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Insider Trading as Fraud

Zachary J. Gubler

INSIDER TRADING AS FRAUD[*]

ZACHARY J. GUBLER[**]

Federal insider trading law consists, for the most part, of federal common law rooted in a statutory regime that prohibits securities fraud. Commentators have long lamented this fact, viewing the law's grounding in an antifraud statute as a quirk of history with little to recommend it. After all, what does fraud have to do with insider trading?

A lot, it turns out. In this Article, I develop a theory explaining and defending the fraud-based nature of federal insider trading law. Specifically, I argue that Rule 10b-5, the antifraud rule in question, should be understood as altering the common law rule barring parties from contracting for fraud liability. As contract scholars have shown, this common law rule prevents contracting parties from effectively deterring certain hard-to-detect breaches of which insider trading is but one example. Rule 10b-5, I argue, reverses the common law rule, allowing contracting parties to contract for fraud liability and the accompanying extracompensatory damages for insider trading.

The implications of this explanation of the fraud-based nature of insider trading are significant. First, it explains the current—often derided—shape of the doctrine. Second, it identifies the proper scope of insider trading liability, which is not, as many commentators have assumed, limited to purely fiduciary relationships. Third, it provides courts with a tractable way of identifying that scope of liability, laying out an inquiry that turns on the availability of alternatives to fraud liability for deterring insider trading. Finally, it implies that, in interpreting whether a given contractual arrangement gives rise to insider trading liability, the SEC should be able to cast a broader liability net than the courts.

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** Marie Selig Professor of Law, Arizona State University Sandra Day O'Connor College of Law. Special thanks go to Peter Molk, Andrew Tuch, and participants at the ASU Junior Faculty Colloquium. All errors are mine.

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INTRODUCTION

Federal insider trading law[1] is a "riddle, wrapped in a mystery" to repurpose a famous phrase.[2] Consider, for example, that under settled law there is no insider trading liability when a thief—with no relationship to a company—steals the company's material nonpublic information and trades on it.[3] By contrast, there is insider trading liability if the thief happens to be the company's lawyer who trades on his client's material nonpublic information in breach of his fiduciary duty of loyalty and confidentiality.[4] However, the lawyer can escape that liability simply by informing his client of his intent to trade ahead of time.[5] In fact, he might even be able to escape liability by disclosing mere circumstantial evidence of his breach—for example, his bank account statement showing unusual (and unusually large) deposits.[6] Let us refer to these three examples as the "unaffiliated thief," the "brazen fiduciary,"[7] and the "halfhearted fiduciary," respectively. What explains the absence of liability in these three propositions?

1. When this Article uses the term "insider trading," it means trading on the basis of material nonpublic information regardless of one's position.

2. *See* Winston Churchill, *Russia: 'A Riddle, Wrapped in a Mystery, Inside an Enigma'*, *in* NEVER GIVE IN!: THE BEST OF WINSTON CHURCHILL'S SPEECHES 199, 199 (Winston S. Churchill ed., 2003).

3. This is the clear implication of Supreme Court case law. *See* United States v. O'Hagan, 521 U.S. 642, 651–52 (1997); Chiarella v. United States, 445 U.S. 222, 232–33 (1980); *see also* SEC v. Dorozhko, 574 F.3d 42, 44 (2d Cir. 2009) (holding an unaffiliated hacker liable on the ground that his fraud lay in his affirmative misrepresentation of identity).

4. *See O'Hagan*, 521 U.S. at 665–66.

5. *Id.* at 655.

6. Admittedly, this result is not as obvious as the others. However, it follows from *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462, 479–80 (1977), where the Court held that there was no Rule 10b-5 liability, and *United States v. O'Hagan*, 521 U.S. at 665–66, where it held that there was. The only difference between the two cases is that in *Santa Fe*, the breach arose in a context—a freeze-out merger—where there was substantial disclosure pursuant to federal law, so much so that it was not difficult for the plaintiffs to allege a fiduciary breach based on publicly available information. However, this might only follow once one views these two cases through the lens of the contractual fraud theory, which I think is one of its benefits. Many—if not most—commentators working with other theories find these cases to be more or less irreconcilable. *See infra* note 18 and accompanying text.

7. This is Donna Nagy's term. *See* Donna M. Nagy, *Reframing the Misappropriation Theory of Insider Trading Liability: A Post-*O'Hagan *Suggestion*, 59 OHIO ST. L.J. 1223, 1257 (1998) [hereinafter Nagy, *Reframing Misappropriation*].

One possibility is fraud. After all, Rule 10b-5,[8] the heart of the federal insider trading law regime, prohibits fraud in connection with the purchase or sale of securities.[9] Perhaps these scenarios simply fall short of fraud. Upon closer inspection, however, this explanation does not seem immediately convincing. If fraud were to explain these results, then it is an unusual type of fraud, indeed. To be sure, the common law of fraud has long recognized liability where someone fails to disclose material information while under a duty to do so,[10] but it does not typically countenance liability for breaches of other duties, such as the lawyer's duty of loyalty and confidentiality in the hypothetical above. Nor should this result change if such breaches are done in complete secret (they usually are, after all).[11] Therefore, it is not clear why disclosing such breaches, either by the brazen or halfhearted fiduciary, would have any effect on liability under traditional views of fraud.

Perhaps for this reason, many commentators view insider trading law's roots in fraud as hardly more than a quirk of history with little to recommend it.[12] Instead, they tend to sidestep the text of Rule 10b-5 altogether, favoring the

8. 17 C.F.R. § 240.10b-5 (2019) (making it illegal "(a) [t]o employ any device, scheme, or artifice to defraud, (b) [t]o 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) [t]o 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"); *see also* 15 U.S.C. § 78j(b) (2018) (making it illegal "[t]o 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, or any securities-based swap agreement any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors").

9. 17 C.F.R. § 240.10b-5.

10. *See, e.g.*, RESTATEMENT (SECOND) OF TORTS § 551(1)–(2)(a) (AM. LAW INST. 1977) ("(1) One who fails to disclose to another a fact that he knows may justifiably induce the other to act or refrain from acting in a business transaction is subject to the same liability to the other as though he had represented the nonexistence of the matter that he has failed to disclose, if, but only if, he is under a duty to the other to exercise reasonable care to disclose the matter in question. (2) One party to a business transaction is under a duty to exercise reasonable care to disclose to the other before the transaction is consummated, (a) matters known to him that the other is entitled to know because of a fiduciary or other similar relation of trust and confidence between them . . . .").

11. *See* Donald Langevoort, *Rereading* Cady, Roberts*: The Ideology and Practice of Insider Trading Regulation*, 99 COLUM. L. REV. 1319, 1323 (1999) [hereinafter Langevoort, *Rereading* Cady, Roberts] (suggesting that all breaches are concealed and therefore that concealment is not a persuasive way to distinguish *Santa Fe* and *O'Hagan*).

12. *See, e.g.*, Stephen M. Bainbridge, *Insider Trading Regulation: The Path Dependent Choice Between Property Rights and Securities Fraud*, 52 SMU L. REV. 1589, 1644 (1999) [hereinafter Bainbridge, *Insider Trading Regulation*] (characterizing the insider trading prohibition's location in a securities fraud statute as a "historical accident"); Samuel W. Buell, *What Is Securities Fraud?*, 61 DUKE L.J. 511, 561 (2011) ("The fit between insider trading and securities fraud is famously awkward."); Thomas Lee Hazen, *Identifying the Duty Prohibiting Outsider Trading on Material Nonpublic Information*, 61 HASTINGS L.J. 881, 889 (2010) ("[D]ealing with insider trading through an antifraud rule is like trying to fit a square peg into a round hole."); Jeanne L. Schroeder, *Taking Stock: Insider and Outsider Trading by Congress*, 5

view that insider trading is really about one of three things: enforcing property rights in information,[13] rooting out private corruption perpetrated by fiduciaries,[14] or protecting against unjust enrichment.[15] But if there is a preference for these alternative theories, it cannot be because they do a better job than the fraud-based theory in explaining the shape of the law; they do not. The property and unjust enrichment theories cannot explain the lack of liability for the unaffiliated thief. One normally cannot avoid liability for stealing another person's property on the grounds that the property owner is a perfect stranger.[16] Nor does the fact that the parties are strangers make the enrichment any less unjust.[17] Further, none of these alternative theories can explain why liability should turn on disclosure of the breach itself, whether of the brazen or more halfhearted variety.[18]

In this Article, I develop a theory—what I call the "contractual fraud theory"—that is respectful of the fraud-based nature of Rule 10b-5's text and at

WM. & MARY BUS. L. REV. 159, 176 (2014) (characterizing as "refreshing[]" a proposal that the "federal courts . . . recognize that insider trading law does not involve fraud").

13. *See* United States v. Chestman, 947 F.2d 551, 576–77 (2d Cir. 1991) (Winter, J., concurring in part and dissenting in part); Stephen M. Bainbridge, *Incorporating State Law Fiduciary Duties into the Federal Insider Trading Prohibition*, 52 WASH. & LEE L. REV. 1189, 1255 n.278 (1995) [hereinafter Bainbridge, *Incorporating State Fiduciary Duties*]; Bainbridge, *Insider Trading Regulation*, *supra* note 12, at 1589; Dennis W. Carlton & Daniel R. Fischel, *The Regulation of Insider Trading*, 35 STAN. L. REV. 857, 861 (1983) ("[T]he insider trading debate is really a debate about whether the firm, as a matter of contract, should be able to allocate property rights in valuable information to managers or to investors."); Frank H. Easterbrook, *Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information*, 1981 SUP. CT. REV. 309, 312 (arguing that "the central question [is] whether the principal [has] a property interest sufficient to require the agent neither to use nor to disclose [inside information] without the principal's consent"); David D. Haddock & Jonathan R. Macey, *A Coasian Model of Insider Trading*, 80 NW. U. L. REV. 1449, 1449 (1986); Kimberly Krawiec, *Fairness, Efficiency, and Insider Trading: Deconstructing the Coin of the Realm in the Information Age*, 95 NW. U. L. REV. 443, 445 (2001); Jonathan R. Macey, *From Fairness to Contract: The New Direction of the Rules Against Insider Trading*, 13 HOFSTRA L. REV. 9, 11 (1984) [hereinafter Macey, *From Fairness to Contract*]; Kenneth Scott, *Insider Trading: Rule 10b-5, Disclosure and Corporate Privacy*, 9 J. LEGAL STUD. 801, 804 (1980) (discussing "protection to the property rights of the firm in inside information").

14. *See, e.g.*, Sung Hui Kim, *Insider Trading as Private Corruption*, 61 UCLA L. REV. 928, 932–33 (2014).

15. *See, e.g.*, Robert Thompson, *The Measure of Recovery Under Rule 10b-5: A Restitution Alternative to Tort Damages*, 37 VAND. L. REV. 349, 391 (1984) (explaining the proper way to calculate damages for insider trading assuming that liability inquiry has to do with whether someone has been unjustly enriched).

16. *See infra* notes 179–86 and accompanying text.

17. *See infra* notes 179–86 and accompanying text.

18. In fact, most commentators agree that the lack of liability for the "brazen fiduciary" is indefensible. *See* Kim, *supra* note 14, at 1003–04 (opining that this "doctrinally odd result makes no policy sense"); Nagy, *Reframing Misappropriation*, *supra* note 7, at 1256 n.169 (quoting another commentator as characterizing *O'Hagan*'s "full disclosure to the source exception" as a "foul ball" (quoting Joseph McLaughlin, 'O'Hagan'*: Some Answers, More Questions*, N.Y. L.J., July 1, 1997, at 1, 1); Richard W. Painter, Kimberly D. Krawiec & Cynthia A. Williams, *Don't Ask, Just Tell: Insider Trading After* United States v. O'Hagan, 84 VA. L. REV. 153, 179–80 (1998) (characterizing this concession by the *O'Hagan* majority as "startling"); *see also infra* notes 124–37 and accompanying text.

the same time manages to explain modern insider trading law. I argue that the fraud-like remedies available under Rule 10b-5 serve to facilitate certain types of contracting over information that might not be available under the common law but that are nevertheless valuable in light of the high costs involved in detecting insider trading.[19]

The contracting problem at the heart of the contractual fraud theory arises from the observation that, in most cases, the information that forms the basis of insider trading does not benefit from the protection of property rights.[20] Imagine a firm that wishes to hire a consultant to provide strategic advice regarding a potential merger. If the firm wants to protect its merger-related information against impermissible uses by the consultant, including insider trading,[21] it will need to rely on fiduciary duty law (assuming the consultant is a fiduciary) and contract law. Both sources of law incorporate provisions that prohibit insider trading. Under the duty of loyalty, fiduciary duty law prohibits a fiduciary from using its principal's assets—including the principal's information—for its own gain.[22] Under contract law, contracting parties can make use of confidentiality and non-use provisions that would similarly prohibit insider trading.[23]

19. As contract scholars have shown, the costs of verifying a contract breach (what I call here, "the costs of detection") can cause contracting to break down. *See* Aaron S. Edlin & Alan Schwartz, *Optimal Penalties in Contracts*, 78 CHI.-KENT L. REV. 33, 33–35 (2003); Gregory Klass, *Contracting for Cooperation in Recovery*, 117 YALE L.J. 2, 2 (2007). The obvious contractual solution to the problem posed by the costly detection inherent in insider trading is to contractually require the information recipient to cooperate in recovery. But such contractual provisions—like an obligation to disclose a breach—are not effective unless enforced with fraud liability, which is not available under the common law. By restoring fraud liability for insider trading, Rule 10b-5 helps solve this contracting problem.

20. The domain of patent law is limited to processes, machines, articles of manufacture, or compositions of matter. If copyright law applied to the information, it would only prevent it from being duplicated in a graphic form. Finally, trade secret law covers information essentially having to do with the domain of patent law and, therefore, would exclude the type of event-driven market information discussed in the example.

21. Perhaps the firm does not want there to be unusual trading in the target company's stock for fear of prematurely tipping off the market to a pending merger announcement. *See* Carlton & Fischel, *supra* note 13, at 881–82; Easterbrook, *supra* note 13, at 328–29. More generally, however, the firm's confidential information is an asset, and it does not want to give away that asset for free. *See, e.g.*, Michael Burstein, *Exchanging Information Without Intellectual Property*, 91 TEX. L. REV. 227, 232–33 (2012) (discussing how biotech companies exchange valuable information in the absence of property rights).

22. *See* RESTATEMENT (THIRD) OF AGENCY § 8.05 (AM. LAW INST. 2006) ("An agent has a duty (1) not to use property of the principal for the agent's own purposes or those of a third party; and (2) not to use or communicate confidential information of the principal for the agent's own purposes or those of a third party."). For this reason, courts usually view insider trading as a breach of fiduciary duty. *See, e.g.*, *In re* Oracle Corp., 867 A.2d 904, 905 (Del. Ch. 2004); Brophy v. Cities Serv. Co., 70 A.2d 5, 7 (Del. Ch. 1949).

23. *See, e.g.*, MODEL MERGER AGREEMENT FOR THE ACQUISITION OF A PUBLIC COMPANY 350–51 (AM. BAR ASS'N 2011) (setting forth a model nonuse and confidentiality provision).

However, this is, at best, only an incomplete solution to the problem facing our hypothetical firm because it only works if the firm is able to detect when the consultant has breached that underlying duty. And yet, given information's non-rivalrous nature[24]—in other words, the fact that its use does not alter anyone else's use—insider trading is an almost archetypal example of a breach that is very costly to detect.[25] As the contract literature points out, in cases where such detection costs are high, contracting might break down.[26]

There is, however, one possible contracting solution to this "costly detection problem."[27] Our hypothetical firm could decide to contractually require the consultant to cooperate with it in detecting a breach of the underlying duty, whether that underlying provision is located in a fiduciary relationship or a contractual one.[28] In particular, the firm could insist on a covenant to report any breach of the underlying duty. Let us call this a "reporting covenant." Thus, the firm would effectively say to the consultant: "You are prohibited from using our information for insider trading purposes, and you have an obligation to report any insider trading in violation of this covenant not to trade."

This is a potentially elegant solution but only if the failure to report the underlying violation—in our example, the insider trading—is subject to extracompensatory damages. After all, if the underlying violation gives rise to contract damages and the failure to report that violation does not result in any additional damages, then there is no incentive to report the violation.[29] The solution is "elegant" because normally the failure to disclose information in the face of a duty to do so constitutes fraud and is subject to extracompensatory damages.[30] However, notice that it is only *potentially* elegant because, at common law, courts are extremely reluctant to allow contracting parties to "contract for fraud liability"; that is to say to enforce the breach of a contractual

24. Non-rivalry is the property of a good whereby use of the good by one person does not diminish the value of its use to another. *See, e.g.*, Michael A. Carrier, *Cabining Intellectual Property Through a Property Paradigm*, 54 DUKE L.J. 1, 32 (2004).

25. *See, e.g.*, Albert Choi & George Triantis, *Completing Contracts in the Shadow of Costly Verification*, 37 J. LEGAL STUD. 503, 504–05 (2008) (providing confidentiality agreements as an example of a contract provision with high detection costs).

26. *See id.* at 503 ("In contract theory, verification costs are an important barrier to complete contracts.").

27. The contract literature actually tends to refer to these problems as ones involving costly verification, by which it means to refer to the costs of proving a breach in court. *See, e.g.*, Klass, *supra* note 19, at 2. I instead choose to use the word "detection" throughout this Article, even though I mean the same thing as "verification," simply because I think it is more intuitive for those readers who are not familiar with the contracting literature.

28. In other words, while the underlying confidentiality or non-use agreement might come from fiduciary duty law or contract, the reporting covenant would be an additional contract provision that overlays the relationship.

29. Klass, *supra* note 19, at 7, 12.

30. *See* RESTATEMENT (SECOND) OF TORTS § 551(1)–(2)(a) (AM. LAW INST. 1977).

disclosure obligation through extracompensatory (in other words fraud) damages.[31]

Under the contractual fraud theory, Rule 10b-5 reverses this common law rule, at least with respect to a particularly hard-to-detect breach: insider trading. This means that parties can *explicitly* contract for fraud liability for insider trading through the use of a reporting covenant like the one in our hypothetical. That, in and of itself, constitutes a significant break with the common law.[32] But the contractual fraud theory also means that courts can—in certain circumstances—find that parties have contracted for fraud liability *implicitly* under Rule 10b-5. To make this determination, courts—but not necessarily the United States Securities and Exchange Commission ("SEC")[33]—should engage in the hypothetical bargain analysis familiar to contract scholarship.[34] In other words, the court should ask whether the parties themselves would have opted into the Rule 10b-5 regime if they had explicitly addressed this issue.

The contractual fraud theory represents a dramatic departure from how scholars have traditionally thought about federal insider trading law. Under what is arguably the dominant theory,[35] insider trading law is about protecting property rights in information.[36] The contractual fraud theory turns that thinking on its head. Under this new theory, insider trading law is not about protecting property rights in information; it is about facilitating contracting over information *in the absence* of property rights.[37]

The contractual fraud theory has several advantages. First, it is simply more respectful of the fraud-based nature of Rule 10b-5's text than alternative

31. *See* Klass, *supra* note 19, at 2.

32. *See id.*; *see also* RESTATEMENT (SECOND) OF CONTRACTS § 355 (AM. LAW INST. 1981) ("Punitive damages are not recoverable for a breach of contract.").

33. The SEC should probably take a different approach, considering not simply the private welfare of the contracting parties but the welfare of the public more generally. This means that the SEC might have a different view of the scope of insider trading liability under Rule 10b-5 than the Supreme Court. *See infra* Section III.C.

34. *See, e.g.*, David Charny, *Hypothetical Bargains: The Normative Structure of Contract Interpretation*, 89 MICH. L. REV. 1815, 1877 (1991) ("Courts generally interpret contracts — resolve ambiguities and fill in missing terms — by asking what the parties would have agreed to had they explicitly addressed the issue before the court.").

35. *See* Bainbridge, *Insider Trading Regulation*, *supra* note 12, at 1606 ("There is a growing consensus that the federal insider trading prohibition is more easily justified as a means of protecting property rights in information than as a way of protecting investors.").

36. *See id*.

