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NOTES

THE RISE AND FALL (AND RISE?) OF INFORMATION-BASED INSIDER TRADING ENFORCEMENT

THOMAS A. MCGRATH III

INTRODUCTION

As a general proposition, we all know what the “classic” case of insider trading looks like: when one trades in a security on the basis of nonpublic (“inside”) information regarding the security, issuer, or market for the security, one is engaged in insider trading. We also know that it is Rule 10b-5, promulgated under section 10(b) of the 1934 Securities Exchange Act, that makes such activity illegal. Usually we think of the typical “insider” as being an officer, director, or other employee of

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2. Insider trading is reached under the federal securities laws by § 10(b) of the Securities Exchange Act of 1934 (the “Act” or the “1934 Act”) and Rule 10b-5. Section 10(b) provides as follows:

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

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [Securities and Exchange] Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.


While § 10(b) is not self-executing, in 1942 the Securities and Exchange Commission (“SEC”) promulgated Rule 10b-5, which provides in relevant part as follows:

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

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

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


Section 10(b) does not provide for a private cause of action. Nonetheless, the courts have implied one, limited to plaintiffs who are either purchasers or sellers of securities. See Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 729-31 (1975); Birnbaum v. Newport Steel Corp., 193 F.2d 461 (2d Cir.), cert. denied, 343 U.S. 956 (1952). To date, enforcement of § 10(b) has largely been through civil litigation. See United States v. Newman, 664 F.2d 12, 16 (2d Cir. 1981).
the issuer. Additionally, we may know that one who trades on the tip of an insider (a "tippee") is also liable for insider trading. But whether a particular instance of trading on insider information violates the law has troubled courts for many years. The evolution of the law of insider trading has led, in many cases, to criminal prosecutions and civil actions based on theories of conduct and harm, rather than proof of specific, enumerated elements of a crime or cause of action. As the law now stands, insider trading is really a conclusion drawn not from any statutory prescription, but from fifty years of jurisprudence and Securities and Exchange Commission ("SEC") enforcement. Most significantly, because of the unique and storied history of insider trading law, not all trading by insiders or tippees on nonpublic information is illegal. Consider the following hypotheticals.

(1) The chief financial officer of Widgetco, knowing the company will skip a dividend, sells her shares before the announcement. Insider trading? Yes.

(2) A legal assistant in a law firm's mergers and acquisitions department purchases shares of target companies before public disclosure. Insider trading? Yes.

But, compare the following.

(3) An investment bank, investigating takeover targets for Acquisition Corp., receives confidential information from one of the possible targets. After Acquisition withdraws its bid, the bank buys a large block of target company stock and uses the confidential information to induce a third company to offer a higher bid. The bank reaps significant profits. Insider trading? No.

(4) The CEO of Conglomerates, Inc., without any motive for personal benefit, discloses to his estranged son that the company is negotiating to be acquired. The son purchases stock in his father's company. Insider trading? No.

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4. For this reason, some have challenged insider trading prosecutions brought under Rule 10b-5 as unconstitutional for failure to give "fair notice" that the conduct is illegal. See, e.g., United States v. Lang, 766 F. Supp. 389, 402 (D. Md. 1991); United States v. Willis, 737 F. Supp. 269 (S.D.N.Y. 1990); see also United States v. Chestman, 947 F.2d 551, 564 (2d Cir. 1991) (en banc) (contrasting explicit prohibitions of Rule 14e-3 with Rule 10b-5's "catchall" nature), cert. denied, 112 S. Ct. 1759 (1992). One commentator has suggested that Rule 10b-5's vagueness is its strength because of its adaptability to the current popular, academic, and later, judicial understanding of how corporate finance and investing works. See Donald C. Langevoort, 10b-5 as an Adaptive Organism, underscore Annual Survey of Financial Institutions and Regulation, Happy Birthday Rule 10b-5: 50 Years of Antifraud Regulation, 61 Fordham L. Rev. S7, S7 (1993).


(5) Issuer Co. begins a long-term debt repurchase program (that does not constitute a tender offer) in anticipation of a larger re-structuring likely to enhance the price of its bonds. Insider trading? No.⁹

(6) The Executive Vice President of Garbage Co., knowing the company is about to sell-off a subsidiary and the transaction will devalue the company's junk bonds, sells her long-term holdings before the announcement. Insider trading? Maybe not.
(a) What if she takes the proceeds and buys company common stock? Insider trading? Probably not, at least with respect to the bonds.
(b) What if the original purchaser of the junk bonds was a shareholder of Garbage Co.? Insider trading? Maybe.

