CROWELL & MORING LLP
Securities Law Developments

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Recent Developments in Section 10(b) and 14(e) Liability:
Insider Trading and Tender Offer Liability

In its recent opinion in United States v. O'Hagan, the Court of Appeals for the Eighth Circuit rejected insider trading liability under the “misappropriation” theory because it held that the theory was beyond the scope of Section 10(b) of the Securities and Exchange Act of 1934 (“Exchange Act”) and Rule 10b-5 thereunder. The Court of Appeals also ruled that the Securities and Exchange Commission (“SEC”) exceeded its rulemaking authority under Exchange Act Section 14(e) by enacting Rule 14e-3(a), which regulates securities trading in the context of tender offers. It held that Rule 14e-3(a), like the misappropriation theory, impermissibly provides for insider trading liability without a showing of a fiduciary breach to someone from whom he or she purchases securities. United States v. O'Hagan, Nos. 94-3714, 94-3856, 1996 U.S. App. LEXIS 18913 (Aug. 2, 1996).

Factual Background

James O'Hagan was a partner in the Minneapolis law firm of Dorsey & Whitney, which acted as local counsel for Grand Metropolitan PLC (“Grand Met”), the British conglomerate, in connection with its tender offer for the Pillsbury Company (“Pillsbury”). As Grand Met’s counsel, O'Hagan owed that company fiduciary duties, but owed none to Pillsbury. O'Hagan purchased Pillsbury call options and securities in a series of transactions after he learned of Grand Met’s tender offer plans, but before the public announcement of the offer. Following the tender offer announcement, the price of Pillsbury’s stock rose dramatically. O'Hagan then exercised his options and purchased Pillsbury stock at the pre-tender offer price, later selling his holdings. In addition to earning a $4,000,000 profit, he also earned the attention of the U.S. Attorney’s office, which filed at 57-count indictment alleging mail and securities fraud and money laundering. The Eighth Circuit reversed the district court’s convictions on each violation.

The Misappropriation Theory

The misappropriation theory provides for liability for an individual who (1) misappropriates material nonpublic information in breach of a duty arising out of a relationship of trust and confidence and (2) uses that information in a securities transaction. The theory dispenses with the requirement that the trader breach a duty to a market participant from whom he or she purchases or sells securities by failing to disclose material nonpublic information to that party.

The misappropriation theory originated in Chiarella v. United States, 445 U.S. 222 (1980). That case involved an employee of a financial printer, Chiarella, who, in violation of a fiduciary duty to his employer, misused information obtained during his employment to purchase securities of the targets of his employer’s clients prior to corporate mergers. The Supreme Court held that there is no general duty to the securities marketplace. Thus, there can be no
fraud upon the other party to the transaction unless a trader has a preexisting relationship with that person. Although Chiarella did breach a fiduciary duty to his employer, the case was not submitted to the jury on the theory of fraud against the employer. For this reason, the majority declined to pass on this alternate theory.

In his dissent, Chief Justice Burger argued that because unlawful means were used to obtain the material nonpublic information upon which Chiarella traded, the general rule that there is no duty to disclose such information to individuals to whom no duty is owed must give way. According to Chief Justice Burger, “A person who has misappropriated nonpublic information has an absolute duty to disclose that information or to refrain from trading.” Thus, Chief Justice Burger would have affirmed Chiarella’s conviction because he “stole to put it bluntly” the information that prompted his trades.

After Chiarella, the SEC followed Chief Justice Burger’s reasoning and began to prosecute insider trading cases seeking Section 10(b) liability under the misappropriation theory, thereby disregarding Chiarella’s requirement that there be a breach of a fiduciary duty owed to a party to a securities transaction. Until recently, various federal appellate courts — including those of the Second, Seventh and Ninth Circuits — had upheld the theory as a source of Section 10(b) liability.

O’Hagan’s Rejection of the Misappropriation Theory

O’Hagan follows the Fourth Circuit, which in United States v. Bryan re rejected the misappropriation theory. According to the O’Hagan court, it reached this conclusion because, “contrary to Section 10(b)’s explicit requirements, the misappropriation theory does not require ‘deception,’ and, even assuming that it does, it renders nugatory the requirement that the ‘deception’ be ‘in connection with the purchase or sale of any security.’” Thus, O’Hagan, following the Supreme Court in Chiarella, stated that there is no duty to disclose material nonpublic information to, or abstain from trading with, someone to whom the trader owes no fiduciary duty. A duty of disclosure exists only in the context of a fiduciary-like relationship. Otherwise, there is no “fraud” “in connection with” a securities transaction because there is no general duty to speak. Since O’Hagan owed no fiduciary duty to the individuals with whom he traded, there was no basis for liability under Section 10(b).

Limitation of Tender Offer Liability

O’Hagan extends the same logic beyond Section 10(b) to tender offer situations regulated by Section 14(e) and Rule 14e-3(a). Like the misappropriation theory, Rule 14e-3(a) was adopted by the SEC in the wake of Chiarella in an effort to build on Chief Justice Burger’s dissent. In promulgating the Rule, the Commission attempted to avoid the fiduciary duty requirement by imposing liability even where nonpublic information about a tender offer was not obtained in breach of a fiduciary duty to the market participants from whom the securities were purchased. Pursuant to the Supreme Court’s holdings, however, O’Hagan recognized that a showing of fraud under Sections 10(b) and 14(e) requires a breach of a fiduciary duty to parties to the securities transaction. Because Rule 14e-3(a) permits liability without such a breach, the Rule exceeds its statutory authority.

1 See 58 F.3d 933 (4th Cir. 1995); see also Crowell & Moring Securities Law Development, July 31, 1995 for an analysis of the Bryan decision.
Conclusion

O’Hagan may help bring about a resolution of the limits to liability for insider trading under Sections 10(b) and 14(e) of the Exchange Act. The O’Hagan court dismissed the entire indictment because it found every count to be premised on the securities violations that the court voided. Thus, the Department of Justice has an incentive to appeal the decision, an incentive that it lacked in Bryan where the court upheld Bryan’s mail and wire fraud convictions. Moreover, because unlike Bryan, O’Hagan owed fiduciary duties to a market participant, but not to the market participants from whom he purchased securities, the court’s ruling has sharpened the distinction between those market participants to whom a fiduciary duty is owed and those to whom no duty is owed.

With the split among the Circuits now growing, resolution of Section 10(b) and 14(e) liability will rest with the Supreme Court. If the Supreme Court follows the O’Hagan and Bryan reasoning, it likely will disapprove of the misappropriation theory and Rule 14e-3(a). If it does so, there may be a new call for a statutory definition of insider trading. In any event, it is important for corporations and their officers, directors and employees to continue to safeguard their company’s secrets for legal, ethical and business reasons. Corporate counsel should insure that appropriate safeguards are in place to prevent unauthorized securities trading.

If you would like further information regarding these recent developments in Section 10(b) and Section 14(e) liability, please feel free to call us.

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