37. There is some work on the more general issue about how one can contract for information in the absence of property rights, including the nonlegal strategies that contracting parties take to limit impermissible uses of the information being shared. *See, e.g.*, Burstein, *supra* note 21, at 227. As discussed in greater depth below, contracting parties can of course undertake such strategies to limit insider trading. *See infra* notes 232–33 and accompanying text. However, there is a point where it is more cost effective to rely on the threat of legal liability as a mechanism to deter such impermissible uses.

theories of insider trading.[38] Furthermore, unlike the other available theories, the contractual fraud theory actually explains the law as it has been received.[39] In particular, the contractual fraud theory helps untangle that "riddle, wrapped in a mystery" mentioned previously.[40] Take the case of the lack of liability for the unaffiliated thief. Because the contractual fraud theory requires—at the very least—a contractual relationship, there shouldn't be any liability in that situation, which is what the cases tell us.[41] And since, under the contractual fraud theory, the point of Rule 10b-5 is to lessen the costs of detecting insider trading, there shouldn't be liability where those costs are already at a minimum because the brazen or halfhearted fiduciary has essentially disclosed the breach.[42] Again, this is precisely the result reached in the relevant jurisprudence.

If the contractual fraud theory is correct, then the implications for insider trading law are significant. First, contrary to the claims of certain commentators,[43] insider trading liability should not be limited to purely fiduciary relationships but should extend to at least some contractual ones as well.[44] Second, the contractual fraud theory implies that it is misguided for courts, like the Second Circuit in its influential *United States v. Chestman*[45] opinion, to determine whether Rule 10b-5 applies to a non-fiduciary relationship through the use of an unwieldy, indeterminate list of factors aimed at identifying what is essential about fiduciary relationships.[46] The point of the contractual fraud theory is that, for purposes of insider trading law, there is in fact nothing magical about fiduciary relationships. Rule 10b-5 is really about harnessing contract-based fraud liability to solve a contracting problem left unaddressed by the common law. Whether the underlying duty to refrain from insider trading arises from fiduciary duty law[47] or a contract provision[48] is beside the point.

38. *See infra* Section II.B.2–3.

39. *See infra* Section II.B.1.

40. *See supra* notes 2–7 and accompanying text.

41. *See infra* notes 270–71 and accompanying text.

42. *See infra* notes 270–71 and accompanying text.

43. *See, e.g.*, Stephen M. Bainbridge, *Regulating Insider Trading in the Post-Fiduciary Duty Era: Equal Access or Property Rights?*, *in* RESEARCH HANDBOOK ON INSIDER TRADING 80, 87 (Stephen M. Bainbridge ed., 2013) [hereinafter Bainbridge, *Post-Fiduciary Duty Era*].

44. *See infra* Section II.B.1.

45. 947 F.2d 551, 567 (2d Cir. 1991) (en banc).

46. *See id.*; United States v. Kim, 184 F. Supp. 2d 1006, 1011 (N.D. Cal. 2002) (characterizing *Chestman* as requiring the following elements to establish a fiduciary-like relationship: "1) disparate knowledge and expertise, 2) a persuasive need to share confidential information, and 3) a legal duty to render competent aid").

47. The common law says that it does. *See, e.g.*, *In re* Oracle Corp., 867 A.2d 904, 905 (Del. Ch. 2004); Brophy v. Cities Serv. Co., 70 A.2d 5, 8 (Del. Ch. 1949) (holding that insider trading is a violation of the duty of loyalty).

48. For example, a traditional non-use provision prohibiting the contracting party's use of its counterpart's information for anything other than a narrowly defined set of things.

Finally, the contractual fraud theory gestures toward the proper role the courts and the SEC should play in determining the scope of insider trading liability. With respect to the courts, the question they should address is whether there are reasons to believe that the relevant parties would have wanted their contractual solution for protecting the information at issue to be enforced by the extracompensatory damages of Rule 10b-5.[49] With respect to the SEC, the contractual fraud theory would allow a broader inquiry that takes into account not just the private costs and benefits of insider trading but the public ones, as well. In this sense, under the contractual fraud theory, the SEC might take a different view of Rule 10b-5 than the courts.

This Article proceeds in three parts. Part I is background. It tells the story of how the Supreme Court and the SEC have constructed a body of insider trading law based on Rule 10b-5. It also discusses the extant theories of insider trading, those narratives that explain what insider trading is all about, and why these theories do a poor job of explaining the law as it has been received. Part II develops the contractual fraud theory, demonstrates how it differs from the extant theories of insider trading, and explains why it does a better job than those theories in explaining the current state of the law. Part III sketches out the implications of the contractual fraud theory and identifies what the theory means for the future of federal insider trading law.

I. BACKGROUND

In 1942, the SEC adopted Rule 10b-5,[50] which prohibits fraud in connection with the purchase or sale of securities.[51] The rule was adopted with little fanfare, which should not be all that surprising considering that it was viewed at the time as little more than a rule aimed at addressing securities fraud.[52] There was no indication that anyone thought that the rule had anything

49. This question will itself turn on additional considerations, including the difficulty of detecting the breach in question and the availability of alternative methods for enforcing compliance. *See infra* Section II.A.1.a.

50. Employment of Manipulative and Deceptive Devices by any Purchaser of a Security, 13 Fed. Reg. 8183–84 (Dec. 22, 1948), codified as amended at 17 C.F.R. § 240.10b-5 (2019).

51. 15 U.S.C. § 78j(b) (2018) (making it illegal "[t]o 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, or any securities-based swap agreement[,] any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors"); *see* 17 C.F.R. § 240.10b-5 (making it illegal "(a) [t]o employ any device, scheme, or artifice to defraud, (b) [t]o 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) [t]o 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").

52. *See* THOMAS LEE HAZEN, THE LAW OF SECURITIES REGULATION 467 (2005). In fact, in one of the few comments made regarding the proposed rule, Commissioner Sumner Pike famously said, "[W]e are against fraud, aren't we?" *Id.*

to do with insider trading law. However, the lack of any forthcoming insider trading legislation on the part of Congress, combined with an increasing number of insider trading cases crossing the SEC's desk, required the Commission's enforcement arm to get creative. So, in the early 1960s, the SEC began crafting a strategy to build insider trading law on top of Rule 10b-5.[53] This strategy led to a winning streak in the lower courts, causing the great Professor Louis Loss to observe that "Rule 10b-5 . . . seems to be taking over the universe gradually."[54] It wasn't until the late 1970s that the Supreme Court started imposing constraints on the SEC's vision.[55]

A. *How Insider Trading Laws Have Developed*

1. *Santa Fe v. Green*: The Centrality of Fraud

Of these constraints, one of the most important was articulated in *Santa Fe Industries Co. v. Green*,[56] when the Supreme Court held that Rule 10b-5 required something more than just a garden-variety state fiduciary duty claim.[57] In other words, when the rule discussed fraud, it really meant fraud.

Santa Fe involved a shareholder challenge to a freeze-out merger by the majority shareholder.[58] The plaintiffs in the suit, minority shareholders who voted against the merger, objected to the merger price on the ground that it undervalued the corporation's assets.[59] These shareholders could have brought an action in the Delaware Chancery Court, the place of the target's incorporation, for a judicial appraisal of the value of their shares.[60] Instead, they brought a suit in federal court under Rule 10b-5.[61]

The problem, however, was that Rule 10b-5 requires fraud, and there was no apparent fraud in the case.[62] There was no breach of an affirmative representation. Nor was there any fraudulent non-disclosure, at least not under the traditional reading of that doctrine.[63] Under the traditional reading, a claim

53. *See* Adam C. Pritchard, *Justice Lewis F. Powell, Jr., and the Counterrevolution in the Federal Securities Laws*, 52 DUKE L.J. 841, 843–44 (2003) [hereinafter Pritchard, *Powell and the Counterrevolution*].

54. *See id.* at 843.

55. *See id.* at 843–44.

56. 430 U.S. 462 (1977).

57. *See id.* at 479–80.

58. *See id.* at 465–66.

59. *See id.* at 466–67.

60. *See id*.

61. *See id.* at 467.

62. *See id.* at 474.

63. I say "traditional reading" to distinguish it from the theory of fraud that the Court identified in *O'Hagan* and that I am characterizing under the contractual fraud theory of insider trading as a case of the Court finding an implicit reporting covenant—a promise to disclose the breach of an underlying covenant, either a confidentiality or non-use provision, prohibiting insider trading. Non-disclosure of a breach is not historically what gives rise to fraudulent non-disclosure.

for fraudulent non-disclosure arises from a fiduciary's failure to disclose material information to a principal with whom the fiduciary is engaged in a transaction.[64] In *Santa Fe*, the majority shareholder of the target company owed fiduciary duties to the minority shareholders with whom the majority shareholder was engaged in a transaction to acquire the minority shareholders' shares in the target firm.[65] However, all of the information that the majority shareholder had used to value the target's assets and to arrive at a merger price had been disclosed, and disclosed accurately, to the shareholders prior to the merger vote.[66] Indeed, it was these very disclosure materials that the shareholders relied on to demonstrate that the merger price was too low in light of the value of the underlying corporate assets.[67] Thus, under the traditional reading of fraudulent non-disclosure, there was no non-disclosure. Consequently, the shareholders' allegations consisted of little more than a claim that the majority shareholder and the target executives had breached their fiduciary duties.[68] Without more, the Court held, there could be no liability under Rule 10b-5.[69]

2. *Chiarella v. United States*: Origins of the Fiduciary-Based Theory

The *Santa Fe* opinion placed a significant constraint on the SEC's attempts to use Rule 10b-5 to construct a coherent body of insider trading law. However, it did not mean that the enterprise was futile. In 1980, the Supreme Court finally endorsed a theory of primary liability for insider trading that was consistent with the statute's focus on fraud as set forth in *Santa Fe*. In *Chiarella*

64. *See, e.g.*, RESTATEMENT (SECOND) OF TORTS § 551(1)–(2)(a) (AM. LAW INST. 1977) ("(1) One who fails to disclose to another a fact that he knows may justifiably induce the other to act or refrain from acting in a business transaction is subject to the same liability to the other as though he had represented the nonexistence of the matter that he has failed to disclose, if, but only if, he is under a duty to the other to exercise reasonable care to disclose the matter in question. (2) One party to a business transaction is under a duty to exercise reasonable care to disclose to the other before the transaction is consummated, (a) matters known to him that the other is entitled to know because of a fiduciary or other similar relation of trust and confidence between them . . . .").

65. *See Santa Fe*, 430 U.S. at 465–66.

66. *See id.* at 466 ("The minority stockholders of Kirby were notified the day after the merger became effective and were advised of their right to obtain an appraisal in Delaware court if dissatisfied with the offer of $150 per share. They also received an information statement containing, in addition to the relevant financial data about Kirby, the appraisals of the value of Kirby's assets and the Morgan Stanley appraisal concluding that the fair market value of the stock was $125 per share.").

67. *See id.* at 467 ("The amended complaint asserted that, based on the fair market value of Kirby's physical assets as revealed by the appraisal included in the information statement sent to minority shareholders, Kirby's stock was worth at least $772 per share.").

68. *See id.* at 477 ("No doubt Congress meant to prohibit the full range of ingenious devices that might be used to manipulate securities prices. But we do not think it would have chosen this 'term of art' if it had meant to bring within the scope of § 10(b) instances of corporate mismanagement such as this, in which the essence of the complaint is that shareholders were treated unfairly by a fiduciary.").

69. *See id.* at 479–80.

v. United States,[70] the Court held that Rule 10b-5 prohibited a corporate insider from trading in his own corporation's stock based on material nonpublic information belonging to his corporation.[71] Of course, this rule had to be reconciled with the holding of *Santa Fe*. But the *Chiarella* Court was confident that it satisfied the statute's requirement of fraud.[72]

In this judgment, the Court relied heavily on an influential SEC opinion called *Cady, Roberts*.[73] In that opinion, the Commissioner of the SEC himself, William Cary, had opined that insider trading is a form of fraudulent concealment and therefore is fraudulent under the common law.[74] More specifically, in Cary's view, the majority rule in the states was that a corporate insider, by virtue of his fiduciary relationship, owes a duty of disclosure to his corporation's shareholders.[75] The insider violates this disclosure duty when he trades in his corporation's stock without disclosing any material nonpublic information pertaining to that stock to the shareholder on the other side of the transaction.[76]

But Cary, it turns out, was wrong.[77] No state court had agreed, at least not when the insider was trading in the type of impersonal, exchange-based market at issue in the typical insider trading case.[78] Nevertheless, the *Chiarella* Court deferred to the *Cady, Roberts* opinion, thus giving birth to the "classical theory" of insider trading.[79]

The classical theory was far from perfect, and, in fact, would eventually lead to many unintended and untoward consequences. For example, under its logic, there would be no liability for insider trading in debt securities.[80] Nor would there be liability for insiders who sold (rather than purchased) securities,

70. 445 U.S. 222 (1980).

71. *See id.* at 231–32.

72. *See id.* at 232–33.

73. *Id.* at 277 n.8; *In re* Cady, Roberts & Co., 40 S.E.C. 907 (1961).

74. *Cady, Roberts & Co.*, 40 S.E.C. at 910–11, 911 n.13.

75. *See id.* at 911.

76. *See id.*

77. *See, e.g.*, Adam C. Pritchard, United States v. O'Hagan*: Agency Law and Justice Powell's Legacy for the Law of Insider Trading*, 78 B.U. L. REV. 13, 22–26 (1998) [hereinafter Pritchard, *Agency Law and Powell's Legacy*] (providing an overview of the history surrounding the legal precedent).

78. Bainbridge, *Incorporating State Fiduciary Duties*, *supra* note 13, at 1220 ("The uniform state law approach in the secondary market context remained a no duty rule."); Pritchard, *Agency Law and Powell's Legacy*, *supra* note 77; *see also* Barbara A. Ash, *State Regulation of Insider Trading—A Timely Resurgence?*, 49 OHIO ST. L.J. 393, 399 (1988); Charles C. Cox & Kevin S. Fogarty, *Bases of Insider Trading Law*, 49 OHIO ST. L.J. 353, 361 (1988).

79. *See* Chiarella v. United States, 445 U.S. 222, 228 (1980).

80. Insiders owe no duties to debtholders, and the breach of a fiduciary duty is the predicate for insider trading liability under the traditional reading of the classical theory, where the person on the other side of the insider's trade is a debtholder. *See* Pritchard, *Agency Law and Powell's Legacy*, *supra* note 77, at 28.

even if based on material nonpublic information.[81] Moreover, the classical theory only applied to corporate insiders.[82] It failed to reach the case where a person trades on the basis of material nonpublic information in the stock of a corporation with which the trader has no relationship, or at least no fiduciary relationship.[83] The SEC needed another theory of primary liability for this type of "outsider trading."

3. *United States v. O'Hagan*: Origins of the Contractual Fraud Theory

The SEC got what it was looking for in *United States v. O'Hagan*.[84] The defendant in that case was James O'Hagan, a partner in the law firm of Dorsey & Whitney in Chicago.[85] At the time, O'Hagan's law firm was representing a company called Grand Met in a tender offer for Pillsbury, a transaction that, once announced publicly, would cause the price of Pillsbury stock to increase significantly.[86] Although O'Hagan was not actually working on the tender offer itself, he obtained possession of the information by virtue of his relationship with his law firm.[87] He then purchased a substantial amount of Pillsbury stock and call options that, upon announcement of the tender offer, netted O'Hagan over $4.3 million in profit, which O'Hagan apparently used to conceal his prior embezzlement and conversion of unrelated client trust funds.[88]

O'Hagan was convicted on all fifty-seven counts of the indictment and sentenced to forty-one months in prison.[89] Incredibly, the Eighth Circuit reversed all of O'Hagan's convictions on the theory that O'Hagan had no duty to the shareholders against whom he was trading (in this case Pillsbury shareholders) and therefore was not liable under the classical theory of insider trading.[90]

The Supreme Court, however, reversed the Eighth Circuit, articulating a new ground for primary liability that would reach corporate "outsiders" like O'Hagan.[91] The misappropriation theory that the *O'Hagan* Court adopted

81. Because insiders owe no duties to "potential shareholders," and the breach of a fiduciary duty is the predicate for insider trading liability under the traditional reading of the classical theory, there is no insider trading liability where the person on the other side of the insider's trade is a potential shareholder, as is often the case where the insider is selling rather than buying. *See id.* at 26.

82. Because insiders owe no duties to stockholders of other corporations where such insiders are not employed, there is no liability where such insiders trade on the basis of material nonpublic information in the stock of such other corporations. *See* United States v. O'Hagan, 521 U.S. 642, 652–53 (1997).

83. *See id.*

84. 521 U.S. 642 (1997).

85. *See id.* at 647.

86. *See id.*

87. *See id.* at 647–48.

88. *See id.* at 648.

89. *See id.* at 648–49.

90. *See* United States v. O'Hagan, 92 F.3d 612, 627 (8th Cir. 1997).

91. *See O'Hagan*, 521 U.S. at 665–66.

extends Rule 10b-5 liability to defendants who owe a duty of loyalty or confidentiality to the *source* of the nonpublic information that forms the basis of the trade.[92]

As the *O'Hagan* Court explained, "[u]nder [the misappropriation] theory, a fiduciary's *undisclosed*, self-serving use of a principal's information to purchase or sell securities, in breach of a duty of loyalty and confidentiality, defrauds the principal of the exclusive use of that information."[93] For the majority, the fraud underlying the misappropriation theory arises from the fact that the fiduciary failed to report the breach of the underlying covenant not to profit from the principal's property.[94] The clear implication, which the *O'Hagan* majority explicitly identified, is that a trader in O'Hagan's position could avoid 10b-5 liability by notifying his information source of an intent to trade on its information.[95] This is the "brazen fiduciary" problem identified in the introduction to this Article,[96] and it is one of the most criticized aspects of the *O'Hagan* decision.[97] Indeed, one commentator has flatly said that it "makes no policy sense."[98]

The *O'Hagan* Court had to overcome several conceptual and doctrinal hurdles in adopting the misappropriation theory. First, the Court had to come to terms with the statutory requirement that the fraud be "in connection with" the purchase or sale of a security.[99] The majority reasoned that: "This element is satisfied because the fiduciary's fraud is consummated, not when the fiduciary gains the confidential information, but when, without disclosure to his principal, he uses the information to purchase or sell securities. The securities transaction and the breach of duty thus coincide."[100]

This coincidence test proved controversial and not without reason. On the one hand, the test was underinclusive, potentially barring tipper-tippee liability since the tipper's fraudulent tip does not coincide with the tippee's subsequent securities transaction.[101] But it was also arguably overinclusive, potentially

92. *See id.* at 652.

93. *Id.* (emphasis added).

94. *See id.* at 655 ("Because the deception essential to the misappropriation theory involves feigning fidelity to the source of information, if the fiduciary discloses to the source that he plans to trade on the nonpublic information, there is no 'deceptive device' and thus no § 10(b) violation—although the fiduciary-turned-trader may remain liable under state law for breach of a duty of loyalty.").

95. *See id.*

96. *See supra* notes 4–7 and accompanying text.

97. *See supra* note 18 and accompanying text.

98. *See* Kim, *supra* note 14, at 1004.

99. 15 U.S.C. § 78j(b) (2018).

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

101. In particular, the coincidence test would arguably foreclose the possibility of using the misappropriation theory to reach tippers and tippees. In the case of the misappropriating tipper, the fiduciary's breach does not coincide with the tippee's securities transaction. And therefore, under the coincidence test, the tip falls outside the scope of the statute. For this reason, lower courts have

giving rise to liability in cases that seem far afield from the concerns of the federal securities laws, "for example where a broker is directed to purchase stock for a client and instead purchases such stock—using client funds—for his own account."[102] The majority's response to this argument was that the misappropriation of information (some of which falls within the statute's reach) is simply different from the misappropriation of money (which falls outside of the reach of the statute).[103] The reason is that misappropriated information derives its value "ordinarily" from its utility in securities trading whereas misappropriated funds have a multitude of valuable uses.[104] The problem was that this argument also did not seem quite right. In fact, the dissent pointed out several different ways in which information could be used.[105]

The "in connection with" requirement was not the only hurdle the *O'Hagan* majority had to overcome. The Court also needed to figure out how to reconcile the misappropriation theory with the *Santa Fe* holding that Rule 10b-5 required more than a mere breach of fiduciary duty. The *O'Hagan* majority hung its hat on the fact that in *Santa Fe* there was complete disclosure, whereas there was none in *O'Hagan*.[106] But under the traditional reading of the doctrine of fraudulent non-disclosure, this argument does not withstand scrutiny.[107] To be sure, in *Santa Fe* the majority shareholders had, pursuant to the federal proxy rules, disclosed a significant amount of information about the transaction that the company was engaged in, the freeze-out merger.[108] The problem, however, is that the underlying transaction information was irrelevant

interpreted *O'Hagan* to mean that the coincidence test is not a necessary condition for satisfying the "in connection with" element. *See, e.g.*, United States v. Falcone, 257 F.3d 226, 232–33 (2d Cir. 2001) (opining that the coincidence test was not met in a misappropriation-based tipper-tippee case but finding that that was not the only available test).