This Note will examine the status of insider trading regulation in its statutory formulation and, particularly, with respect to current judicial theories of liability. Part I will focus on the original, "equal access" theory of insider trading liability, as it was developed by the SEC and the lower federal courts. Part II will analyze the subsequent, so-called "traditional" theory of insider trading as established by the Supreme Court in *Chiarella v. United States*.¹⁰ This Section will also explore the scope of the theory and criticism of its foundations and application. Part III will address the development of the "misappropriation" theory as an alternative for prosecutors and plaintiffs in light of the *Chiarella* doctrine. Part IV will analyze problems in insider trading regulation that have developed under the *Chiarella* doctrine, exemplified by the treatment of options and debt securities. Finally, this Note will suggest that the sometimes inconsistent results that have developed have grown from efforts by the lower federal courts to reach all types of insider trading, working within the common law restraints of *Chiarella*. This Note will conclude that a return to the equal access theory will result in a more uniform application of Rule 10b-5 and that, in fact, a return to equal access analysis may be signalled by the ways in which courts deal with the difficulties associated with reaching insider trading in non-equity securities.

I. INSIDER TRADING LIABILITY BASED ON UNEQUAL AND UNFAIR ACCESS TO INFORMATION

The original theory of insider trading—the equal access theory—was premised on considerations of fairness and the public interest in market participants having equal access to corporate information—"the level playing field."¹¹ The SEC first applied Rule 10b-5 to sanction insider trading based on the premise of unequal access to information. This rule prohibits any person who has material non-public information concerning a publicly traded security from using or attempting to use the information for personal gain or to cause another person to trade on the basis of the information. Rule 10b-5 encompasses a wide range of activities, including the purchase or sale of securities while in possession of material non-public information, and the dissemination of false or misleading statements about a company's financial condition or operations.

¹¹. The equal access theory should be distinguished from the parity of information theory. Parity of information suggests that parties to transactions must act in reliance on
trading in *In re Cady, Roberts & Co.*,\(^{12}\) holding that one whose position gives access to material, nonpublic information concerning a security has a duty to disclose such information or abstain from trading.\(^{13}\) This became known as the disclose or abstain rule, the breach of which constituting a violation of Rule 10b-5.\(^ {14}\)

In reaching their decision, the Commissioners found that, traditionally, the courts and the SEC held that corporate insiders have a duty to “disclose material facts which are known to them by virtue of their positions but which are not known to persons with whom they deal and which, if known, would affect their investment judgment.”\(^{15}\) More specifically, the duty to disclose or abstain rested on two bases: (i) the “existence of a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone,”\(^ {16}\) and (ii) “the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing.”\(^ {17}\) Applying this standard to the facts before it in *Cady, Roberts*, the SEC found that a broker-dealer had breached its disclose or abstain duty and had violated Rule 10b-5 when it sold a company’s stock in reliance on nonpublic information concerning the company’s intended dividend action. The broker-dealer had obtained the tip from an employee who was also a director of the company. Without awaiting public disclosure, the broker-dealer sold its holdings, reaping significant profits.\(^ {18}\)

*Cady, Roberts* was based squarely on the expansive purpose of Rule 10b-5 and other federal securities regulations. Reasoning that the antifraud provisions are not meant to be specific, “but rather are designed to encompass the infinite variety of devices by which undue advantage may be taken of investors and others,”\(^ {19}\) the Commission concluded that the securities regulations were meant to fill a gap in the common law such that “misleading or deceptive activities [are reached] whether or not they are precisely and technically sufficient to sustain a common law ac-

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the same information. The goal of the equal access theory is to assure that both parties are able to obtain legally—through industry, diligence, etc.—the same information.

