the general public by incarcerating BI for the tortious deception of A and B, while conceding in Moss that BI owes no duty of disclosure to the general public.

The Second Circuit's fast and loose analysis of the "in connection with" requirement in the criminal context will be scrutinized by the Supreme Court in Carpenter v. United States.\textsuperscript{132} In this case, confidential information regarding an employer's publication schedules was misappropriated and used by an employee and his tippees to

\begin{itemize}
  \item \textsuperscript{128} Id. at 8.
  \item \textsuperscript{129} Id. at 16.
  \item \textsuperscript{130} Id. at 13.
  \item \textsuperscript{131} See id. at 16 ("[P]laintiff's 'misappropriation' theory would grant him a windfall recovery simply to discourage tortious conduct by securities purchasers.").
  \item \textsuperscript{132} 791 F.2d 1024 (2d Cir.), cert. granted, 107 S. Ct. 666 (1986).
\end{itemize}
make trading profits. Because the schedules indicated the exact times that favorable or negative stories about publicly-traded companies would be published, this nonpublic information could be used advantageously in trading those companies' securities in the open market prior to publication. The Second Circuit identified the requisite deception by taking a tortuous path: (1) the employer had a confidentiality policy applicable to employees; (2) the employee breached his duty of confidentiality by disclosing and exploiting the confidential information to make trading profits in securities; (3) the employee's breach of the duty of confidentiality, without mention of any duty to disclose, constituted deception.

The court then concluded that the "in connection with" requirement was satisfied by reference both to the employee's securities transactions (analogous to BI's purchases) and to the corresponding transactions by an indeterminate group of investors with whom the employee traded (analogous to TS's sales). Through this nefarious logic, BI's breach of fiduciary duties, despite the caveat of Santa Fe, is elevated to a breach of the federal securities laws. In reviewing this case, the Supreme Court has the choice of rewriting Santa Fe or allowing Congress to rewrite the law.

V. CONCLUSION

The misappropriation theory, whether applied in the context of A against BI, G against BI, TS against BI, or even B against BI, works a serious distortion of rule 10b-5 jurisprudence. While Santa Fe undertook to mark a bright line between state law breaches of fiduciary duty and violations of rule 10b-5, Chiarella and its progeny have dulled that line by constructing rule 10b-5 law on state law theories of fiduciary duty. The Second Circuit, at least in the criminal context, has erased the line by annexation of virtually any intentional tort or breach of contract somehow associated with a securities transaction. Although the Supreme Court in Carpenter may clarify the "in connection with" requirement of rule 10b-5, its solution is likely to provide only temporary relief from the uneasy tension between state and federal law in this area.

133. Id. at 1026-27.
134. Id. at 1031.
135. Id. at 1031-34.
136. Id. at 1032-33.
The factual predicate considered in this commentary demands a federal remedy, not only to protect the investment banker's clients, but to protect the marketplace generally against the unscrupulous use of confidential business information. It is as clear now as it was in 1929 that state tort law is insufficient to address all the abuses in interstate securities trading. It is equally clear that an ad hoc approach to insider trading under rule 10b-5 has resulted in confusion and uncertainty. Regardless of the outcome in Carpenter, Congress should define both the insider and outsider trading it intends to prohibit and should develop a comprehensive public and private remedial scheme to enforce those prohibitions. The integrity of the marketplace in securities is one of the nation's greatest assets and should be protected against all forms of corruption.