102. *See O'Hagan*, 521 U.S. at 685 (Thomas, J., dissenting).

103. *See id.* at 656 (majority opinion) (holding that confidential information pertaining to publicly traded companies ordinarily derives its value from its utility in securities trading).

104. *See id.* ("The [misappropriation] theory does not catch all conceivable forms of fraud involving confidential information; rather, it catches fraudulent means of capitalizing on such information through securities transactions.").

105. *See id.* at 685 (Thomas, J., dissenting) ("In this case, for example, upon learning of Grand Met's confidential takeover plans, O'Hagan could have done any number of things with the information: He could have sold it to a newspaper for publication; he could have given or sold the information to Pillsbury itself; or he could even have kept the information and used it solely for his personal amusement, perhaps in a fantasy stock trading game." (citations omitted)).

106. *See id.* at 655 (majority opinion).

107. The traditional reading is the one adopted by the *Chiarella* Court and embodied in the *Restatement of Torts*, to which the *Chiarella* Court cited. *See* Chiarella v. United States, 445 U.S. 222, 227–28 (1980) ("At common law, misrepresentation made for the purpose of inducing reliance upon the false statement is fraudulent. But one who fails to disclose material information prior to the consummation of a transaction commits fraud only when he is under a duty to do so. And the duty to disclose arises when one party has information 'that the other [party] is entitled to know because of a fiduciary or other similar relation of trust and confidence between them.'" (quoting RESTATEMENT (SECOND) OF TORTS § 551(2)(a) (AM. LAW INST. 1976))).

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

to the Court's theory in *O'Hagan*, which was premised on the non-disclosure of the *breach* itself.[109] Moreover, the underlying transaction information in *O'Hagan*—the information regarding Grand Met's planned tender offer—was, in fact, disclosed to the parties to whom James O'Hagan owed fiduciary duties: his firm and the firm's client, Grand Met. After all, it was their information. Of course, it is true that there was *something* that was not disclosed in *O'Hagan*—the fact that James O'Hagan breached his fiduciary duties to his principals. But that information was also concealed in *Santa Fe*—the majority shareholder never admitted to the minority that it had breached a duty.

One novel possibility is that the distinction between *O'Hagan* and *Santa Fe* actually has something to do with the brazen fiduciary problem discussed previously.[110] If disclosure of an intent to trade in breach of a fiduciary duty allows the brazen fiduciary to avoid liability, then maybe disclosure of more circumstantial evidence of the breach might yield the same result, even though the breach itself has not been disclosed in so many words. This situation is the "halfhearted fiduciary" example mentioned in the introduction to this Article.[111] On the one hand, it makes some sense of the cases, considering that the fiduciaries in *Santa Fe* disclosed a significant amount of information concerning the underlying freeze-out transaction.[112] And, therefore, the defendants there look like halfhearted fiduciaries in this sense. On the other hand, this distinction runs into the same problem as the brazen fiduciary scenario—it is hard to explain why any disclosure, halfhearted or brazen, should allow the fiduciary to avoid liability.

While the contractual fraud theory has an answer, for now, it suffices to say that the *O'Hagan* Court's adoption of the misappropriation theory marked a revolutionary new turn in the development of insider trading jurisprudence. However, the majority's attempts to overcome the two major hurdles to the misappropriation theory were of questionable success. Its discussion of the statute's "in connection with" requirement seemed to lack a limiting principle, and its attempt to reconcile the facts of *O'Hagan* with those of *Santa Fe* seemed facile at best.[113]

109. *See O'Hagan*, 521 U.S. at 655 ("Because the deception essential to the misappropriation theory involves feigning fidelity to the source of information, if the fiduciary discloses to the source that he plans to trade on the nonpublic information, there is no 'deceptive device' and thus no § 10(b) violation—although the fiduciary-turned-trader may remain liable under state law for breach of a duty of loyalty.").

110. *See supra* notes 4–7 and accompanying text.

111. *See supra* notes 4–7 and accompanying text.

112. *See Santa Fe*, 430 U.S. at 466.

113. *See* Painter et al., *supra* note 18, at 186 ("The *O'Hagan* Court struggles with the *Santa Fe* problem but does not satisfactorily resolve it. Only by ignoring the *Santa Fe* Court's warning about immersing Section 10(b) jurisprudence in state fiduciary duty law can the *O'Hagan* Court reconcile itself to the misappropriation theory's equating of fiduciary breach with 'deception.'").

The contractual fraud theory, however, breathes new life into the *O'Hagan* majority's arguments on both counts. The theory supports the majority's argument that an embezzlement of money is different, in a legally significant way, from the embezzlement of information.[114] Further, the contractual fraud theory helps reconcile *O'Hagan* and *Santa Fe* using the much-criticized reasoning of the *O'Hagan* majority itself.[115] No extant theory of insider trading accomplishes that task. But before we delve into the different theories of insider trading, and the contractual fraud theory in particular, let us first consider *O'Hagan*'s aftermath.

4. The SEC's Rule 10b5-2

The *O'Hagan* opinion opened new frontiers in insider trading law. At the same time, it created a list of unanswered questions.[116] At the top of that list was whether—and if so, under what circumstances—the misappropriation theory might apply to relationships that are not strictly fiduciary in character.[117] What if, for example, James O'Hagan was not a fiduciary of Grand Met but instead the counterparty to an important commercial contract with the company? Assume further that, in the course of that relationship, O'Hagan discovered the information about Grand Met's planned Pillsbury tender offer. If O'Hagan used that information to trade in Pillsbury stock, would he be liable for insider trading under the misappropriation theory? What if the contract did not mention anything about needing to keep information confidential? What if it did? What if the contract went further, containing an agreement not only prohibiting the information's disclosure but also barring its use?

Recognizing the uncertainty surrounding these questions, the SEC, in response to *O'Hagan*, promulgated Rule 10b5-2 in an attempt to offer greater clarity.[118] This rule provides that trading on information subject to a promise of confidentiality gives rise to liability under *O'Hagan*. Although district courts in

114. *See infra* Section I.C.5.

115. *See infra* Section I.C.5.

116. *See, e.g.*, Pritchard, *Agency Law and Powell's Legacy*, *supra* note 77, at 43–46; Larry E. Ribstein, *Federalism and Insider Trading*, 6 SUP. CT. ECON. REV. 123, 136–39 (1998).

117. *See, e.g.*, Bainbridge, *Insider Trading Regulation*, *supra* note 12, at 1634 ("Does a duty to disclose to the information's source arise before trading in all fiduciary relationships?"); Hazen, *supra* note 12, at 894 ("The essence of the misappropriation theory is the existence of a fiduciary or other relationship that imposes a duty not to trade on confidential information obtained by reason of such relationship. The existence of that duty triggers the concomitant disclose or abstain obligation, violation of which results in trading liability. The relevant decisions reveal serious problems in trying to identify the relationships sufficient to implicate the misappropriation theory."); Painter et al., *supra* note 18, at 191 ("Unfortunately, the scope of fiduciary duties, particularly outside the traditional corporate insider context, is far from clear."); Carol B. Swanson, *Reinventing Insider Trading: The Supreme Court Misappropriates the Misappropriation Theory*, 32 WAKE FOREST L. REV. 1157, 1209 (1997) ("[T]he Court did not explain the scope of fiduciary relationships or the nature of the applicable law.").

118. 17 C.F.R. § 240.10b5-2 (2019).

many circuits have deferred to this interpretation of *O'Hagan*,[119] others have pushed back.[120] Of those in this latter group, one court has held that a non-use agreement is a minimum requirement for misappropriation-based insider trading liability.[121] Other courts have held that the misappropriation theory requires a traditional fiduciary duty.[122]

The bottom line is that there is considerable confusion in the lower courts as to the scope of insider trading liability under Rule 10b-5 after *O'Hagan*. As explained in greater detail in Part II, the contractual fraud theory cuts through this confusion. The theory implies that, although courts should not be able to apply the *O'Hagan* rule to arm's-length contracts regardless of whether they contain confidentiality or non-use agreements, the SEC should. Additionally, it implies that courts should probably be able to apply, without an SEC rulemaking, the *O'Hagan* rule to what are referred to as "hybrid agreements," which include joint ventures and strategic alliances.[123] But before we consider how the contractual fraud theory accomplishes all of this, let us first make sure that we appreciate the current messiness in the law of insider trading.

5. Lower Court Cases

The uncertainty over the scope of insider trading liability in the wake of *O'Hagan* created varied results in the lower courts and a circuit split in the courts of appeals. Consider how the law would treat the following six scenarios. For further context, illustrations are included in the footnotes. The table uses "undetermined" to indicate where the relevant court has not yet weighed in on the issue.

Table 1. Approaches to Rule 10b-5's Application to Insider Trading: The Courts

Scenario Possibly Subject to Rule 10b-5	Supreme Court Classified as Fraud?	Circuit Courts Classified as Fraud?
1: Brazen Fiduciary[124]	No	No
2: Halfhearted Fiduciary[125]	No	No
3: Contract with Non-Use Provision[126]	Undetermined	Split
4: Contract with Confidentiality Provision[127]	Undetermined	Split
5: Unaffiliated Thief[128]	No	No[129]
6: Unaffiliated Innocent Acquirer[130]	No	No

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The question is, as a legal matter, which of these scenarios are subject to Rule 10b-5? The Supreme Court has only clearly weighed in on three of them, finding that there is no liability in the first,[131] fifth,[132] and sixth cases.[133] The Court's insider trading jurisprudence also arguably implies that there should be no liability in the second case.[134]

119. *See, e.g.*, United States v. McGee, 892 F. Supp. 2d 726, 729 (E.D. Pa. 2012); SEC v. Nothern, 598 F. Supp. 2d 167, 175 (D. Mass. 2009); SEC v. Kirch, 263 F. Supp. 2d 1144, 1150 (N.D. Ill. 2003).

120. *See, e.g.*, SEC v. Cuban, 634 F. Supp. 2d 713, 725 (N.D. Tex. 2009) ("The agreement, however, must consist of more than an express or implied promise merely to keep information confidential. It must also impose on the party who receives the information the legal duty to refrain from trading on or otherwise using the information for personal gain. With respect to confidential information, nondisclosure and non-use are logically distinct." (citation omitted)), *vacated on other grounds*, 620 F.3d 551 (5th Cir. 2010); United States v. Kim, 184 F. Supp. 2d 1006, 1014–15 (N.D. Cal. 2002) (questioning, albeit implicitly, the validity of Rule 10b5-2, the adoption of which post-dated the facts of the case by concluding that the confidential relationship at issue in the case did not give rise to liability under the statute even though it would under the SEC's rule), *aff'd*, 95 F. App'x 857 (9th Cir. 2008).

121. *See, e.g.*, *Cuban*, 634 F. Supp. 2d at 725.

122. *See* United States v. Falcone, 257 F.3d 226, 234–35 (2d Cir. 2001); United States v. Chestman, 947 F.2d 551, 568 (2d Cir. 1991) (en banc); *Kim*, 184 F. Supp. 2d, at 1014–15; *see also* Bainbridge, *Post-Fiduciary Duty Era*, *supra* note 43, at 86–87 (relying on *United States v. Chestman* to argue that *O'Hagan* requires, if not a traditional fiduciary relationship, then at the very least its functional equivalent); Donna M. Nagy, *Insider Trading and the Gradual Demise of Fiduciary Principles*, 94 IOWA L. REV. 1315, 1323–24 (2009) [hereinafter Nagy, *Gradual Demise*] (criticizing Rule 10b5-2 on the ground that it is inconsistent with the emphasis of Supreme Court precedent on a fiduciary-like relationship).

123. *See infra* notes 248–59 and accompanying text.

124. Brazen Fiduciary—Imagine a lawyer whose client is the acquirer in a merger that has not yet been disclosed to the market. By virtue of his position as the acquirer's lawyer, the lawyer knows that the price of the target firm's stock will increase significantly once the deal is announced. The lawyer purchases stock in the target company and does indeed make a windfall once the merger is announced. Before doing so, however, he notifies his client of his intent to trade.

125. Halfhearted Fiduciary—The same facts apply as the brazen fiduciary scenario, except in this situation, instead of providing his client with notice of his clear intent to trade, the lawyer provides circumstantial evidence of his intent, for example a copy of a bank statement showing the transfer of a significant amount of funds.

126. Contract with Non-Use Provision—Imagine a supplier of that same acquiring company. The supplier is subject to a confidentiality agreement with the acquirer. The supplier trades on the information from the acquirer.

127. Contract with Confidentiality Provision—Imagine the same facts, but this time a confidentiality agreement replaces the non-use provision.

128. Unaffiliated Thief—Imagine that the supplier has no agreement whatsoever with the acquirer or the target but obtains the information through theft and then profits by trading on it.

129. Note that the Second Circuit in *Dorozhko* is an exception to the general rule. *See* SEC v. Dorozhko, 574 F.3d 42, 51 (2d Cir. 2009).

130. Unaffiliated Innocent Acquirer—Imagine the same facts as the unaffiliated thief, but the supplier comes into possession of the acquirer's information because he overhears it at lunch.

131. *See* United States v. O'Hagan, 521 U.S. 642, 655 (1997).

132. *See id.* at 662; Chiarella v. United States, 445 U.S. 222, 230 (1980).

133. *See* Dirks v. SEC, 463 U.S. 646, 667 (1983).

134. *Compare* Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 475, 479 (1977) (holding that a breach of fiduciary duties that, although not disclosed, is nevertheless inferable from other disclosure does not

The first scenario, the brazen fiduciary, asks whether there is Rule 10b-5 liability where the trade breaches a fiduciary duty but is not concealed. The Court answered that question in the negative in *United States v. O'Hagan*.[135] James O'Hagan's liability was premised on the fact that he concealed the breach of his underlying duty of loyalty from his law firm and the firm's client, Grand Met.[136] The *O'Hagan* majority was careful to point out that if he had notified his principals of the breach, the result would have been different.[137] In other words, there is no liability for the brazen fiduciary.

The second scenario, the halfhearted fiduciary, is far less obvious. It asks whether there is similarly no liability for the halfhearted fiduciary, that is to say, a fiduciary who, unlike his brazen counterpart, does not disclose the breach in so many words but instead discloses circumstantial evidence making it easier for the principals to uncover it. There is a good argument that this is the only principled way of distinguishing *Santa Fe* and *O'Hagan*. *Santa Fe* effectively involves a halfhearted fiduciary—the majority shareholders disclosed all of the material information concerning the freeze-out, allowing the minority to allege a fiduciary breach. The reason this reading remains novel is likely because it suffers from the same infirmities of the brazen fiduciary—it is far from obvious why one should be able to escape liability simply by making it easier for the principal to uncover the breach.[138] The contractual fraud theory supplies an answer to that question and therefore helps reconcile *Santa Fe* and *O'Hagan*.

The fifth scenario, the unaffiliated thief, addresses whether there is Rule 10b-5 liability when the trade is made on the basis of stolen information.[139] The clear implication of Supreme Court precedent is that there is no liability in that scenario.[140] It is worth noting that, in *SEC v. Dorozhko*,[141] the Second Circuit has challenged this precedent, extending liability to a hacker in the absence of a contractual or fiduciary relationship[142] in a case where the district court opined that finding liability "would . . . undo decades of Supreme Court precedent."[143]

give rise to liability under Rule 10b-5), *with O'Hagan*, 521 U.S. at 655 (holding that a concealed breach of fiduciary duties gives rise to liability under Rule 10b-5).

135. *See O'Hagan*, 521 U.S. at 655.

136. *See id.* at 654.

137. *See id.* at 655.

138. In *Santa Fe*, the defendants had shared with the plaintiffs the results of an appraisal that appraised the assets in question at a much higher price than the one they were offering. *See Santa Fe*, 430 U.S. at 467. Since the defendants were not actually disclosing a fiduciary breach, but were arguably disclosing relevant evidence of one, this resembles the halfhearted fiduciary example. *See id.*

139. SEC v. Dorozhko, 574 F.3d 42, 44–45 (2d Cir. 2009); *see also supra* notes 2–8 and accompanying text.

140. *See O'Hagan*, 521 U.S. at 661; Chiarella v. United States, 445 U.S. 222, 234 (1980).

141. 574 F.3d 42 (2d Cir. 2009).

142. *Id.* at 49–51.

143. SEC v. Dorozhko, 606 F. Supp. 2d 321, 323 (S.D.N.Y. 2008), *vacated*, 574 F.3d 42 (2d Cir. 2009).

Even those commentators who would favor liability as a policy matter in these scenarios take issue with the Second Circuit's approach in *Dorozhko*.[144]

The sixth scenario, the unaffiliated innocent acquirer, asks whether there is Rule 10b-5 liability when the trader has neither a fiduciary nor contractual relationship with the source of the information (or other traders in the marketplace for that matter) and obtains the information innocently. The Court answered that question in the negative in *Dirks v. SEC*.[145] *Dirks* raised the issue of tipper-tippee liability: Under what circumstances is there liability where someone shares material nonpublic information with a third-party who trades on it? Because tipper-tippee liability is a species of derivative liability—liability that derives from primary liability—the case was also about the nature of primary liability in an insider trading case. The SEC argued for a rule that would have created liability for a tippee who receives "inside information from an insider."[146] In other words, the SEC proposed "the idea that the antifraud provisions require equal information among all traders."[147] However, the Supreme Court rejected this proposed rule on the grounds that it was inconsistent with *Chiarella*[148] and risked inhibiting market analysts' attempts to ferret out information.[149]

Beyond these four scenarios, the Supreme Court has not weighed in on the other issues reflected in the hypotheticals above. That task has instead fallen to the lower courts, which have split over liability in these scenarios. The field is complicated by the fact that the SEC itself has weighed in, through the adoption of Rule 10b5-2, which would result in liability in the third and fourth cases.[150] One might reasonably ask why Rule 10b5-2 does not in effect settle—once and for all—the disagreements among the lower courts, even among these scenarios where the Supreme Court has yet to weigh in. The answer is because the lower courts are not in agreement that Rule 10b5-2 is a valid exercise of the

144. 18 DONALD C. LANGEVOORT, INSIDER TRADING REGULATION, ENFORCEMENT AND PREVENTION § 6:14, Westlaw (database updated April 2019) (noting that *Dorozhko* poses the question of whether a new approach to insider trading ought to be recognized but opining that profiting from stolen information "plainly threatens market integrity"); Nagy, *Reframing Misappropriation*, *supra* note 7, at 1253 (doubting that securities trading by a computer hacker who unlawfully gains access to confidential information would violate Section 10(b)); Robert A. Prentice, *The Internet and Its Challenges for the Future of Insider Trading Regulation*, 12 HARV. J.L. & TECH. 263, 296 (1999) (arguing that "from a traditional point of view" hacking-and-trading is not covered by insider trading laws but advancing policy reasons for finding liability).

145. 463 U.S. 646 (1983).

146. *Id.* at 655.

147. *Id.* at 657.

148. *See id.* at 657 (interpreting *Chiarella* as holding that "only some persons, under some circumstances, will be barred from trading while in possession of material nonpublic information").

149. *See id.* at 658.

150. 17 C.F.R. § 10b5-2 (2019). Under Rule 10b5-2, there must be a confidentiality agreement between the source of the information and the recipient. *Id.* Because the fifth and sixth hypotheticals do not involve an agreement at all, Rule 10b5-2 would not apply.

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SEC's rulemaking authority under the Exchange Act.[151] Consider how the lower courts have ruled in each of these remaining hypotheticals.

The third scenario, involving a contractual non-use provision, asks whether there should be Rule 10b-5 liability when the trader, in breach of a non-use provision, fails to disclose his trading on information obtained from a contractual counterparty. Most lower courts that have considered the issue have held that there is Rule 10b-5 liability under these facts.[152] The Second and Ninth Circuits take a different approach. They have held that that Rule 10b-5 liability only arises in the context of a fiduciary relationship or its "functional equivalent."[153] For these courts, Rule 10b5-2 is invalid to the extent that it extends liability beyond these fiduciary or quasi-fiduciary contexts.[154] Several commentators agree with this approach.[155]

151. *See supra* notes 124–30 and accompanying text.