13. *See id.* at 911.
14. *See id.*
15. *Id.*
16. *Id.* at 912; *see also id.* at 912 n.15 (citing purpose of Exchange Act to eliminate personal interests as an “emolument of corporate office,” §§ 2 and 16 of the Act, 15 U.S.C. §§ 78b, 78p(b), H.R. Rep. No. 1383, 73d Cong., 2d Sess. 13 (1934) and S. Rep. No. 792, 73d Cong., 2d Sess. 9 (1934)).
18. *See id.* at 913; *see also Speed v. Transamerica Corp.*, 99 F. Supp. 808, 828-29 (D. Del. 1951) (majority shareholder who bought out minority shareholders, knowing firm was undervalued, was liable for fraudulent non-disclosure); Kardon v. Nat’l Gypsum Co., 73 F. Supp. 798, 800 (E.D. Pa. 1947); *In re Ward LaFrance Truck Corp.*, 13 S.E.C. 373, 380, 381 (1943) (non-disclosure in purchase on behalf of issuer breached fiduciary duty, placing shareholders at unfair disadvantage).
tion for fraud and deceit." Put simply, and (ir)reverently, the common sense import of section 10(b) is "Thou shalt not devise any other cunning devices."

The Commission, of course, found it unnecessary to say that fraud is illegal in connection with a face-to-face sale or purchase of securities. However, in the context of anonymous national exchange transactions, where parties never meet, no special relationships exist to give rise to a duty to speak. As will be discussed more fully below, without this duty, there was no cause of action for fraud under the pre-regulation regime. Into this vacuum Congress infused Rule 10b-5, a new proscription against misrepresentations in connection with the sale or purchase of securities.

The courts initially and enthusiastically adopted the disclose or abstain rule in SEC v. Texas Gulf Sulphur Co. (hereinafter "TGS"). In this landmark case, the Second Circuit ventured even further than the SEC in its interpretation of the equal access theory, holding that anyone in possession of material nonpublic information is subject to the disclose or abstain duty. The court believed the disclose or abstain rule and the equal access theory were consistent with congressional intent, captured in section 10(b) of the 1934 Act, that investors "have equal access to the rewards of participation in securities transactions" and are subject to the same risks. The theory, or some form of it, was later approved by the Fifth, Sixth, Seventh, and Ninth Circuits.

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20. Id. at 910 (citing Hooper v. Mountain States Sec. Corp., 282 F.2d 195, 201 (5th Cir. 1960), cert. denied, 365 U.S. 814 (1961)).
22. See infra notes 30-66 and accompanying text.
23. Necessarily, the information to be disclosed must be "material, nonpublic" information. In the proxy context, the Supreme Court has ruled that a fact is material if "there is a substantial likelihood that a reasonable shareholder would consider it important." TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976). That is, if the reasonable investor would view disclosure of the fact as significantly altering the "total mix" of available information, it is "material." Id. The Supreme Court expressly adopted this standard in Rule 10b-5 application in Basic Inc. v. Levinson, 485 U.S. 224, 232 (1988).

Information is nonpublic if it is not generally available to the public. With respect to insider trading, however, this means that the market has not yet had an opportunity to take account for the information and the insider maintains an "informational advantage." Langevoort, supra note 1, § 5.03, at 5-9. For this reason, an insider must wait some period of time after public dissemination before trading in order to permit the market to take account of it. See SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 854 (2d Cir. 1968) (en banc), cert. denied, 394 U.S. 976 (1969).

24. 401 F.2d 833, 848 (2d Cir. 1968) (en banc), cert. denied, 394 U.S. 976 (1969). The court also made clear that disability from disclosing (due to corporate interest or confidence) is not a defense, but merely requires abstinence from trading. See id.
25. See id. The rule adopted by the court would properly be identified as a parity-of-information theory. See supra note 11.
27. See Freeman v. Decio, 584 F.2d 186, 189 (7th Cir. 1978); Fridrich v. Bradford,
In *TGS*, the court emphasized the purposes of the 1934 Act: to protect investors and to achieve efficient markets and a just price through the requirement of disclosure because manipulation or secreting information obstructs efficiency.\(^{28}\) Rule 10b-5, therefore, properly incorporated the policy of insuring the justifiable expectation of investors that they will have access, even on impersonal exchanges, to material information.\(^{29}\) After *TGS*, then, access to material nonpublic information carried with it a corresponding responsibility, or duty, to disclose or abstain from trading. The equal access theory was based on basic fairness considerations and a broad interpretation of the purposes of the securities laws generally, and specifically, section 10(b) and Rule 10b-5.

II. THE REFORMATION: BACK TO THE COMMON LAW

Nineteen years passed between the promulgation of Rule 10b-5 and the SEC's first insider trading action.\(^{30}\) Another nineteen years would pass before the next major event in the law of insider trading. During these intervening years, the law of insider trading had remained relatively constant and was supported by the flexible framework of the equal access theory. In 1980, however, the landscape of insider trading law changed dramatically.

A. *The Chiarella Doctrine*

In *Chiarella v. United States*,\(^{31}\) the Supreme Court limited the duty to disclose or abstain to those in some special relationship of trust or confidence such that at common law they would be obligated to speak.\(^{32}\) Thus, the Court recoiled from the equal access theory and returned Rule 10b-5's prohibition of insider trading to principles of fiduciary relations and common law fraud. The Rule, wrote the Court, is a "catchall provision, but what it catches must be fraud."\(^{33}\)

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\(^{28}\) See *Texas Gulf Sulphur*, 401 F.2d at 858-59 (citing H.R. Rep. No. 1383, 73d Cong., 2d Sess. 11 (1934)). "[N]o investor, no speculator, can safely buy and sell securities upon exchanges without having an intelligent basis for forming his judgment as to the value of the securities he buys or sells." Id. at 849 n.10.

\(^{29}\) Id. at 858.


\(^{32}\) See id. at 233.

\(^{33}\) Id. at 235. Some have interpreted *Chiarella* to mean that there can be no violation of 10b-5 absent a fiduciary relationship between seller and buyer. See id. at 239 (Brennan, J., concurring); Langevoort, *supra* note 1, § 1.03, at 1-13 n.1. An exception to this rule has been carved out as a matter of fairness. Although never explicitly adopted by the Supreme Court, it has been widely acknowledged by the courts that the absence of a fiduciary relationship between an insider as seller and a non-shareholder as buyer is not a defense to insider trading liability. "[F]or it would be a sorry distinction to allow [an insider] to use the advantage of his position to induce the buyer into the position of a beneficiary, although he was forbidden to do so, once the buyer had become one." *Gratz*
Vincent Chiarella was the employee of Pandick Press, a financial printer on Wall Street. Having deciphered the codenames of three tender offer targets, he purchased target stock and then sold his holdings—at a significant profit—immediately following public announcement of the intended acquisitions. Chiarella was convicted of insider trading. The Second Circuit affirmed the conviction finding that Chiarella had profited from an unfair informational advantage by virtue of his employment. The Supreme Court reversed, however, finding Chiarella had no duty to target company shareholders.

While the Court apparently agreed with precedent regarding the duties of insiders, it expressly rejected the underlying theory of equal access that had been the basis for Cady, Roberts and TGS. According to the Court, the focus of insider trading analysis is common law fraud and the duty to disclose that arises from a relationship of trust and confidence. Under the equal access theory, because a special relationship of trust and confidence generally gave the trustee access to nonpublic information, it also gave rise to a duty to disclose or abstain. After Chiarella, such a relationship became a necessary condition of the duty to disclose or abstain.

In the court below, the Second Circuit had, once again, espoused an information-based theory, although its holding was less expansive than its decision in TGS. In this second pass at insider trading, the Second Circuit withdrew from its parity of information theory in TGS and adopted the equal access theory originally enunciated by the SEC in Cady, Roberts. That is, the court held that anyone with regular access to information not available to the public is forbidden from trading without disclosure. Ironically, on appeal, even this more conservative rule was viewed as overreaching by the SEC and the Solicitor General.