152. *See* United States v. McGee, 763 F.3d 304, 314 (3d Cir. 2014) (implicit confidentiality agreement between friends and members of the same Alcoholics Anonymous group); SEC v. Cuban, 620 F.3d 551, 552–53 (5th Cir. 2010) (confidentiality agreement in the context of a stock purchase); SEC v. Yun, 327 F.3d 1263, 1272 (11th Cir. 2003) (confidentiality agreement between a married couple).

153. *See* United States v. Chestman, 947 F.2d 551, 568 (2d Cir. 1991) (en banc); United States v. Kim, 184 F. Supp. 2d 1006, 1010 (N.D. Cal. 2002). To be sure, *Chestman* was decided prior to the promulgation of Rule 10b5-2 and it is not entirely clear how the Second Circuit would view the validity of that rule in light of their prior holding that a fiduciary or fiduciary-like relationship is necessary. The District Court for the Northern District of California in *Kim* interpreted the fiduciary or fiduciary-like requirement as a constraint on the validity of Rule 10b5-2. *Kim*, 184 F. Supp. 2d at 1015. In other words, the holding of *Kim* is that the SEC's rule is only valid to the extent that it applies to such relationships. *Id.* In dicta in *Chestman*, the Second Circuit seemed to imply that a mere contractual duty of confidentiality might be a fiduciary-like relationship sufficient to give rise to insider trading liability. *See Chestman*, 947 F.2d at 569–70. At least one district court in the Second Circuit has read *Chestman* that way. *See* United States v. Corbin, 729 F. Supp. 2d 607, 615 (S.D.N.Y. 2010). However, it's not how everyone reads the case. *See, e.g.*, Bainbridge, *Post-Fiduciary Duty Era*, *supra* note 43, at 91. It is true that, in a more recent case, the Second Circuit has extended Rule 10b-5 liability to non-fiduciary cases. *See* SEC v. Dorozhko, 574 F.3d 42, 51 (2d Cir. 2009). Yet, there, the court drew a distinction between the traditional fraudulent non-disclosure cases—like *Chiarella*, *O'Hagan*, and *Chestman*—and an affirmative representation case—like *Dorozkho* itself. *See id.* at 48. *Dorozhko* involved the theft of information by a computer hacker who gained access to corporate information through what the SEC characterized as a misrepresentation of his identity. *See id.* at 44. Thus, in the Second Circuit at least, a fiduciary relationship does not seem to be required when there is an affirmative representation whereas such a relationship, or its functional equivalent, is required with respect to fraudulent non-disclosure, which is the traditional way of viewing insider trading under either *Chiarella* or *O'Hagan*.

154. *See Kim*, 184 F. Supp. 2d at 1015.

155. Bradley J. Bondi & Steven D. Lofchie, *The Law of Insider Trading: Legal Theories, Common Defenses, and Best Practices for Ensuring Compliance*, 8 N.Y.U. J.L. & BUS. 151, 190 (2011) (opining that "the SEC may have exceeded the constitutional bounds of its authority with Rule 10b5-2"); Ray J. Grzebielski, *Friends, Family, Fiduciaries: Personal Relationships as a Basis for Insider Trading Violations*, 51 CATH. U. L. REV. 467, 492 (2002) (questioning whether Rule 10b5-2 is "outside of the SEC's authority under Rule 10b-5"); Nagy, *Gradual Demise*, *supra* note 122, at 1364 ("Rule 10b5-2's extension of the misappropriation theory to breaches of a confidentiality agreement has contributed to the demise of fiduciary principles in the law of insider trading. And while *O'Hagan*'s policy justifications may support liability for the wrongful use of such confidential information, O'Hagan's fiduciary-based framework

There is also disagreement among the lower courts over the fourth scenario, a contractual confidentiality provision, which asks whether there is Rule 10b-5 liability where the trader, in breach of a confidentiality (but not a non-use) provision fails to disclose his trading on information obtained from a contractual counterparty. In *United States v. McGee*[156] and *SEC v. Yun*,[157] the Third and Eleventh Circuits, respectively, held that a confidentiality agreement is sufficient to give rise to insider trading liability under Rule 10b-5.[158]

In *SEC v. Cuban*,[159] however, a district court in the Fifth Circuit disagreed with the Third and Eleventh Circuits, although the reviewing court decided the issues on appeal without weighing in on the confidentiality versus non-use distinction.[160] In *Cuban*, the district court reasoned that there is no policy justification for refusing to extend insider trading liability to the breach of a contractual obligation.[161] However, the court emphasized that, as a legal matter, insider trading must actually constitute a breach of the contract in question.[162] And while insider trading breaches a non-use agreement, in the court's estimation, it did not breach a confidentiality agreement.[163] The court further concluded that Rule 10b5-2 cannot change this result, presumably because the SEC is constrained by the court's interpretation of the statute.[164]

As evidenced by this brief discussion, in the insider trading law firmament, there are a few fixed stars and several wandering ones. As for the fixed stars, there is generally no insider trading liability for the brazen fiduciary, the unaffiliated thief, or the unaffiliated innocent acquirer. It is arguable that there is also no liability for the halfhearted fiduciary. Beyond these cases, however, the lower courts disagree over basic questions of insider trading liability, including whether a fiduciary relationship is a necessary condition for liability and, if not, whether a non-use provision (in addition to a confidentiality agreement) is required. This state of affairs is partly attributable to the fact that there is not a theory of insider trading that fully answers these questions. If there were a theory that could account for the fixed stars, then perhaps it could

militates against it."); Marc I. Steinberg, *Insider Trading, Selective Disclosure, and Prompt Disclosure: A Comparative Analysis*, 22 U. PA. J. INT'L ECON. L. 635, 647 (2001) (interpreting *Chestman* as requiring a fiduciary-like duty and therefore questioning whether Rule 10b5-2, in overturning that decision, will be upheld).

156. 763 F.3d 304 (3d Cir. 2014)

157. 327 F.3d 1263 (11th Cir. 2003)

158. *McGee*, 763 F.3d at 314; *Yun*, 327 F.3d at 1272–73.

159. *See* SEC v. Cuban, 634 F. Supp. 2d 713, 725 (N.D. Tex. 2009), *vacated on other grounds*, 620 F.3d 551 (5th Cir. 2010).

160. SEC v. Cuban, 620 F.3d 551, 555 (5th Cir. 2010) (reading the complaint as alleging the existence of a non-use agreement between plaintiff and defendant).

161. *See Cuban*, 634 F. Supp. 2d at 724.

162. *See id.* at 728.

163. *See id.* at 725.

164. *See id.* at 729.

also resolve the confusion regarding the wandering ones. There are several possible theories to offer. The problem, however, is that not one of them does the necessary work.

B. *Possible Theories*

Before discussing the extant theories of insider trading law, it might be helpful to address a preliminary question: what exactly is meant by theories of insider trading law? What I do *not* mean is what litigators might refer to as the theory of the case in an insider trading litigation—or at least not merely that. That is to say, by the term "theory," I do not simply mean an explanation for why insider trading gives rise to liability under the statute. Instead, as used here, "theory" means a coherent explanation for what insider trading law is really about, taking into account Rule 10b-5's crucial role in anchoring this body of law.

There have been many different attempts to advance insider trading "theories" in this broad sense. All of these extant theories can be placed in one of three categories: fiduciary-based, property-based, or unjust enrichment-based theories. These qualify as theories as they each—in the broadest sense—seek to answer the question posed above: What is insider trading really about? For the fiduciary-based theories, it is about enforcing fiduciary obligations. For the property-based theories, it is about protecting property, particularly informational property. For the unjust enrichment-based theories, it is about fairness. Unfortunately, none of these theories can fully explain the body of law as it exists.

1. Fiduciary Theory

One possible theory of insider trading law is that the law does and should focus on insider trading by those in entrusted[165] or, in other words, fiduciary, or fiduciary-like, positions in light of the unique costs of insider trading in this context. These costs include the costs resulting from the distortion of the incentives of the entrusted agent; the costs associated with the time and attention the agent spends on engaging in insider trading; and the costs associated with the loss in the perception of legitimacy of such entrusted agent as a result of insider trading.[166]

One can see a fiduciary-based theory at work in a case like *Chiarella*. There, insider trading liability is premised on the failure of a fiduciary to disclose information to his principal when engaged in a transaction with the principal.[167]

165. Kim, *supra* note 14, at 960–61.

166. *See id.* at 961–67.

167. *See* Chiarella v. United States, 445 U.S. 222, 227–29 (1980).

Why a fiduciary and not someone else? Presumably because the Court believes that the costs of insider trading by the fiduciary are that much more significant.

2. Property Theory

Another theory of insider trading law is that the law does and should focus on protecting quasi-property rights in information in order to incentivize socially desirable activities on the part of the information producer.[168] Under this theory, information is a public good, which means that it is difficult to exclude people from consuming it once it is produced (i.e., it is nonexcludable) and it is never used up in the course of consuming it (i.e., it is non-rivalrous).[169] Because of these characteristics, it is difficult for producers of information to recoup their costs of production in the absence of property rights.[170] Therefore, if left to the market, information, like other public goods, is likely to be underproduced.[171] Because firms produce a lot of information that is not protected by intellectual property law, they need some other source of law—insider trading law—to protect that information.[172] Such protection comes in the form of a property right prohibiting others from using the information.[173] The implication of this theory is that such right can then be assigned through contract.

3. Unjust Enrichment

An alternative theory of insider trading law is that the law does, and should, reflect unjust enrichment principles. In other words, the defendant must "give back that which he obtained by invasion of the plaintiff's interest whether or not that gain equals the plaintiff's loss."[174] Under an unjust enrichment view of insider trading law, the court asks whether the defendant incurred a benefit and whether retention of the benefit would be wrongful. This theory likely would not lead to a liability outcome that is different from that of the fiduciary

168. *See supra* note 13 and accompanying text.

169. *See* Bainbridge, *Insider Trading Regulation*, *supra* note 12, at 1606–07.

170. *See id.*

171. *See id.*

172. One can imagine a number of such examples: information regarding a planned corporate takeover that, if disclosed prematurely, will increase the cost to the acquirer of proceeding with the transaction; information about a planned corporate restructuring that will be politically controversial and, if not disclosed in a context-specific way, will impose significant reputational (and other) costs on the corporation; or information about a new project that, at the moment, is so speculative that it cannot be patented but that, if disclosed even at this early point in time, might make it difficult for the company to beat out its competition in the research and development race. None of the information in the foregoing examples is protected under intellectual property law. Yet, the firm producing this information would be harmed in the absence of property rights, and this harm is likely to have adverse ex ante effects.

173. *See, e.g.*, Bainbridge, *Insider Trading Regulation*, *supra* note 12, at 1607–08.

174. Thompson, *supra* note 15, at 393.

theory,[175] but it might lead to different remedies. In particular, the unjust enrichment theory would view the defendant's gain as a "natural built-in limit which prevents draconian liability for the defendant."[176]

C. *How Well Do the Extant Theories Stack Up?*

Although these are all plausible theories of how insider trading law might work in the abstract, they are not plausible theories of how insider trading law appears to work in practice under Rule 10b-5.

1. Explaining the Positive Law

The first reason these extant theories are not plausible under Rule 10b-5 is that they do not effectively explain Supreme Court precedent—those fixed stars in the insider trading firmament discussed previously.[177] Therefore, they cannot be relied upon to help us resolve the wandering stars: the various circuit splits. To see this, let us revisit our table of hypothetical scenarios from before,[178] but this time we will append to that table the liability outcomes that would likely result from applying the various extant theories discussed above to those hypothetical scenarios.

175. *See id.* at 391–92 (discussing liability in terms of the fiduciary theory).

176. *Id.* at 393.

177. *See supra* text accompanying notes 164–65.

178. *See supra* notes 124–30 and accompanying text.

Table 2. Approaches to Rule 10b-5's Applications to Insider Trading: The Courts and the Extant Theories

Scenario	SCOTUS	Lower Courts	Fiduciary Theory[179]	Property Rights Theory[180]	Unjust Enrichment Theory[181]
1: Brazen Fiduciary	No[182]	No	Yes	Yes	Yes
2: Halfhearted Fiduciary	No[183]	No	Yes	Yes	Yes
3: Contract with Non-Use Provision	Undecided	Split[184]	No	Yes	Yes
4: Contract with Confidentiality Provision	Undecided	Split[185]	No	Yes	Yes
5: Unaffiliated Thief	No[186]	No	No	Yes	Yes

179. The fiduciary theory requires the breach of a fiduciary duty for purposes of Rule 10b-5 liability and therefore would not result in liability in cases like scenarios 3, 4, 5, and 6 where there is no such duty. Because one cannot avoid the breach of a fiduciary duty by providing notice of one's breach, these facts do not eliminate liability under the fiduciary theory in scenarios 1 and 2.

180. Under the property rights theory, trading on someone else's information is akin to stealing, and therefore under this theory, there would be liability under all of the above scenarios.

181. Under the unjust enrichment theory, the defendant must be unjustly enriched to attract liability, which is the case in all of the scenarios except scenario 6, the unaffiliated innocent acquirer.

182. *See* United States v. O'Hagan, 521 U.S. 642, 647, 676 (1997).

183. *See supra* notes 137–38 and accompanying text.

184. *Compare* United States v. McGee, 763 F.3d 304, 314 (3d Cir. 2014) (finding that Rule 10b-5 liability arises from a mere relationship, whether contractual or not, demonstrating a history, pattern, or practice of sharing confidences), SEC v. Cuban, 620 F.3d 551, 557–58 (5th Cir. 2010) (finding that Rule 10b-5 liability would arise from the breach of a non-use provision), *and* SEC v. Yun, 327 F.3d 1263, 1273–74 (11th Cir. 2003) (finding that Rule 10b-5 liability arises from a mere relationship, whether contractual or not, demonstrating a history, pattern, or practice of sharing confidences), *with* United States v. Chestman, 947 F.2d 551, 568 (2d Cir. 1991) (en banc) (requiring the breach of a fiduciary relationship or its "functional equivalent" for insider trading liability under Rule 10b-5), *and* United States v. Kim, 184 F. Supp. 2d 1006, 1015 (N.D. Cal. 2002) (requiring the breach of a fiduciary relationship or its "functional equivalent" for insider trading liability under Rule 10b-5).

185. *Compare McGee*, 763 F.3d at 314 (finding that Rule 10b-5 liability arises from a mere relationship, whether contractual or not, demonstrating a history, pattern, or practice of sharing confidences), *and Yun*, 327 F.3d at 1272–73 (finding that Rule 10b-5 liability arises from a mere relationship, whether contractual or not, demonstrating a history, pattern, or practice of sharing confidences), *with* SEC v. Dorozhko, 606 F. Supp. 2d 321, 323 (S.D.N.Y. 2008) (finding that Rule 10b-5 liability can be premised on a contractual duty but requires something more than a confidentiality provision).

186. *See* Chiarella v. United States, 445 U.S. 222, 232–33, 235 (1980); *see also O'Hagan*, 521 U.S. at 647.

Scenario	SCOTUS	Lower Courts	Fiduciary Theory	Property Rights Theory	Unjust Enrichment Theory
6: Unaffiliated Innocent Acquirer	No[187]	No	No	Yes	No

Both the property and unjust enrichment theories have a particularly difficult time explaining the results that the Supreme Court has reached. Under the property theory, insider trading is akin to conversion. Therefore, it should give rise to liability for any unauthorized trading, regardless of whether that trading is innocent, disclosed (either brazenly of halfheartedly), or the result of theft. For this reason, under the property theory, there would be liability in all of the above cases.

The same is true of the unjust enrichment theory, except for the fact that it would absolve one of liability where the enrichment from the trade is not "unjust," as would be the case for the unaffiliated innocent acquirer. Thus, the unjust enrichment theory does a little better than the property theory in explaining these results, but neither theory does a particularly good job. Nor do these theories sufficiently explain Rule 10b5-2 itself, which is premised on a contractual relationship and therefore cuts across property and fairness concerns. Thus, the property and unjust enrichment theories lack explanatory power when it comes to the Supreme Court's insider trading jurisprudence and Rule 10b5-2.

The fiduciary theory does not fare much better. If insider trading law is to focus on "the use of an entrusted position for self-regarding gain,"[188] then one would expect to see courts extending Rule 10b-5 liability to any breach of the duty of loyalty, regardless of whether there is disclosure of the breach or not. And therefore the fiduciary theory does not fully explain the results in the first or second scenario in table 2 above.

2. The Purpose of 10b-5

The failure of these theories to explain the shape of the law is a symptom of a larger problem. Under these theories, the fact that insider trading law under Rule 10b-5 is based on fraud is an unfortunate anomaly that gets in the way of how things actually should be in an ideal world.[189] Nor do these theories really explain why Rule 10b-5 exists in the first place.[190] In other words, these various

187. *See* Dirks v. SEC, 463 U.S. 646, 657–58, 665 (1983).

188. Kim, *supra* note 14, at 934.

189. *See supra* note 12 and accompanying text.

190. *See* United States v. Chestman, 947 F.2d 551, 578 (2d Cir. 1991) (Winter, J., concurring in part and dissenting in part) ("It must be noted, however, that, although the [property-based] rationale

theories are difficult to reconcile with the fraud-based language of the text of section 10(b) and Rule 10b-5.

3. Federalism Concerns

Additionally, if Rule 10b-5 is really about property, fiduciary duty law, or unjust enrichment, there is a concern about what effect incorporating these common law categories into federal law might have on the common law itself.[191] This concern is at the heart of the federalism issues raised by many commentators who criticize the Court's adoption of the misappropriation theory in *O'Hagan*.[192] The concern is that liability under *O'Hagan* would attach not only to traditional fiduciary relationships but also to other fiduciary-like relationships as well.[193] Moreover, the court would have to determine which obligations apply to such fiduciary-like relationships.[194] Thus, the federalization of fiduciary duty law would likely affect not only the domain but also the content of fiduciary duty law.[195] As a consequence, federal securities law would drive these determinations.

4. Making Sense of *O'Hagan*

Under these theories, the misappropriation theory articulated in *O'Hagan* just does not make sense. From the perspective of the fiduciary-based or unjust enrichment-based theories, it is difficult to explain why the source of the information should be able to authorize the insider trading, which the misappropriation theory allows.[196] True, the property-based theory has an easier

. . . provides a policy for prohibiting a specific kind of insider trading, any obvious relationship to Section 10(b) is presently missing because theft rather than fraud or deceit, seems the gravamen of the prohibition . . . . Nevertheless, the law is far enough down this road . . . that a court of appeals has no option but to continue the route.").

191. Indeed, this concern is implicit in the *Santa Fe* Court's warning against section 10(b) jurisprudence in state fiduciary-duty law. *See* Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 478–79 (1977).

192. *See* Painter et al., *supra* note 18, at 186–87; Ribstein, *supra* note 116, at 158, 171.

193. *See* Painter et al., *supra* note 18, at 186–87; Ribstein, *supra* note 116, at 167.

194. *See* Painter et al., *supra* note 18, at 187; Ribstein, *supra* note 116, at 167–69.

195. *See* Painter et al., *supra* note 18, at 186–87; Ribstein, *supra* note 116, at 169–71.

196. Admittedly, this assumes that fiduciary duties are not waivable. This is clearly true of corporate law but not true of other domains like the law of limited liability companies. As to the normative desirability of waivable fiduciary duties, there is disagreement. *Compare* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 8–10, 91–93 (1991) [hereinafter EASTERBROOK & FISCHEL, ECONOMIC STRUCTURE], Henry N. Butler & Larry E. Ribstein, *Opting Out of Fiduciary Duties: A Response to the Anti-Contractarians*, 65 WASH. L. REV. 1, 29 (1990) (arguing that "[t]he critical point to understand under the contract theory is that fiduciary duties are not distinct from the contract but are simply one of many drafting alternatives"), *and* Frank H. Easterbrook & Daniel R. Fischel, *Contract and Fiduciary Duty*, 36 J.L. & ECON. 425, 427 (1993) [hereinafter Easterbrook & Fischel, *Fiduciary Duty*] ("Fiduciary duties are not special duties . . . . Actual contracts always prevail over implied ones."), *with* Victor Brudney, *Corporate Governance: Agency Costs, and the Rhetoric of Contract*, 85 COLUM. L. REV. 1403, 1414–15, 1414 n.29 (1985), John C.

time explaining this feature of the misappropriation theory.[197] But none of these theories, including the property theory, explains the brazen fiduciary problem—the fact that under *O'Hagan*, a trader should be able to avoid liability simply by giving notice to the information source of an intent to trade on the source's information.[198]

5. Reconciling *Santa Fe* and *O'Hagan*

Finally, none of these theories provides a satisfactory way to reconcile *Santa Fe* and *O'Hagan*. The challenge lies in explaining why there is liability in the latter case but not the former. With one exception, none of the extant theories provide any help here. Furthermore, the one exception—the property theory—has a number of other shortcomings.

Recall that in *Santa Fe* the Court held that Rule 10b-5 requires actual fraud, meaning that the breach of a fiduciary duty, with nothing more, fails to give rise to insider trading liability under the rule.[199] And yet, in *O'Hagan*, it seemed that, as a basis for holding James O'Hagan liable under Rule 10b-5, there was little more than a breach of the duty of confidentiality he owed to his firm and his firm's client, Grand Met.[200]

How does one reconcile these results? Neither the unjust enrichment theory nor the fiduciary theory help, as each would require liability in both cases. Assuming the factual accuracy of the plaintiffs' allegations in *Santa Fe*, those allegations would spell out a case of unjust enrichment and a breach of fiduciary duty. The same could be said of *O'Hagan*. Therefore, under the unjust enrichment and fiduciary duty theories, there would be liability in both cases, which is not what actually happened.

It is true that the property theory does a better job generating the observed results. After all, in *O'Hagan*, there is clearly a conversion of property, assuming, as the property theory does, that Rule 10b-5 vests property rights in

Coffee, Jr., *No Exit?: Opting Out, The Contractual Theory of the Corporation, and the Special Case of Remedies*, 53 BROOK. L. REV. 919, 972–74 (1988), *and* Jeffrey N. Gordon, *The Mandatory Structure of Corporate Law*, 89 COLUM. L. REV. 1549, 1554–55, 1597 (1989). This debate plays out not just in corporate law but across the fiduciary duty spectrum. *See, e.g.*, Melanie B. Leslie, *Trusting Trustees: Fiduciary Duties and the Limits of Default Rules*, 94 GEO. L.J. 67, 68–69 (2005).

197. The reason is that property should be alienable, and therefore if insider trading law confers property rights in information to information sources, then that right should be alienable. *See, e.g.*, Bainbridge, *Insider Trading Regulation*, *supra* note 12, at 1645; Langevoort, *Rereading* Cady, Roberts, *supra* note 11, at 1323 (noting that the duty in *O'Hagan* is contractual and that this development "pleases those who see the insider trading prohibition largely as a corporate property protection mechanism").

198. *See* United States v. O'Hagan, 521 U.S. 642, 655 (1997).

199. Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 479–80 (1977).

200. *See, e.g.*, Langevoort, *Rereading* Cady, Roberts, *supra* note 11, at 1323 ("But notwithstanding a respectful bow to the earlier decision, it renders *Santa Fe* of minimal significance given that very few breaches of fiduciary duty are ever done brazenly. There is almost always some element of concealment.").

information. By contrast, in *Santa Fe* there is no conversion, even if one takes the plaintiffs' allegations as true. But the property theory has other problems, documented previously, including that it has a hard time explaining the rest of insider trading jurisprudence.[201]

More fundamentally, however, none of these theories, including the property theory, helps us understand the *O'Hagan* majority's own apparent rationale for distinguishing the two cases. The *O'Hagan* majority seems to say that Rule 10b-5 applies because of James O'Hagan's failure to disclose his breach to his principal.[202] This raises two questions. First, it is not clear why a concealed breach from our earlier scenarios constitutes fraud and what the limiting principle is there.[203] Second, taking the majority's fraud theory as a given, it is not clear why that same theory does not result in fraud in *Santa Fe*. After all, the corporate executives in *Santa Fe* might have disclosed the information regarding the freeze-out to their shareholders. But they certainly did not disclose that they were breaching a fiduciary duty, which was, after all, the source of liability in *O'Hagan*. In other words, the *O'Hagan* majority seems to be saying that a defendant can avoid liability not only by disclosing the actual breach but also by disclosing underlying facts that would make it easier for the plaintiff to discover that breach. This is the "halfhearted fiduciary" case, which arguably reconciles the two cases.[204] Yet, if this is how we reconcile the two cases, none of these theories explain why a halfhearted fiduciary should be able to avoid liability.

D. *Conclusion: The Extant Theories Do Not Stack Up Well*

The extant theories of Rule 10b-5-based insider trading law have a difficult time explaining the jurisprudence: they do not explain why Rule 10b-5 is necessary instead of relying only on state law;[205] they raise significant federalism concerns;[206] they have a difficult time making sense of the rule that the Court

201. *See supra* Sections I.C.1–2.

202. *O'Hagan*, 521 U.S. at 655 ("In contrast to the Government's allegations in this case, in *Santa Fe Industries*, all pertinent facts were disclosed by the persons charged with violating § 10(b) and Rule 10b–5; therefore, there was no deception through nondisclosure to which liability under those provisions could attach. Similarly, full disclosure forecloses liability under the misappropriation theory: Because the deception essential to the misappropriation theory involves feigning fidelity to the source of information, if the fiduciary discloses to the source that he plans to trade on the nonpublic information, there is no 'deceptive device' and thus no § 10(b) violation—although the fiduciary-turned-trader may remain liable under state law for breach of a duty of loyalty." (citations omitted)).

203. The closest the common law comes to saying that the breach of a duty—other than a duty to disclose—constitutes fraud is the doctrine of promissory fraud, which requires the promisor to intend to breach contemporaneous with making the promise.

204. *See supra* text accompanying notes 3–7.

205. *See supra* Section I.C.2.

206. *See supra* Section I.C.3.

develops in *O'Hagan*;[207] and they cannot explain the rationale the *O'Hagan* Court offers to distinguish that case from *Santa Fe*.[208]

By contrast, the contractual fraud theory addresses all of these concerns. It does a better job than any of these theories in explaining the shape of the law. It does not treat the statute's basis in fraud as an inconvenient truth and instead views it as central to the problem at issue: how to address, through contract, the fact that insider trading is a breach that is hard to detect. For this reason, the contractual fraud theory explains the existence of Rule 10b-5. We need Rule 10b-5 because, without it, the common law does not solve the costly detection problem. The contractual fraud theory does not pose the same risks to federalism values. Moreover, the rule announced in *O'Hagan* makes perfect sense under the contractual fraud theory. It is only logical that the information source should have the right to authorize insider trading. And under the contractual fraud theory, the fact that a trader that discloses his intent to trade to the source of the information (the so-called brazen fiduciary) is not a problem. In fact, it is a feature, not a bug. Finally, the contractual fraud theory helps us distinguish *Santa Fe* from *O'Hagan* on the basis that the breach in *Santa Fe* was not particularly costly to detect in light of disclosure of the underlying facts while the costs of detecting the breach in *O'Hagan* was significant.

To develop these arguments, let us first consider the contractual fraud theory in greater depth.

II. THE CONTRACTUAL FRAUD THEORY

A. *Overview*

Under the contractual fraud theory, insider trading liability arises whenever the trading breaches a duty to report—either explicit or implied by a court—which is the violation of an underlying covenant—whether contractual or fiduciary-based—that prohibits the insider trading in the first place. This failure to report constitutes fraud pursuant to Rule 10b-5 and should therefore give rise to the fraud-like, extracompensatory damages provided for by the rule.

The contractual fraud theory is premised on the notion that insider trading is extremely costly to detect for parties wishing to protect their information from this impermissible use. Under this theory, insider trading is but one type of "costly detection problem."[209] Thus, parties that wish to protect the use of their information from insider trading have incentives to reduce these detection costs. This is true regardless of whether the relationship between the source and

207. *See supra* Section I.C.4.
208. *See supra* Section I.C.5.
209. *See supra* note 19 and accompanying text.

recipient of the information is contractual or fiduciary.[210] Both relationships might include a bar on insider trading—a contractual confidentiality or non-use provision in the case of the contracting relationship and a duty of loyalty in the case of the fiduciary relationship. Call this the "negative insider trading covenant." The problem, however, is that, even with a negative insider trading covenant in place, the information source set on protecting his information faces steep costs to detecting underlying breaches of that covenant.

One approach to minimize these detection costs would be to contract for "cooperation in recovery."[211] In other words, the information source might require the party in receipt of the confidential information to disclose any breach of the underlying covenant, whether contractual or fiduciary, that bars insider trading.[212] This is the "reporting covenant" discussed in the introduction to this Article.[213] A reporting covenant, at least in theory, lowers detection costs by creating an additional source of liability if the information recipient fails to inform the information source of a breach of the underlying negative insider trading covenant.[214]

However, the problem is, as contract scholars have explained, this disclosure duty is ineffective if it is enforced with traditional contract

210. There is an important remedial difference between contract law and fiduciary duty law. Whereas the remedy for breach of contract is expectation damages, the remedy for a fiduciary breach is disgorgement. *See* E. Allan Farnsworth, *Your Loss or My Gain? The Dilemma of the Disgorgement Principle in Breach of Contract*, 94 YALE L.J. 1339, 1341 (1985). One might think that this remedial difference would eliminate the costly detection problem when the underlying non-use provision comes from fiduciary, rather than contract, law since the disgorgement amount generally will be greater than expectation damages. However, this is not necessarily the case. While it's true that the fiduciary might be marginally less inclined to breach than the contracting party, there is still an incentive to breach if he thinks it is unlikely to be caught and if the worst that can happen is a disgorgement of his profits. Now, it is true that common law courts will occasionally award punitive damages for certain types of fiduciary breaches. However, usually the availability of punitive damages for fiduciary breaches is reserved for cases where the harm has a public orientation. *See, e.g.*, Barbagallo v. Marcum LLP, 820 F. Supp. 2d 429, 448–49 (E.D.N.Y. 2011) (granting defendant's motion to dismiss with respect to plaintiff's punitive damages claims regarding alleged misappropriation of trade secrets and fiduciary breaches on the grounds that such allegations do not implicate behavior directed toward the public). To be sure, there actually are good arguments as to why insider trading in breach of a duty entails public harms, but I am not aware of any cases that have held this with respect to common law fiduciary duty claims. Where insider trading claims were brought under state law fiduciary duty claims, the penalty is usually just disgorgement. *See, e.g.*, Brophy v. Cities Serv. Co., 70 A.2d 5, 8 (Del. Ch. 1949) (holding that insider trading in breach of state fiduciary duty law requires disgorgement of profits).

211. This is Gregory Klass's term. *See* Klass, *supra* note 19, at 2.

212. An example is Section 5.4 of the ABA's Model Stock Purchase Agreement (the "SPA"). MODEL STOCK PURCHASE AGREEMENT § 5.4 (AM. BAR ASS'N 2d ed. 2010).

213. *See supra* notes 28–29 and accompanying text.

214. *See* Klass, *supra* note 19, at 12 ("Such duties[, like the reporting covenant,] make it easier to verify whether performance has happened and thereby increase the probability that the promisee will be able to prove any breach in court. In addition, such terms can reduce litigation costs (by reducing the cost of information to the promisee) and make performance more observable (by telling the promisee about it).").

remedies.[215] If the promisor fails to report an impermissible use of the promisee's confidential information, the only way the promisee can recover is by proving that there was indeed a breach of the negative insider trading covenant, the underlying bar on insider trading.[216] If there was, then the promisor also breached the failure to report that underlying breach.[217] But if the promisee can prove the underlying breach, then there is no separate harm incurred as a result of the breach of the reporting covenant.[218] After all, the whole point of the reporting covenant is to make it possible for the promisee to detect an underlying breach.[219] If the promisee is already aware of such breach, then there is no additional harm arising from the promisor's failure to report it.[220] Consequently, in terms of mere compensatory remedies, the promisee is entitled to compensation for the underlying breach but nothing more.[221] But such compensatory remedies do not impose any additional cost on the promisor. Accordingly, when only compensatory damages are available, there is little that prevents the promisor from breaching that underlying covenant or duty.[222] As a result, if enforced with traditional compensatory damages, the reporting covenant does not in actuality have much, if any, effect—it does not do anything to help the promisee detect the underlying breach.

The way through this impasse is to award extracompensatory damages of the sort available in fraud for breaches of the reporting covenant.[223] Then the promisor would incur an additional cost for the failure to report the underlying breach and, if calculated correctly, the resulting punitive damages could be expected to incentivize the promisor to actually report the underlying breach.[224] Additionally, from a legal perspective, it would seem that courts would be justified in awarding extracompensatory damages for the breach of a reporting covenant. After all, the failure to disclose information while under an obligation to do so sounds a lot like classic fraudulent concealment, which, as a species of fraud, triggers noncompensatory damages.[225]

Thus, in the case of a reporting covenant, it would seem that the policy goals and the legal requirements are in alignment—the covenant is only effective as a means of lowering the detection costs of a breach involving insider

215. *See id.* at 15–27 (arguing that, if the failure to report the violation of an underlying covenant results in the same liability as if one does report, there is no incentive to report).

216. *See id.* at 17.

217. *See id.* at 17–18.

218. *See id.* at 17.

219. *See id.*

220. *See id.*

221. *See id.*

222. *See id*. at 26, 32.

223. *See id.* at 32.

224. *See id.* at 32–33.

225. *See* RESTATEMENT (SECOND) OF TORTS § 551(1)–(2)(a) (AM. LAW INST. 1977).

trading if the covenant is enforced with extracompensatory damages. It just so happens that, as a legal matter, such damages are warranted in light of the fact that the breach of the covenant sounds not just in contract but in fraud as well, where extracompensatory damages are warranted.

However, at common law, courts tend to be skeptical of awarding extracompensatory damages even in those cases, like the reporting covenant described above, where the parties seem to be contracting for fraud liability.[226] Indeed, courts appear to be particularly reluctant where the fraud is premised on non-disclosure in the face of a *contractual* duty like the one created by the reporting covenant.[227] The upshot is that, at common law, it is unlikely that courts will allow parties to effectively enforce covenants to cooperate in recovery, even if the parties specifically opt for extracompensatory damages by explicitly contracting for fraud liability. In other words, the common law does not help parties address the costly detection problem.

Rule 10b-5, by contrast, does, or at least that is the claim at the heart of the contractual fraud theory. Under this theory, Rule 10b-5 allows parties to do something that they cannot do under state law—contract for extracompensatory damages for a particular instance of the costly detection problem, insider trading. Under Rule 10b-5, if the contract includes a covenant to report the breach of a provision prohibiting insider trading, and if the promisor engages in insider trading based on confidential information without disclosing it to the counterparty, then Rule 10b-5 provides for extracompensatory damages to enforce that reporting duty.[228] That is the core of the contractual fraud theory of insider trading. Moreover, Rule 10b-5 allows these contracting parties to have such contract provisions enforced by public enforcement authorities, another feature that helps address the costly detection problem by making it more likely that such breaches will be detected. Of course, one might wonder why we decided to federalize only one type of costly detection problem—insider trading—and not others. The answer is that insider trading has potentially significant welfare implications and therefore is a comparatively relevant subject matter for federal law.[229]

Thus, under the contractual fraud theory, Rule 10b-5 allows parties to contract for fraud liability whereas they cannot do this at common law (or cannot without extreme uncertainty). Where a party engages in insider trading

226. *See* Klass, *supra* note 19, at 45–47.

227. Indeed, only a small handful of cases can be located. *See, e.g.*, Klass, *supra* note 19, at 45 n.99 (noting that he could find only "one case applying fraudulent suppression based on a contractual duty to disclose" in 2007).

228. *See* Donald C. Langevoort, *The Insider Trading Sanctions Act of 1984 and Its Effect on Existing Law*, 37 VAND. L. REV. 1273, 1278 (1984). In addition to the criminal penalties for insider trading, the civil penalties include treble damages. *Id.*

229. *See infra* Section II.A.2.

in breach of a reporting covenant, the extracompensatory damages of the federal securities laws apply, which, combined with federal enforcement resources, lower the detection costs of insider trading.

Not only can contracting parties explicitly contract for fraud liability under the contractual fraud theory, but it also follows that courts (or the SEC) should be able to read into contracts implicit elections for such liability. That is to say, in certain circumstances, courts (or the SEC) should be able to decide that a "negative insider trading covenant"[230] is implicitly accompanied by a duty to disclose any breach of that underlying covenant. Thus, failure to disclose would breach that reporting covenant and trigger Rule 10b-5.

Before proceeding, a clarification is in order. Up to this point, the discussion has explicitly assumed that insider trading's costly detection problem is a problem regardless of whether the underlying bar on insider trading comes from a contractual or fiduciary relationship. When reference is made to courts interpreting the "contract" between the source of the information and the recipient, it is still the assumption that the underlying ban on insider trading is coming from a contractual or fiduciary relationship, in particular a confidentiality or non-use provision in the case of contract or the duty of loyalty in the case of the fiduciary relationship. The question is whether there is an implicit contractual overlay that requires a duty to report a breach of that underlying contractual or fiduciary duty. In other words, under what circumstances should courts (or the SEC) infer such a contractual provision in a relationship, whether contractual or fiduciary?

That question is really one of contract interpretation. And the answer depends on whether one thinks that the goal of interpreting the contract is to maximize private welfare—in other words, the welfare of just the contracting parties themselves—or the welfare of the public more generally.[231] I argue below that courts should generally take a private-welfare maximizing view but that the SEC would be justified in taking a public-welfare maximizing view.

1. The Private-Welfare Maximizing View

From a private-welfare maximizing view, whether the contract should be interpreted as containing an implicit provision triggering Rule 10b-5 liability for insider trading would turn on a hypothetical bargaining analysis. This is a fairly standard way of deciding contract interpretation questions.[232] The hypothetical bargain analysis asks what the parties themselves were likely to

230. *See supra* notes 210–12 and accompanying text.

231. *See, e.g.*, ROBERT COOTER & THOMAS ULEN, LAW & ECONOMICS 44–45 (Denise Clinton et al. eds., 5th ed. 2008) (discussing the difference between private and social welfare).

232. *See* Charny, *supra* note 34, at 1877 ("Courts generally interpret contracts — resolve ambiguities and fill in missing terms — by asking what the parties would have agreed to had they explicitly addressed the issue before the court.").

have decided had they considered this issue at the time of contracting.[233] In other words, what factors govern whether parties will agree to fraud liability for enforcing a negative insider trading covenant?

a. Two Factors

There are two factors that are particularly relevant: the difficulty of detecting the underlying breach and the availability of alternative means for enforcing compliance. The more costly it is to detect the underlying breach and the less cost effective the alternative means for enforcing compliance, the more likely it is that contracting parties will choose (implicitly) to enforce a contractual prohibition on insider trading through the fraud liability granted by Rule 10b-5.

i. Difficulty of Detecting the Underlying Breach

The contractual fraud theory is premised on the notion that insider trading can be regulated through contract law but only if contract law permits parties to contract for fraud liability. Insider trading is costly to detect, and attempts to use contracts to compel the recipient of confidential information to report any insider trading to require something more than compensatory contract damages. Thus, the theory is constructed on the fact that insider trading presents a costly detection problem. The implication is that if, for whatever reason, insider trading in a given case is not costly to detect, then this fact should weigh against the applicability of Rule 10b-5 and therefore against the court finding an implicit duty to report the insider trading.

What might lower the costs of detecting the underlying breach of either a contractual or fiduciary duty? One possibility is the existence of a separate disclosure regime that might help the beneficiary of the contractual or fiduciary duty to uncover the breach. In fact, *Santa Fe* is just such a case.[234] There, the controlling shareholder was obligated under the proxy rules to provide the minority shareholders with expansive disclosure concerning the facts of the transaction, management's interests, and the opinions of the board, accountants, and investment bankers, among other things. Indeed, it was this disclosure that allowed the minority shareholders to bring the suit in the first place, claiming that the transaction was unfair and therefore breached the controlling shareholders' fiduciary duties.[235] Thus, *Santa Fe* provides an example of a case where the breach of the underlying duty was not costly to verify in any way because of the proxy rules requiring disclosure. This helps explain why the Court held that Rule 10b-5 did not apply in that case.

233. *See id.*
234. *See* Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 466–67 (1977).
235. *See id*.

ii. Alternative Means of Enforcing Compliance

The other consideration is the availability of an alternative means of enforcing the promisor's compliance with the contractual prohibition to engage in insider trading. Fraud liability is one way of encouraging compliance with a covenant not to engage in insider trading. But it is not the only way.

One common alternative for encouraging compliance in this context involves controlling the flow of information that might lead to insider trading.[236] Parties can control the flow of information in several ways: by refusing to share certain information with contracting counterparties, by delaying disclosure of such information until a time when its value as inside information is less, or by narrowing the number of intended recipients of the information.[237] One sees contracting parties employ any or all of these methods frequently when they share confidential information that they do not want disclosed or used in certain impermissible ways.

However, these alternative means of enforcing compliance are not as readily available in all circumstances. As a general matter, these alternatives are probably going to be more cost effective in arm's-length transactions as opposed to within firms. In other words, it is more cost effective for a firm to pursue these alternatives when dealing at arm's length with, let's say, a supplier than it is with the Chief Marketing Officer of the firm itself. That is to say, if a firm has sensitive information that it does not want used for insider trading purposes, it is easier to refuse to share that information, or delay disclosure of it, to the supplier than it is the Chief Marketing Officer.

The distinction has to do with the fundamentally different nature of the two relationships. In the case of the Chief Marketing Officer, the firm is hiring his knowledge and expertise for a variety of unspecified, multifaceted problems that will persist over an undetermined period of time. In that context, it will be difficult to control the flow of information through the means outlined above. It is difficult to know what type of information the Chief Marketing Officer will need to do his job. And his contacts with other members of the firm will be frequent and varied, making it unrealistic as a practical matter of controlling information flow in this way.

This is not true, by contrast, of the supplier in the arm's-length contract. In that case, the transaction is much simpler. The relationship is specific and predetermined. And the contacts with the disclosing party are discrete and less varied. Consequently, it is relatively cost-effective to employ control of information flow as an alternative means of enforcing compliance.

236. *Cf.* Burstein, *supra* note 21, at 256–58 (identifying the control of information flow as one strategy used by those who must contract over information in the absence of property rules protecting that information).

237. *See* Carlton & Fischel, *supra* note 13, at 890.

Some readers will notice that my description of the differences between the case of the Chief Marketing Officer and that of the supplier mirrors in important ways how Ian Macneil and Stewart Macaulay talked about relational contracting.[238] They conceived of contracts as falling on a spectrum from arm's length to relational, with the precise location on the spectrum a function of the "duration of the relationship; thickness of future ties between the contracting parties; and the clarity of future rights and obligations."[239] In other words, one could say that the more relational a contractual relationship, the more costly it will be to regulate insider trading in the relationship by controlling information flow. The reasons for this are because of the very nature of those relational contracts, as described by Macneil and Macaulay.

Another way of thinking about this is through the lens of the institutional economics literature that emerged out of Ronald Coase's theory of the firm.[240] Indeed, some characterize Coase's theory as a theory of relational contracting,[241] and Coase himself seemed to validate this view.[242] Coase's insight was that, as transaction costs increase, economic production will go from being organized through arm's-length contracting to being organized in firms or hierarchies.[243] More modern elaborations of Coase's insight find that there exists a spectrum of economic organization with firms on one end, contracts on the other and

238. *See* Stewart Macaulay, *Non-Contractual Relations in Business: A Preliminary Study*, 28 AM. SOC. REV. 55, 62–63 (1963); Stewart Macaulay, *Relational Contracts Floating on a Sea of Custom? Thoughts About the Ideas of Ian Macneil and Lisa Bernstein*, 94 NW. U. L. REV. 775, 778 (2000); Ian R. Macneil, *The Many Futures of Contracts*, 47 S. CAL. L. REV. 691, 718–19 (1974); Ian R. Macneil, *Relational Contract Theory: Challenges and Queries*, 94 NW. U. L. REV. 877, 882–83 (2000); Ian R. Macneil, *Relational Contract: What We Do and Do Not Know*, 1985 WIS. L. REV. 483, 509. *See generally* IAN R. MACNEIL, THE RELATIONAL THEORY OF CONTRACT: SELECTED WORKS OF IAN MACNEIL (David Campbell ed., 2001) (providing a general understanding of Ian Macneil's thoughts on relational contracting).

239. D. Gordon Smith & Brayden G. King, *Contracts as Organizations*, 51 ARIZ. L. REV. 1, 9 (2009).

240. *See* Ronald H. Coase, *The Nature of the Firm*, 4 ECONOMICA 386, 391–92 (1937) [hereinafter Coase, *Nature of the Firm*]; *see also* George S. Geis, *The Space Between Markets and Hierarchies*, 95 VA. L. REV. 99, 107–08 (2009). For a general introduction to Coase's work, see generally NEW INSTITUTIONAL ECONOMICS: A GUIDEBOOK (Éric Brousseau & Jean-Michel Glachant eds., 2008).

241. *See* Smith & King, *supra* note 239, at 16.

242. *See, e.g.*, Ronald H. Coase, *The Nature of the Firm: Meaning*, *in* THE NATURE OF THE FIRM: ORIGINS, EVOLUTION, AND DEVELOPMENT 48, 56 (Oliver E. Williamson & Sidney G. Winter eds., 1991) [hereinafter Coase, *Meaning*] ("A number of economists have said in recent years that the problem of the firm is essentially a choice of contractual arrangements. I have never thought otherwise.").

243. *See* Coase, *Nature of the Firm*, *supra* note 240, at 390–95.

more hybrid organizations, like joint ventures, strategic alliances,[244] and other interfirm collaborations, in the muddy middle.[245]

Thus, through the Coase lens, what Macauley and Macneil identified were the determinants of the variation in transaction costs among different types of contracting relationships, where relatively longer-term, more thickly tied, open-ended relationships are associated with greater transaction costs. And these high-transaction-cost relationships are more likely to be organized within a firm.[246] But high-transaction-cost relationships are not limited to firms. Frank Easterbrook and Daniel Fischel have argued that these same factors that underlie relatively greater transaction costs and that lead to hierarchies and relational contracts also seem to determine the existence of fiduciary duties.[247] We can see this represented in figure 1.

244. *See* George W. Dent, Jr., *Gap Fillers and Fiduciary Duties in Strategic Alliances*, 57 BUS. LAW. 55, 55, 57 (2001); Ranjay Gulati & Harbir Singh, *The Architecture of Cooperation: Managing Coordination Costs and Appropriation Concerns in Strategic Alliances*, 43 ADMIN. SCI. Q. 781, 781 (1998) ("An alliance is commonly defined as any voluntarily initiated cooperative agreement between firms that involves exchange, sharing, or co-development, and it can include contributions by partners of capital, technology, or firm-specific assets."); Claude Ménard, *The Economics of Hybrid Organizations*, 160 J. INSTITUTIONAL & THEORETICAL ECON. 345, 352–55 (2004) ("Last, there are alliances among firms, particularly frequent when the development or transfer of technologies is at stake. Here, we are closer to standard contractual practices."). For background on hybrid arrangements more generally, see Geis, *supra* note 240, at 121–26; Joanne E. Oxley & Brian S. Silverman, *Inter-Firm Alliances: A New Institutional Economics Approach*, *in* NEW INSTITUTIONAL ECONOMICS: A GUIDEBOOK, *supra* note 240.

245. *See* Oxley & Silverman, *supra* note 244, at 209.

246. *See* Smith & King, *supra* note 239, at 16–18; *see also* Geis, *supra* note 240, at 122.

247. *See* Easterbrook & Fischel, *Fiduciary Duty*, *supra* note 196, at 427 ("[W]e concluded, a 'fiduciary' relation is a contractual one characterized by unusually high costs of specification and monitoring. The duty of loyalty replaces detailed contractual terms, and courts flesh out the duty of loyalty by prescribing the actions the parties themselves would have preferred if bargaining were cheap and all promises fully enforced. The usual economic assessments of contractual terms and remedies then apply. Fiduciary duties are not special duties; they have no moral footing; they are the same sort of obligations, derived and enforced in the same way, as other contractual undertakings.").

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Figure 1: Alternative Means of Regulating Insider Trading

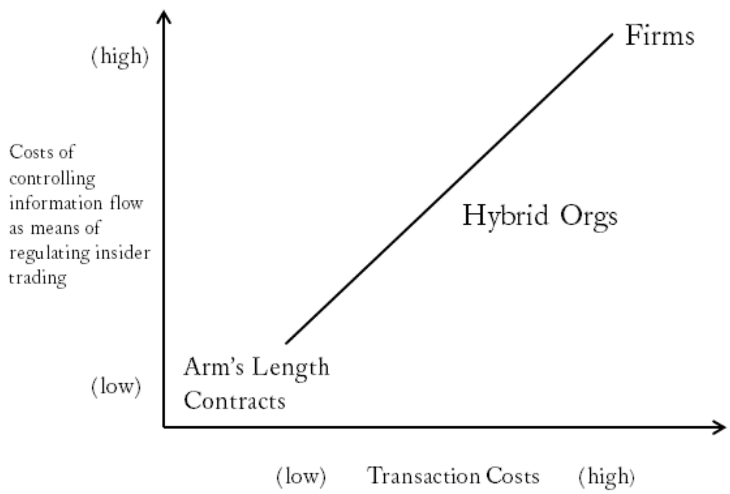

Figure 1 illustrates that, as a means of regulating insider trading, controlling information flow depends on the costs of doing so, which depends on the nature of the relationship. It seems that those costs are likely to be directly related to the factors that determine the existence of firms and hierarchies. In other words, information sources will find it relatively more costly to regulate insider trading based on that information by controlling information flow when in the context of firms or fiduciary relationships than in the context of arm's-length contracts.

To summarize, the question is under what circumstances we might expect sources and recipients of information to contract for fraud liability under Rule 10b-5 to regulate the risk of insider trading. This analysis suggests that, everything else equal, sources and their recipients will find it cost effective to opt into the Rule 10b-5 liability regime (through the use of a reporting covenant) where there is no alternative disclosure regime that would reduce the costs of detection, and where there is no alternative means of deterring insider trading by, for example, controlling information flow.

b. Answering the Question Posed by the Private-Welfare Maximization View

The foregoing analysis allows us to finally suggest an answer to the question posed by the private-welfare maximization approach to the contractual fraud theory. That question is this: How does a court go about finding the existence of an implied covenant to report the violation of an underlying duty not to engage in insider trading?[248]

Under the private-welfare maximizing view, the court should ask what the parties themselves would have done had they addressed the issue. The answer, based on the foregoing analysis, is that in the absence of an alternative disclosure regime making it easier to detect the breach, courts should find an implied duty to report the breach in fiduciary and intrafirm relationships—and possibly in hybrid relationships—but not in arm's-length contracting relationships.

Consider an employee of IBM who uses material nonpublic information he obtains from his employer to trade in the stock of companies other than IBM. That's the intrafirm case. Now, compare that to the arm's-length case—instead of an employee of IBM, maybe a supplier in an arm's-length contract with IBM (selling stuff in exchange for cash) who acquires the information from IBM during the course of that contractual relationship. As depicted in figure 1, the contractual fraud theory predicts that it is private-welfare maximizing for parties to regulate insider trading in the intrafirm case through fraud liability (under Rule 10b-5 by way of a reporting covenant) but to leave the parties to adopt alternatives to fraud liability in the arm's-length case where the costs of doing so are relatively less.

c. *Testing the Answer to the Private-Welfare Maximizing View*

The further implication is that courts should adopt default rules reflecting this result—that is to say, a default reporting covenant in intrafirm relationships but not in arm's-length ones. In fact, this is essentially what the Supreme Court did in *O'Hagan*.[249] And, as discussed in greater detail below, although private parties could contract around the rule the Court announced in *O'Hagan*, they rarely do. This is evidence that this is in fact the private-welfare maximizing result.

248. Recall that under the contractual fraud theory, Rule 10b-5 is fundamentally about providing parties with the means to contract for fraud liability so as to reduce the detection costs inherent in insider trading. Contracting parties do so by including a covenant to report a breach of an underlying covenant not to engage in insider trading. These reporting covenants can be explicit or implicit. *See supra* notes 211–33 and accompanying text.

249. Regardless of how one reads *O'Hagan*, the opinion clearly holds that the misappropriation theory applies to situations involving fiduciary relationships like that which exists between a lawyer and his client. The opinion has also been assumed to apply to employer-employee relationships. *See, e.g.*, United States v. Falcone, 257 F.3d 226, 232 (2d Cir. 2001); United States v. Kim, 184 F. Supp. 2d 1006, 1011 (N.D. Cal. 2002) (listing circumstances where the *O'Hagan* rule has applied as including attorney-client, employer-employee, and psychiatrist-patient). In other words, it would apply not just to the relationship between James O'Hagan and Grand Met but also to the relationship between Grand Met CEO and Grand Met. *See, e.g.*, SEC v. Talbot, 530 F.3d 1085, 1096 (9th Cir. 2008) (holding that the *O'Hagan* rule applies to a director who acquired from his own firm information concerning another corporation's stock, which he traded in).

In *O'Hagan*, the Court held that non-disclosure of the trade is fraudulent in fiduciary relationships[250] and, more generally, any employment relationship.[251] This is what I have referred to as the "intrafirm" context. As I said previously, there is absolutely no theory at common law as to why the failure to report the underlying breach here would be fraudulent.[252]

Under the contractual fraud theory, what the Supreme Court is doing is finding an implied reporting covenant in the relationship. This covenant provides that the recipient of the information has a duty to report the breach of the underlying negative insider trading covenant (in the fiduciary context, this negative insider trading covenant is simply contained within the duty of loyalty). Although under the common law the failure to report pursuant to such a reporting covenant would not be considered fraud, Rule 10b-5 alters that common law rule when considered under the contractual fraud theory. The Court in *O'Hagan* should be understood as finding an implied reporting covenant because it is a fiduciary relationship and, in the absence of an alternative disclosure regime, it is relatively cost effective to regulate insider trading in the context of fiduciary relationships through the threat of liability. Furthermore, the *O'Hagan* Court makes clear that this is a default rule, meaning that parties could contract for an alternative if this was not, in fact, the private-welfare maximizing result. However, it is very unusual to see parties contract around the *O'Hagan* rule, so much so that the few exceptions are major business news items when they occur.[253] Thus, it would appear that the Court's approach to the intrafirm and fiduciary cases is precisely that which is predicted by the contractual fraud theory.

But what about the other side of the spectrum, the case of contracting parties in an arm's-length relationship—the example of the supplier to IBM in the example above? The contractual fraud theory predicts that it is not private-welfare maximizing for these arm's-length contracting parties to include reporting covenants in their agreements because there are more cost-effective alternatives in this context for regulating insider trading, including by controlling information flow. Thus, under the contractual fraud theory, courts should not find implied reporting covenants in these arm's-length contracts.

250. *See* United States v. O'Hagan, 521 U.S. 642, 647, 652–53 (1997) (affirming that trading based on nonpublic information constitutes fraud partly because it is a transaction based in deception).

251. *See Falcone*, 257 F.3d at 228 (holding that misappropriation in the employment context violates § 10(b) even when the misappropriation itself lacks "a certain nexus with securities trading").

252. *See supra* notes 226–27 and accompanying text.

253. *See* Kathleen Day, *Cold Researcher Made Profit on Quigley Shares*, WASH. POST, Jan. 31, 1997, at G1 (recounting how an employer authorized a scientist involved in a clinical trial of a medical product to purchase the stock of the product's manufacturer before the public announcement of the trial's positive results).

The *O'Hagan* Court never clearly stated that its implied reporting covenant does not apply to arm's-length relationships.[254] To be sure, the SEC has taken the position in Rule 10b5-2 that the *O'Hagan* rule applies in any contractual situation where the parties have included a confidentiality agreement.[255] Yet, courts have not always been deferential to the SEC's view.[256] Some courts have taken the position that an explicit non-use agreement is a necessary condition for finding insider trading liability.[257] Other courts have suggested that still more is required, demanding nothing less than the "functional equivalent of a fiduciary relationship."[258] Thus, at the very least, there is still considerable uncertainty regarding the factual predicates for triggering insider trading liability under *O'Hagan*.

What is quite clear, however, is that private parties wishing to ensure that the *O'Hagan* rule applies to their relationship—thus avoiding this uncertainty—could do so by explicitly adopting in their contract the federal opt-in provisions outlined above.[259] Yet, parties to arm's-length contracts do not take this route. Nor are there any readily identifiable examples of an arm's-length contract where private parties have decided to opt into the federal insider trading regime by including contractual provisions resembling the federal opt-in provisions discussed previously. This observation suggests that, in these arm's-length contracting cases, it does not maximize the parties' welfare to contract for fraud liability by opting into the Rule 10b-5 regime. This is precisely what the contractual fraud theory of insider trading predicts.

254. Indeed, it was because of this lack of clarity that the SEC promulgated Rule 10b5-2. *See* Selective Disclosure and Insider Trading, 65 Fed. Reg. 51,716, 51,729 (Aug. 24, 2000) (explaining, post-*O'Hagan*, that Rule 10b5-2 is necessary in order to clarify the types of relationships that give rise to insider trading liability).

255. *See* 17 C.F.R. § 240.10b5-2 (2019).

256. *See supra* notes 120–22 and accompanying text.

257. *See, e.g.*, SEC v. Cuban, 634 F. Supp. 2d 713, 725 (N.D. Tex. 2009) (noting that, for insider trading liability to attach, the trader must be subject to an agreement that "impose[s] on the party who receives the information the legal duty to refrain from trading on or otherwise using the information for personal gain"), *vacated on other grounds*, 620 F.3d 551 (5th Cir. 2010).

258. United States v. Chestman, 947 F.2d 551, 568 (2d Cir. 1991) (en banc). To be clear, most courts seem to interpret *Chestman* as holding that a confidentiality agreement alone is sufficient to give rise to insider trading liability based on information that is the subject of that agreement. Indeed, the *Chestman* opinion does suggest as much. *See id.* at 571 ("Keith's status as Susan's husband could not itself establish fiduciary status. Nor, absent a pre-existing fiduciary relation or an express agreement of confidentiality, could the coda—'Don't tell.'"). However, this aspect of the opinion, amounting to little more than dicta, seems at odds with the "functional equivalent" language. Perhaps for this reason, some commentators have taken *Chestman* at face value and assumed that it requires "something more than a mere contract." Bainbridge, *Post-Fiduciary Duty Era*, *supra* note 43, at 87.

259. In other words, a non-use or confidentiality agreement combined with a reporting covenant. *See supra* notes 27–30 and accompanying text.

2. The Public-Welfare Maximizing View

Up to this point, in determining how courts should decide whether to find an implied reporting covenant in a given information sharing relationship under the contractual fraud theory, the discussion has focused on maximizing private welfare—in other words, the joint welfare of the contract parties themselves.

However, there is an alternative way of interpreting these contracts. Courts (or the SEC) could alternatively take a public-welfare maximizing view in determining whether a contract contains an implicit provision for fraud liability. They could decide whether to find an implied reporting covenant in these contracts (and therefore effectively decide whether Rule 10b-5 applies) based on considerations about the *public* costs and benefits of insider trading. If they thought that public welfare would be reduced if insider trading was allowed in a particular case, then they should find an implied reporting covenant. Otherwise, they should not.

Many commentators have discussed the public costs and benefits of insider trading.[260] As the purpose of this Article is not to expand upon that discussion, a summary will suffice. The social costs and benefits can be boiled down largely to what one might call market integrity costs and market efficiency benefits. The idea behind market integrity costs is that insider trading will create the perception, if not the reality, that the market is "rigged" and only serves to benefit the well-placed and the well-heeled of corporate America.[261] A decrease

260. *See, e.g.*, William K.S. Wang, *Trading on Material Nonpublic Information on Impersonal Stock Markets: Who Is Harmed, and Who Can Sue Whom Under SEC Rule 10b-5?*, 54 S. CAL. L. REV. 1217, 1230–40 (1981) (arguing that, although a corporation could lose value if it acquired a reputation for insider trading, it is nearly impossible to identify those actually harmed by insider trading). For further elaboration on this view, see also WILLIAM K.S. WANG & MARC I. STEINBERG, INSIDER TRADING § 2.1, at 9–10 (3d ed. 2010); James D. Cox, *Insider Trading and Contracting: A Critical Response to the "Chicago School"*, 1986 DUKE L.J. 628, 630 (arguing that "insider trading harms neither the individual investor nor the market's allocational efficiency"); Merritt B. Fox, *Insider Trading in a Globalizing Market: Who Should Regulate What?*, 55 LAW & CONTEMP. PROBS. 263, 264 (1992) (calling for a reconsideration of the purpose behind regulating insider trading); Jie Hu & Thomas H. Noe, *The Insider Trading Debate*, FED. RES. BANK ATLANTA ECON. REV., 1997, at 34, 34 (noting that a "substantial body of academic and legal scholarship questions whether insider trading is even harmful, much less worthy of legal action").

261. This idea is one of the interpretations that is given to the claim that insider trading is "unfair." *See, e.g.*, Krawiec, *supra* note 13, at 448. The general unfairness claim has been criticized for its lack of clarity. *See, e.g.*, Easterbrook, *supra* note 13, at 324 ("I suspect that few people who invoke arguments based on fairness have in mind any particular content for the term."); Saul Levmore, *Securities and Secrets: Insider Trading and the Law of Contracts*, 68 VA. L. REV. 117, 119–20 (1982) (arguing that proponents of a "fair" insider trading rule have failed to define the term and proposing a more definitive standard); Jonathan R. Macey, *Ethics, Economics, and Insider Trading: Ayn Rand Meets the Theory of the Firm*, 11 HARV. J.L. & PUB. POL'Y 785, 787 (1988) [hereinafter Macey, *Theory of the Firm*] ("The current scholarship that decries insider trading as 'unfair' completely lacks reasoned argument. Often those who brand insider trading as unfair do not even attempt to explain what insider trading is, much less *why* it is unfair.").

in market integrity is feared to lead to a decrease in market participation, which would result in lower liquidity.[262]

Balanced against this cost that insider trading might undermine the integrity of markets is the possibility that it might result in markets that are more informationally and allocatively efficient.[263] If insiders and others can trade on material nonpublic information, then at least some subset of that information will be compounded into prices more quickly than in the absence of insider trading.[264] In other words, insider trading might lead to markets that are more informationally efficient.[265] Furthermore, the individuals doing the insider trading will include insiders who are particularly expert at valuing the information in question, suggesting that prices will be more accurate in valuing underlying assets.[266] In other words, insider trading might also lead to markets that are more fundamentally efficient. Market efficiency is important among other things because it is correlated with greater gross domestic product and societal wealth more generally.[267]

However one thinks that these costs and benefits balance out, one might nevertheless chafe at the larger argument being made here—that judicial or regulatory decisionmakers might interpret contracts in light of public, not

262. The counterargument is that the concern over market integrity costs depends to a certain extent on the existence of a victim who is harmed by insider trading, and there is no consensus that insider trading results in such harm. *See, e.g.*, Bainbridge, *Incorporating State Fiduciary Duties*, *supra* note 13, at 1241–42 (arguing that, because there is no evidence that investors are actually harmed by insider trading, there is little cause to believe that insider trading would undermine investor confidence); Krawiec, *supra* note 13, at 443 ("[C]ommentators are unable to agree whether insider trading causes losses to other marketplace actors and, if so, to whom.").

263. *See generally* HENRY MANNE, INSIDER TRADING AND THE STOCK MARKET 78–104 (1966) (arguing that "any rules designed to prohibit insider trading will, on the average, generate much steeper price increases than will the free-trading rule," and providing graphical representations of the effects of various potential regulatory schemes).

264. *See id.* at 88–90.

265. *See id.*

266. *See id.*

267. Critics, however, have pointed out that it is unlikely that insider trading will result in significant price movements without the insider's private information being transmitted to the market. *See* Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 630–32 (1984) (arguing that market expectation regarding a particular security will only be affected if insider information is widely disseminated); *see also* Joel Seligman, *The Reformulation of Federal Securities Law Concerning Nonpublic Information*, 73 GEO. L.J. 1083, 1095 (1985) ("It is possible that [an insider trader's] contribution may have no market value."). And this is almost certainly true as long as it is assumed that insiders are subject to significant wealth constraints, which seems reasonable. However, even in the absence of disclosure of the insider's private information, insider trading could affect stock prices if the insider were required to disclose her identity and contemplated trades beforehand, as some commentators have suggested. *See* Jesse M. Fried, *Reducing the Profitability of Corporate Insider Trading Through Pretrading Disclosure*, 71 S. CAL. L. REV. 303, 315 (1998); Gilson & Kraakman, *supra* note 267, at 632 (stating that any argument for allowing insider trading "must also consider a recommendation that the insider be required to disclose, at some period before trading, his identity and the size of the intended trade").

private, considerations. This suggestion might seem eccentric—to put it mildly—but it is not unprecedented. After all, it is well established in contract law that courts can refuse to enforce contracts for public policy reasons.[268] Such a judgment constitutes an act of interpretation with a view toward public welfare maximization. Additionally, certain contract doctrines are arguably used to benefit third parties.[269]

However, one thing is for certain: given the nature of the public-welfare maximizing determination, it does not seem like an inquiry that is naturally suited for the judiciary. It seems more appropriately allocated to the province of expert regulators, such as the SEC.

B. *The Contractual Fraud Theory Compared to the Alternatives*

We have now considered the contractual fraud theory in some depth. But we haven't yet considered how it stacks up to the alternative theories of insider trading. Recall that these alternative theories have all sorts of problems. They have a difficult time explaining the law, including both Supreme Court jurisprudence and the SEC's Rule 10b5-2. They treat the statute's basis in fraud as an inconvenient truth. They are susceptible to the federalism criticism that they will result in securities law concerns driving changes in traditionally state law categories like property, fiduciary duty, and unjust enrichment. They do not explain the structure of the *O'Hagan* rule that the trader should be able to escape liability by either providing the information source with prior notice or by obtaining the source's prior approval. And they do not provide a way of reconciling *O'Hagan* and *Santa Fe*. One of the virtues of the contractual fraud theory, in contrast, is that it addresses all of these concerns.

1. Explaining the Law

The contractual fraud theory does a better job than the alternatives in explaining the lines that the Supreme Court has drawn in its insider trading jurisprudence. Those lines demand liability for insider trading in the context of some—but, in light of *Santa Fe*, not all—fiduciary relationships and disallow liability where there is neither a contractual nor fiduciary relationship, even in the case of theft.[270] As discussed previously, none of the extant theories of insider trading do a very good job explaining this line-drawing.[271]

268. 5 SAMUEL WILLISTON, A TREATISE ON THE LAW OF CONTRACTS § 12:1, at 717 (Richard A. Lord ed., 4th ed. 2009).

269. *See* Aditi Bagchi, *Other People's Contracts*, 32 YALE J. ON REG. 211, 213–14 (2015) (citing the example of judicial preference for clear allocations of property rights in real estate transactions, a "rule which benefits future buyers as well as creditors").

270. *See supra* Sections I.B.1–3.

271. *See supra* notes 165–90 and accompanying text. The fiduciary theory has a difficult time explaining the result in *Santa Fe*. *See supra* notes 165–67, 177–87 and accompanying text. The property theory cannot explain the lack of liability in cases where there is neither a contractual nor fiduciary

The contractual fraud theory, by contrast, can explain this line-drawing. With respect to *Santa Fe*, the contractual fraud theory allows the court to infer a contractual duty to disclose the underlying breach. However, this inference is justified only in certain circumstances, namely where an alternative disclosure regime might reduce the costs of detecting the underlying breach and where it is feasible to regulate insider trading by controlling information flow. Thus, a fiduciary relationship is neither a necessary nor a sufficient condition for liability under the contractual fraud theory, thereby creating space for the result in *Santa Fe*.

Additionally, the contractual fraud theory does not run into the same problems as the property and unjust enrichment theories, particularly with regard to their demand for liability in cases (like theft) where the courts have not seemed willing to go.[272] The contractual fraud theory requires at the very least that there be a contractual relationship between the trader and the source of the information. Accordingly, consistent with Supreme Court precedent, it would not give rise to liability in a situation where there is no relationship between the trader and the information, regardless of how the information is acquired.

2. The Purpose of 10b-5

The contractual fraud theory does not treat the statute's basis in fraud as an inconvenient truth. Rather, it views fraud as central to the problem at issue, which is how to address, through contract, the fact that insider trading presents high detection costs. For this reason, the contractual fraud theory explains the existence of Rule 10b-5. We need Rule 10b-5 because without it the common law does not solve the costly detection problem.[273]

3. Federalism Concerns

Recall that all of the alternative theories of insider trading raise thorny federalism issues.[274] Specifically, each theory runs the risk of causing federal securities law concerns to drive the development of the common law categories of fiduciary duty, property, and unjust enrichment, traditionally areas of the law governed by the states. However, these concerns are substantially less acute—and perhaps avoided altogether—under the contractual fraud theory.

relationship. *See supra* notes 168–73, 177–87 and accompanying text. And while the unjust enrichment theory might be able to account for the lack of liability in the case of the unaffiliated innocent acquirer, it cannot explain why there should be no liability in the case of the unaffiliated thief. *See supra* notes 139–45, 174–90 and accompanying text.

272. *See supra* Sections I.C.2–3.

273. *See supra* notes 188–90 and accompanying text.

274. *See supra* notes 191–95 and accompanying text.

The potential effect that the contractual fraud theory would have on the common law of contracts is more muted than the effect that other insider trading theories would have on these various common law categories. At worst, the contractual fraud theory would cause state courts to recognize explicitly made, contractually created fraud-based liability. In other words, under the common law, courts generally would not view the breach of a contractual covenant to disclose a secondary breach as giving rise to fraud liability (i.e., extracompensatory damages). The contractual fraud theory would view Rule 10b-5 as altering this common law rule, at least as to those circumstances where the primary breach is the result of insider trading.

One might object that the contractual fraud theory still creates a federalism concern. In particular, one might be concerned that common law courts would expand this result—allowing parties to contract for fraud liability in the insider trading context—so that it applies not solely where the breach is a covenant not to engage in insider trading under Rule 10b-5 but where there is non-disclosure of the breach of any contractual duty, such as the failure to use a certain type of building material.[275] For example, in cases like *Richmond Metropolitan Authority v. McDevitt Street Bovis, Inc.*,[276] courts are reluctant to find fraud liability, even when there is an explicit misrepresentation, if the misrepresentation was the result of a breach of contractual duties.[277] The federalism concern, then, might be that the contractual fraud theory would cause courts to expand fraud liability to cases like *Richmond Metropolitan*.

But this strikes me as a much less significant federalism concern than the one expressed with respect to the alternative theories of insider trading.[278] The reason is that there are, in fact, contract-based reasons for this move for which prominent contract scholars have advocated.[279] By contrast, with respect to the federalism concern over the fiduciary-based theory of insider trading, for example, it does seem that what would be driving the expansion of fiduciary duty law would be securities law, which would not really have anything to do with the concerns that animate fiduciary duty law.

4. Making Sense of *O'Hagan*

The alternative theories all have a difficult time explaining *O'Hagan*. Conversely, the contractual fraud theory helps address three problems with the

275. *See, e.g.*, Richmond Metro. Auth. v. McDevitt St. Bovis, Inc., 507 S.E.2d 344, 347 (Va. 1998) (finding no fraud liability even though there were actual misrepresentations concerning the concealed building material in the certificate the construction company was required to deliver at the closing).

276. 507 S.E.2d 344 (Va. 1998).

277. *Id.* at 347.

278. *See supra* notes 192–95 and accompanying text.

279. *See* Klass, *supra* note 19, at 2 (stating that "parties now contract for liability in fraud"); *see also* Edlin & Schwartz, *supra* note 19, at 37 (identifying circumstances justifying noncompensatory damages).

case. The first is that, although the fraud the majority identifies is theoretically credible, it is one that is utterly unknown at common law.[280] Recall that in *O'Hagan*, the Court identified the fraud as James O'Hagan's failure to report the breach of an underlying duty of trust and confidentiality.[281] The problem is that no common law court has ever held that the failure to report the breach of the duty of loyalty constitutes fraud. Nor has a court ever held that, in the absence of an explicit covenant to report a breach, the failure to report the breach of a contract is fraudulent. In fact, as discussed previously, courts appear reluctant to find fraud for a failure to disclose even when the contracting parties are subject to an explicit contractual duty to do so.[282] So, what then is going on? The contractual fraud theory of insider trading provides an answer. Under this theory, Rule 10b-5 is to be understood as changing the common law approach here.

The second *O'Hagan* problem that the contractual fraud theory addresses is the so-called brazen fiduciary problem,[283] which has received almost universal criticism, even from *O'Hagan*'s supporters who view it, at best, as a bug in the Court's approach.[284] Under the contractual fraud theory, the brazen fiduciary problem is not a bug but a *feature*. After all, if the point of Rule 10b-5 is to allow for contracting parties to address the costly detection problem of insider trading, then Rule 10b-5 is unnecessary when detection is not difficult, such as where the brazen fiduciary provides notice of the intention to breach the underlying non-use provision. That is precisely the purpose of a reporting covenant: to either deter the contracting party from the violation of the underlying negative insider trading covenant or to cause him to disclose the violation when it occurs or is about to occur.

Third, the contractual fraud theory helps make sense of the "in connection with" requirement in *O'Hagan*.[285] The nature of information, and how it differs from money and other goods, is crucial. Information is non-rivalrous by nature. It is difficult to know if the information has been used improperly because its use is not obvious. Money's use is obvious. In other words, the fact that this is embezzlement of information, rather than of money, is crucial to why it presents

280. The breach of a contractual obligation does not generally give rise to fraud at common law unless the promisor intended to breach at the time of entering into the contract. *See generally* RESTATEMENT (SECOND) OF CONTRACTS § 164 (AM. LAW INST. 1981) (designating contracts induced by intentionally fraudulent manifestations as voidable by the non-fraudulent party). While some breaches of the duty of loyalty might also constitute fraud, not every breach does.

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

282. *See supra* notes 226–27 and accompanying text.

283. *See supra* notes 124, 135–37, 182, 199–204 and accompanying text.

284. *See, e.g.*, Randall W. Quinn, *The Misappropriation Theory of Insider Trading in the Supreme Court: A (Brief) Response to the (Many) Critics of* United States v. O'Hagan, 8 FORDHAM J. CORP. & FIN. L. 865, 893–94 (2003) (the Assistant General Counsel of the SEC defending the *O'Hagan* opinion but acknowledging that the brazen fiduciary problem is a "gap" in the misappropriation theory).

285. *See supra* notes 99–105 and accompanying text.

a costly detection problem. So, if the purpose of insider trading law under Rule 10b-5 is to lower the costs of detection, then one would need to distinguish between the embezzlement of money and information.

5. Reconciling *Santa Fe* and *O'Hagan*

The contractual fraud theory also helps achieve an outcome that other theories simply cannot: reconciling *Santa Fe* and *O'Hagan*.[286] Not only that, but the theory accomplishes this goal on the terms that the *O'Hagan* majority itself suggested. Recall that the challenge lies in explaining why there was fraud in *O'Hagan* but not in *Santa Fe*, even though neither seems to involve a traditional case of fraud, whether by means of an affirmative misstatement or fraudulent concealment.[287] The *O'Hagan* majority suggests that the fraud derives from James O'Hagan's failure to disclose his fiduciary breach to his principal.[288] However, it is not clear why this constitutes fraud.[289] Nor is it clear why this same rationale does not apply in *Santa Fe*, where the fiduciaries also failed to disclose their breach to their principals, the minority shareholders.[290]

The contractual fraud theory addresses both of these concerns. First, it locates the source of the *O'Hagan* majority's theory of fraud not in the common law of deceit (where one will search for it in vain) but in the common law of contract. It provides that Rule 10b-5 changes the common law rule barring contracting for fraud liability, at least in the case of insider trading, and implies that courts can find that such contracting is implied in certain cases, like *O'Hagan*.

Second, the contractual fraud theory also addresses the other question raised by the *O'Hagan* majority's rationale—why under that rationale there is no liability in *Santa Fe*. In other words, why is there no liability for the "halfhearted fiduciary," the fiduciary who, unlike his brazen counterpart, discloses only circumstantial evidence of his breach?[291] Under the contractual fraud theory, courts should generally find an implied duty to report the breach of an underlying covenant not to engage in insider trading in intrafirm and fiduciary relationships (and possibly hybrid organization) but not in arm's-length relationships. This is true unless an alternative disclosure regime makes it less costly to detect the breach of the prohibition on insider trading. It turns out that *Santa Fe* is just such a case where an alternative disclosure regime makes it less costly to detect the breach. There, the fiduciaries didn't actually disclose their breach, but they did disclose other facts—related to the valuation of the

286. *See supra* notes 199–204 and accompanying text.
287. *See supra* notes 199–204 and accompanying text.
288. *See supra* note 202 and accompanying text.
289. *See supra* note 203 and accompanying text.
290. *See supra* note 204 and accompanying text.
291. *See supra* notes 202–04 and accompanying text.

corporate assets—that made it less costly for the plaintiffs to detect the breach. Under the contractual fraud theory, where detection costs are low, there is no need for fraud damages to incentivize the corporate executives to cooperate in recovery by reporting the breach. This is not the case, however, in *O'Hagan* where the detection costs are truly high and there is no relevant disclosure regime disclosing relevant facts surrounding James O'Hagan's fiduciary violation. Under the contractual fraud theory, that key difference explains why the Court reached such different outcomes.

C. *Fixing* Chiarella

The most significant challenge to the contractual fraud theory is how to reconcile it with the classical theory of insider trading, as articulated in *Chiarella*. Recall that in *Chiarella*, the Court premised insider trading liability on the doctrine of fraudulent concealment, holding that Rule 10b-5 liability applies when an insider, trading with his own shareholders, fails to disclose material nonpublic information.[292] Under the traditional interpretation of *Chiarella*, there is a near consensus that the liability rule articulated in the case is not a default that can be contracted around, a view that is clearly at odds with the contractual fraud theory of insider trading.[293]

The best response to this objection is that the traditional interpretation of *Chiarella* is simply wrong. The correct interpretation only comes from reading the case in light of the contractual fraud theory, which I believe underlies the doctrine announced in *O'Hagan* and *Santa Fe*. When read correctly, the traditional understanding of *Chiarella* changes. No longer does the case stand for the proposition that a CEO's trading on the basis of his own company's information is fraudulent because of his failure to disclose the inside information to the shareholder against whom he is trading and to whom he owes fiduciary duties. That is the traditional interpretation of *Chiarella*, the so-called "classical theory."[294] Rather, under the contractual fraud reading of *Chiarella*, the fraud arises instead from the CEO's breach of an implicit contractual duty to disclose the violation of the underlying fiduciary obligation not to trade on the company's inside information. The difference is subtle but significant because this reading effectively unifies the two cases—*Chiarella* and *O'Hagan*—under the same doctrinal framework. The consequence is that even under *Chiarella*, parties can, as in *O'Hagan*, contract around insider trading liability and the insider himself can avoid liability by disclosing the underlying fiduciary violation to the board of his company.

292. *See* Chiarella v. United States, 445 U.S. 222, 230 (1980).

293. *See* Bainbridge, *Insider Trading Regulation*, *supra* note 12, at 1647–48.

294. *See supra* notes 70–83 and accompanying text.

Critics will no doubt call this approach a revisionist reading, and it certainly is that, but it is also a reading that avoids a major legal error committed by the *Chiarella* Court while at the same time correcting for the pathologies of the traditional reading of the opinion. The major legal error in *Chiarella* was the Court's assumption that insider trading, particularly when conducted over impersonal markets rather than in face-to-face transactions, constituted common law fraud.[295] In fact, that assumption was false, and well-known, well-established cases like *Goodwin v. Agassiz*[296] support this point.[297]

What *was* indisputable at common law was that insider trading, although not fraudulent, nevertheless violated an insider's fiduciary duties.[298] And the contractual fraud theory is about whether one can find a contractual obligation, either explicit or implicit, to disclose that underlying fiduciary violation. Reading *Chiarella* in light of the contractual fraud theory avoids the need to contradict cases like *Goodwin* or to argue that Rule 10b-5 somehow reversed the law of *Goodwin*. To be sure, it does not allow one to avoid having to argue that Rule 10b-5 altered the common law rule against contracting for fraud damages. Indeed, that proposition is central to the contractual fraud theory as I have laid it out here.[299] However, there seem to be few if any cases explicitly holding that private parties cannot contract for fraud damages with respect to insider trading whereas there are many cases holding, like *Goodwin*, that insider trading over impersonal markets is not fraudulent.[300] For this reason, it seems less of a stretch to argue that Rule 10b-5 implicitly altered the common law prohibition against contracting for fraud damages (at least in connection with insider trading) than that it implicitly overturned cases like *Goodwin*.

Not only does this contractual fraud reading of *Chiarella* resolve the opinion's major legal error, but it also avoids some of the pathologies that have resulted from the traditional interpretation of the opinion. For example, under that traditional interpretation, there should be no liability for insider trading in debt instruments.[301] Nor does the traditional interpretation lead to intuitive results with respect to open market repurchases. The traditional interpretation implies that, when conducted during a period where insiders are in possession of material nonpublic information, repurchases should either never result in

295. *See supra* notes 77–78 and accompanying text.

296. 186 N.E. 659 (Mass. 1933).

297. *See id.* at 661—62 (holding that there is no duty to disclose and therefore no common law fraud where the insider in possession of material nonpublic information trades over an impersonal exchange); Zachary J. Gubler, *A Unified Theory of Insider Trading Law*, 105 GEO. L.J. 1225, 1241–42 & nn.104–08 (2017).

298. *See supra* note 22 and accompanying text.

299. *See supra* notes 188–90, 273 and accompanying text.

300. See Gubler, *supra* note 297, at 1241–42 & nn.104–06.

301. *See supra* notes 79–80 and accompanying text; *see also* Pritchard, *Agency Law and Powell's Legacy*, *supra* note 77, at 28 (noting that the classical theory does not prevent insider trading in bonds).

liability or always result in liability.[302] Yet, in reality, it seems that the issue is probably significantly more complicated than that.[303] By bringing *Chiarella* and *O'Hagan* under the same doctrinal framework, the contractual fraud theory effectively creates a unified theory of insider trading law. As I have explained elsewhere,[304] such a doctrinal move would have the effect of fixing these pathologies caused by the traditional reading of *Chiarella*.

In other words, the contractual fraud theory is not so much at odds with *Chiarella* as it is with the traditional interpretation of that case, an interpretation founded upon an erroneous assumption about the common law and one that leads to unnecessarily pathological effects. Reading the case in light of the contractual fraud theory, that theory avoids both the erroneous assumption and these untoward, unintended consequences.

III. IMPLICATIONS OF THE CONTRACTUAL FRAUD THEORY

In addition to its explanatory power with respect to insider trading jurisprudence, the contractual fraud theory also has a number of other important implications.

A. *The Scope of Insider Trading Liability Under Rule 10b-5*

One of the most important, unanswered questions in insider trading law after *O'Hagan* is the scope of liability under Rule 10b-5. In *United States v. Chestman*,[305] the Second Circuit held that the domain of insider trading law was defined by the fiduciary relationship or its functional equivalent.[306] Thus, the *Chestman* court focused on the hallmarks of a traditional fiduciary relationship.[307] It explained that a fiduciary relationship or its "functional equivalent" "cannot be imposed unilaterally by entrusting a person with confidential information."[308] Instead, the *Chestman* Court required "reliance, and de facto control and dominance" on the one hand and "discretionary authority and dependency" on the other.[309] A California district court, synthesizing the *Chestman* rule, has held that the rule requires "(1) disparate

302. *See* Gubler, *supra* note 297, at 1248–51; *see also* Jesse M. Fried, *Insider Trading via the Corporation*, 162 U. PA. L. REV. 801, 813–14 (2014) (explaining that although the SEC takes the position that corporate repurchases may give rise to insider trading liability, the doctrinal grounds for this position are "shaky").

303. *See* Gubler, *supra* note 297, at 1251–52.

304. *See* Gubler, *supra* note 297, at 1255–59.

305. 947 F.2d 551 (2d Cir. 1991) (en banc).

306. *Id.* at 567–70.

307. *See id.*

308. *Id.* at 567.

309. *Id.* at 567–69 (internal quotation marks omitted) (quoting United States v. Margiotta, 688 F.2d 108, 125 (2d Cir. 1982)).

knowledge and expertise, (2) a persuasive need to share confidential information, and (3) a legal duty to render competent aid."[310]

In order to understand the *Chestman* court's approach, keep in mind that the case was decided before *O'Hagan* but after *Chiarella*, and it was *Chiarella* that seemed to adopt a fiduciary-based theory of insider trading law.[311] Thus, it should not be too surprising that the Second Circuit seemed to be grounding insider trading liability in fiduciary duty law. The problem, of course, is that the policies underlying that theory—minimizing the costs associated with fiduciary breaches—are in significant tension with *Santa Fe*, where the court held that a fiduciary breach alone is insufficient for purposes of Rule 10b-5.[312] Additionally, the fiduciary-based theory is fundamentally at odds with the approach taken in *O'Hagan*, where one can escape liability through disclosure of the breach.[313] Perhaps for these reasons, some circuits have refused to follow *Chestman*,[314] instead requiring little more than a promise or expectation of confidentiality.[315]

Thus, there is disagreement as to the scope of insider trading liability under Rule 10b-5, with some circuits taking the narrower *Chestman* approach (requiring the "functional equivalent" of a fiduciary relationship) and other circuits taking a broader one (requiring nothing more than a confidentiality agreement).[316] The contractual fraud theory, by contrast, takes the middle road—it implies that the *Chestman* approach is indeed too narrow and that purely contractual relationships can, and in some cases probably should, give rise to Rule 10b-5 liability.

However, unlike those courts that refuse to follow *Chestman*, the question under the contractual fraud theory is not merely whether the relationship involves a promise or expectation of confidentiality. Rather, the question is whether a court or the SEC should find an implied reporting covenant in such a relationship. That determination turns on whether one thinks that the goal of that interpretive task is to maximize private or public welfare. If private, then

310. United States v. Kim, 184 F. Supp. 2d 1006, 1011 (N.D. Cal. 2002).

311. *See supra* notes 70–83 and accompanying text.

312. *See supra* note 199 and accompanying text.

313. *See supra* notes 202–04 and accompanying text.

314. *See* SEC v. Talbot, 530 F.3d 1085, 1093 (9th Cir. 2008) (overruling district court decision that followed *Chestman*); SEC v. Yun, 327 F.3d 1263, 1272–73 (11th Cir. 2003) (declining to follow *Chestman*); SEC v. Nothern, 598 F. Supp. 2d 167, 176 (D. Mass. 2009) (noting that because it was not bound by *Chestman*, it could find that a fiduciary relationship exists even absent a scintilla of superiority or dominance). Indeed, the Second Circuit itself seems to have walked back the *Chestman* test, at least in part, electing to overlook the dominance requirement that seemed to be integral to the court's original opinion. *See* United States v. Falcone, 257 F.3d 226, 234–35 (2d Cir. 2001) (clarifying the attributes of a fiduciary duty under *Chestman* while downplaying the "dominance" and similar language in *Chestman*).

315. *See, e.g.*, *Yun*, 327 F.3d at 1272–73.

316. *See supra* notes 152–55 and accompanying text.

that determination turns on the availability of an alternative disclosure regime and the plausibility of regulating the confidentiality by controlling information flow.[317] If instead the goal is public welfare maximization, then the determination turns on the public benefits and costs of insider trading law.[318]

B. *The Contractual Fraud Theory Implies That a Confidentiality or Non-Use Agreement Is Necessary for Rule 10b-5 Liability*

In this debate over whether a contractual relationship can form the basis for Rule 10b-5 liability, the contractual fraud theory sides with the broader view—that a contractual relationship can give rise to such liability. But there is a wide gulf between "can" and "does," and in this case the distinction turns on the type of contract in question. Under Rule 10b5-2, a mere agreement to maintain the confidentiality of information is sufficient to give rise to Rule 10b-5 liability, and several courts have endorsed this view.[319] But in the *Cuban* case, the district court held that a confidentiality agreement was insufficient and that something more (like a non-use agreement) was required.[320] The Fifth Circuit did not reverse this decision on appeal.[321] The contractual fraud theory implies that the *Cuban* district court is wrong.

Under the contractual fraud theory, Rule 10b-5 is necessary because it alters the common law rule against contracting for fraud liability, and it does so to help solve the costly detection problem of contracting. Of course, this alteration only raises the question as to why federal law should play this role. But the answer is that insider trading has potential public costs and benefits and therefore does not unreasonably fall within the purview of federal regulation.[322]

This recognition of the public costs and benefits of insider trading implicit in the contractual fraud theory also explains why a confidentiality agreement should count as a negative insider trading covenant—in other words, a covenant that is breached through insider trading. If insider trading has public costs and benefits, this is because the market itself can observe the trading (and infer the positive or negative nature of the underlying information) without disclosure of the underlying information. Thus, insider trading should be viewed as a breach of confidentiality even if the content of the underlying information is not disclosed.

317. *See supra* Section II.A.1.

318. *See supra* Section II.A.2.

319. *See* United States v. McGee, 763 F.3d 304, 314, 317 (3d Cir. 2014); *Yun*, 327 F.3d at 1272–73, 1273 n.23; United States v. Corbin, 729 F. Supp. 2d 607, 619 (S.D.N.Y. 2010).

320. SEC v. Cuban, 634 F. Supp. 2d 713, 730–31 (N.D. Tex. 2009), *vacated on other grounds*, 620 F.3d 551 (5th Cir. 2010).

321. SEC v. Cuban, 620 F.3d 551, 552, 555–58 (5th Cir. 2010).

322. *See supra* Section II.A.2.

Of course, this does not mean that under the contractual fraud theory a confidentiality agreement automatically gives rise to insider trading liability. In fact, as explained above, this is not true.[323] Courts or the SEC must still decide whether that relationship contains a reporting covenant (express or implied).[324]

C. *The Contractual Fraud Theory Implies that Rule 10b5-2 Is Valid*

The contractual fraud theory allows for the SEC to take a different view of the scope of Rule 10b-5 than the courts. The theory requires the interpretation of both the contract and whether a given contractual relationship contains a reporting covenant (either express or implied). The determination of whether there is an implied reporting covenant depends on whether one takes a private- or public-welfare maximizing approach to the interpretive task. I've suggested that institutional competence concerns weigh in favor of the courts taking a private-welfare maximizing approach.[325] This implies that courts should find an implied reporting covenant (and therefore Rule 10b-5 liability for insider trading) in intrafirm and fiduciary relationships but not in arm's-length contracts—leaving some flexibility for those relationships that fall between these two extremes. But the theory also implies that the SEC, with its relatively superior expertise in market-wide considerations, could take a public-welfare maximizing approach to the problem in which case it would focus on the public costs and benefits posed by insider trading.

That brings us to the SEC's Rule 10b5-2. That rule does not draw a distinction between different types of contractual relationships, let alone whether they are arm's length or otherwise. Rather, it simply provides that a confidentiality agreement (whether express or implied) is sufficient for liability.[326] That obviously departs significantly from what the contractual fraud theory implies since liability isn't private-welfare maximizing for arm's-length contracts. But the SEC's different approach is acceptable under the theory.[327] To be sure, this does not mean that there are no constraints on what the SEC can do here. At a minimum, parties must have entered into a contractual relationship subject to a confidentiality agreement, which is what Rule 10b5-2 requires. Thus, while the rule is valid, it is bordering the limit of the SEC's authority under the contractual fraud theory.

323. *See supra* notes 314–16 and accompanying text.

324. *See supra* notes 314–16 and accompanying text.

325. *See supra* notes 232–33, 249 and accompanying text.

326. *See* United States v. Corbin, 729 F. Supp. 2d 607, 614–17 (S.D.N.Y. 2010) (explaining how Rule 10b5-2 creates liability for violations of both express and implied confidentiality agreements and applying it to the facts).

327. *See supra* Section II.A.2.

D. *The Contractual Fraud Theory Has Important Implications for the Outstanding Circuit Splits*

Finally, the contractual fraud theory helps resolve all of the outstanding circuit splits in which scenario insider trading liability would be found, as illustrated in the following table:

Table 3. Approaches to Rule 10b-5's Application to Insider Trading: The Courts, the Extant Theories, and the Contractual Fraud Theory[328]

Scenario	SCOTUS	Lower Courts	Fiduciary Theory[329]	Property Rights Theory[330]	Unjust Enrichment Theory[331]	Contractual Fraud Theory	
						Courts	SEC
1: Brazen Fiduciary	No[332]	No	Yes	Yes	Yes	No	Yes
2: Halfhearted Fiduciary	No[333]	No	Yes	Yes	Yes	No	Yes

328. This table is identical to table 2 set forth above, *see supra* table 2, with one exception: the contractual fraud theory implies that courts might make distinctions between arm's-length contracts on the one hand and hybrid organizations, like strategic alliances, on the other. Accordingly, table 3 breaks the third and fourth cases from before into two scenarios each, one involving an arm's-length contract and the other involving a hybrid organization, like a strategic alliance. Granted, the courts have given us no reason to believe that they would treat these contractual relationships differently, which is reflected in table 3.

329. The fiduciary theory requires the breach of a fiduciary duty for purposes of Rule 10b-5 liability and therefore would not result in liability in cases like scenarios 3, 4, 5, and 6 where there is no such duty. Because one cannot avoid the breach of a fiduciary duty by providing notice of one's breach, these facts do not eliminate liability under the fiduciary theory in scenarios 1 and 2.

330. Under the property rights theory, trading on someone else's information is akin to stealing and therefore under this theory liability would exist in all of the above scenarios.

331. Under the unjust enrichment theory, the defendant must be unjustly enriched to attract liability, which is the case in all of the scenarios except the arm's-length contract with confidentiality provision situation.

332. *See* United States v. O'Hagan, 521 U.S. 642, 655 (1997).

333. *See supra* notes 137–38 and accompanying text.

Scenario	SCOTUS	Lower Courts	Fiduciary Theory	Property Rights Theory	Unjust Enrichment Theory	Contractual Fraud Theory	
						Courts	SEC
3: "Hybrid Agreement" with Non-Use Provision	Undecided	Split[334]	Yes	Yes	Yes	Yes	Yes
4: "Hybrid Agreement" Contract with Confidentiality Provision Only	Undecided	Split[335]	No	Yes	Yes	Yes	Yes
5: Arm's-Length Contract with Non-Use Provision	Undecided	Split[336]	No	Yes	Yes	No	Yes

334. *Compare* United States v. McGee, 763 F.3d 304, 321–22 (3d Cir. 2014) (finding that Rule 10b-5 liability arises from a mere relationship, whether contractual or not, demonstrating a history, pattern, or practice of sharing confidences), SEC v. Cuban, 620 F.3d 551, 555–58 (5th Cir. 2010) (finding that Rule 10b-5 liability would arise from the breach of a non-use provision), *and* SEC v. Yun, 327 F.3d 1263, 1272–73 (11th Cir. 2003) (finding that Rule 10b-5 liability arises from a mere relationship, whether contractual or not, demonstrating a history, pattern, or practice of sharing confidences), *with* United States v. Chestman, 947 F.2d 551, 568 (2d Cir. 1991) (en banc) (requiring the breach of a fiduciary relationship or its "functional equivalent" for insider trading liability under Rule 10b-5), *and* United States v. Kim, 184 F. Supp. 2d 1006, 1010 (N.D. Cal. 2002) (adopting the *Chestman* standard).

335. *Compare McGee*, 763 F.3d at 321–22 (finding that Rule 10b-5 liability arises from a mere relationship, whether contractual or not, demonstrating a history, pattern, or practice of sharing confidences), *and Yun*, 327 F.3d at 1272–73 (adopting an identical standard as *McGee*), *with* SEC v. Dorozhko, 606 F. Supp. 2d 321, 323 (S.D.N.Y. 2008) (finding that Rule 10b-5 liability can be premised on a contractual duty but requires something more than a confidentiality provision).

336. *Compare McGee*, 763 F.3d at 321–22 (finding that Rule 10b-5 liability arises from a mere relationship, whether contractual or not, demonstrating a history, pattern, or practice of sharing confidences), *Cuban*, 620 F.3d at 555–58 (finding that Rule 10b-5 liability would arise from the breach of a non-use provision), *and Yun*, 327 F.3d at 1272–73 (finding that Rule 10b-5 liability arises from a mere relationship, whether contractual or not, demonstrating a history, pattern, or practice of sharing confidences), *with Chestman*, 947 F.2d at 568 (requiring the breach of a fiduciary relationship or its "functional equivalent" for insider trading liability under Rule 10b-5), *and Kim*, 184 F. Supp. 2d at 1010 (adopting the *Chestman* standard).

Scenario	SCOTUS	Lower Courts	Fiduciary Theory	Property Rights Theory	Unjust Enrichment Theory	Contractual Fraud Theory	
						Courts	SEC
6: Arm's-Length Contract with Confidentiality Provision	Undecided	Split[337]	No	Yes	Yes	No	Yes
7: Unaffiliated Thief	No[338]	No	No	Yes	Yes	No	No
8: Unaffiliated Innocent Acquirer	No[339]	No	No	Yes	No	No	No

How then does the contractual fraud theory fare? Very well. In fact, it generates outcomes that are consistent with those that we observe in the real world. Under the contractual fraud theory, there is liability for breaches of the duty of loyalty but not if such breaches are disclosed, whether in a brazen or halfhearted manner. Thus, no liability in the first two cases, which is both consistent with Supreme Court precedent and valuable in helping us distinguish *Santa Fe* and *O'Hagan*.

Importantly, not only would the contractual fraud theory countenance liability for breaches of the duty of loyalty, it could theoretically extend liability to breaches of arm's-length contracts and hybrid arrangements. Notice that this is true regardless of whether the breach is of a non-use or confidentiality provision. This is because, under the contractual fraud theory, insider trading is thought to have social costs and benefits that both make it an appropriate subject of federal law and make it so that insider trading violates confidentiality provisions as well as non-use provisions.[340] However, the courts should only find an implicit reporting covenant where it maximizes *private* welfare, which is only in fiduciary and possibly hybrid arrangements.[341] Thus, the courts cannot accomplish this expansion of liability on their own.

337. *Compare McGee*, 763 F.3d at 321–22 (finding that Rule 10b-5 liability arises from a mere relationship, whether contractual or not, demonstrating a history, pattern, or practice of sharing confidences), *and Yun*, 327 F.3d at 1272–73 (adopting an identical standard as *McGee*), *with Dorozhko*, 606 F. Supp. 2d at 323 (finding that Rule 10b-5 liability can be premised on a contractual duty but requires something more than a confidentiality provision).

338. *See* United States v. O'Hagan, 521 U.S. 642, 660–61 (1997); Chiarella v. United States, 445 U.S. 222, 233–35 (1980).

339. *See* Dirks v. SEC, 463 U.S. 646, 646–49, 659–60 (1983).

340. *See supra* Section II.A.2.

341. *See supra* note 244 and accompanying text.

By contrast, the SEC can, consistent with the theory, take a broader, public-welfare maximizing approach than the courts, which it has done in promulgating Rule 10b5-2. That rule, which is probably at the limit of the SEC's authority under the theory, would extend liability to the contract-based cases (cases three through six). Note also that there is no reason under the contractual fraud theory that would prevent the SEC from plugging the holes in liability created by the brazen fiduciary and the halfhearted fiduciary, which is why the relevant boxes in the table's last column include a "yes." However, this observation is merely aspirational, as the SEC has not yet taken such action.

CONCLUSION

It is often said that federal insider trading law is a mess, resists explanation, and defies the fraud-based foundations of the statutory regime. But if these complaints are true, maybe it is only because we have been telling ourselves the wrong story—that insider trading law is an attempt to enforce property rights in information, to rout out corrupt fiduciaries, or to deter unjust enrichment. We've constructed these elaborate stories because we have been assuming that fraud cannot possibly explain the law as it is nor as it should be.

While this assumption possesses some truth, there is a version of the fraud story that makes normative and descriptive sense of the current landscape, avoiding the pitfalls of our other stories. This Article focused on that argument: Rule 10b-5 allows parties to effectively protect their information from insider trading by requiring counterparties to notify the information source of a breach and to enforce such duties contractually with fraud damages. In other words, Rule 10b-5 allows parties to contract for fraud liability. This contractual fraud theory explains much of what has been taken as messiness in the law.

Some will, no doubt, balk at the idea that insider trading is ultimately about contract law with a bit of fraud thrown in for good measure. While it is true that this theory implies a fairly narrow liability regime if created by courts, it actually augurs in favor of a potentially broad insider trading regime, if created by the SEC. This is because, under the theory, the SEC—but not the courts—has the authority to interpret these contracts with the public welfare in mind, potentially extending liability to any confidentiality agreement, as the SEC has done in Rule 10b5-2.

As with many things, in order to understand insider trading law's future, it is first necessary to understand its present. The contractual fraud theory helps us see the present narrative in a clearer light, resolving the various circuit splits to bring the law in line with the theory in the short run. But the theory also helps us accomplish a longer-term goal: understanding the outer limits of the Rule 10b-5 regime, which is a necessary condition for thinking about whether this regime is adequately prepared to deal with the future of insider trading law.