34. See Chiarella, 445 U.S. at 224.
36. See Chiarella, 445 U.S. at 237. Chiarella also marked a significant departure from SEC enforcement, which, until that time, had been through civil actions. Chiarella was the first case in which a purchaser faced criminal liability for a 10(b) violation. See id. at 235 n.20.
37. See id. at 226-27.
39. 401 F.2d 833 (2d Cir. 1968).
40. See Chiarella, 445 U.S. at 227-30. The Court was divided five-four on the duty to disclose issue. (Although Justice Brennan concurred in the judgment, he adopted Chief Justice Burger's analysis). See id. at 239.
41. See United States v. Chiarella, 588 F.2d 1358, 1365 (2d Cir. 1978), rev'd, 445 U.S. 222 (1980); infra notes 93-123 and accompanying text.
42. See Chiarella, 588 F.2d at 1365.
43. See Frank H. Easterbrook, Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information, 1981 Sup. Ct. Rev. 309, 315. In the Supreme Court, the government abandoned the equal access theory and took the position that liability,
The Supreme Court agreed. Citing an absence of explicit congressional intent to the contrary, it refused to acknowledge that a duty arose out of "regular access" to nonpublic information because to do so would create a duty for all market participants in possession of such information. According to the Court, to do so would "depart[ ] radically from the established doctrine that duty arises from a specific relationship between two parties." The Court based its conclusion on several grounds. First, it recognized that common law misrepresentation creates a duty to speak only where there is a fiduciary relationship or other relationship of trust and confidence. Second, the Court noted that federal courts had held that failure to disclose can be fraud under Rule 10b-5, but only where there is such a relationship. Third, the Court found no evidence of congressional intent to create such a broad duty, nor had Congress or the SEC ever adopted a parity of information theory. Fourth, the regulated, but permitted, use of material nonpublic information in other areas of securities regulation (under the Williams Act, for example) implied congressional reluctance to create such a duty. Fifth, previous Supreme Court law stated that the 1934 Act should not be construed more broadly than its language reasonably permitted. Finally, the Court believed a rule like that suggested by the dissent of Justice Blackmun—that such conduct is generally prohibited—would raise due process questions of notice for criminal and civil defendants.

Justice Blackmun, dissenting, adopted a rule more in keeping with the

and Rule 10b-5 fraud, was based on the breach of a duty of confidentiality owed to the acquiring companies (Pandick's clients). See id.; infra notes 92-123 and accompanying text.

45. See id. at 228 (citing Restatement (Second) of Torts § 551(2)(a) (1976)).
46. See id. at 229-30 (discussing Affiliated Ute Citizens v. United States, 406 U.S. 128, 152-53 (1972) (failure to disclose material facts creates Rule 10b-5 liability because defendant, although not a fiduciary, had assumed a relationship to act on behalf of the injured party such that non-disclosure constituted a breach of duty)); see also Frigitemp Corp. v. Financial Dynamics Fund, Inc., 524 F.2d 275, 282 (2d Cir. 1975) (party charged with failure to disclose must have duty to speak); General Time Corp. v. Talley Indus., 403 F.2d 159, 164 (2d Cir. 1968) (one who is neither a fiduciary nor an insider has no duty to disclose material facts), cert. denied, 393 U.S. 1026 (1969).
47. See Chiarella, 445 U.S. at 233.
49. See Chiarella, 445 U.S. at 233. Under the Williams Act, 15 U.S.C. § 78m(d)(1), a tender offeror may purchase up to five percent of the target company's stock prior to disclosure of its intent to acquire. Additionally, the Supreme Court noted exceptions to the general prohibition against a member of a national securities exchange from trading for its own account. See Chiarella, 445 U.S. at 233 n.16 (citing § 11 of the 1934 Act, 15 U.S.C. § 78k(a)(1) (1988)). The Court noted, however, that these exceptions, for example allowing specialists to trade on their informational advantage, were created to preserve an orderly market. See id. But insider trading serves no useful purpose. See S. Rep. No. 792, 73d Cong., 2d Sess. 6 (1934). But see Dennis W. Carlton & Daniel R. Fischel, The Regulation of Insider Trading, 35 Stan. L. Rev. 857, 894-95 (1983).
50. See Chiarella, 445 U.S. at 234 (citations omitted).
lower courts. He advocated that "persons having access to confidential material information that is not legally available to others generally are prohibited by Rule 10b-5 from engaging in schemes to exploit their structural informational advantage through trading in affected securities." He viewed the majority's imposition of a requirement of a special relationship as transforming Rule 10b-5 from an "intentionally elastic 'catch-all'" into an overly narrow regulation which catches relatively little and makes investment in national securities markets "needlessly risky . . . for the uninitiated investor." Justice Blackmun argued further that the Court's technical interpretation of the securities laws was inconsistent with its prior flexible interpretations. Furthermore, Blackmun argued that the securities laws were not meant to replicate the common law of fiduciary relations which, along with the common law protections against fraud, were inadequate in insuring the fairness of transactions on "impersonal" national securities markets. Thus, although the majority claimed support from precedent, Blackmun found the decision neither "fully in step with administrative and judicial application of Rule 10b-5 to 'insider' trading," nor even "fully consistent with developments in the common law of fraud."

Advocating the equal access theory, Justice Blackmun again found the majority's analysis flawed for failing to account fully for the importance of defendant's access to confidential information unavailable to the ordinary investor. Moreover, according to Justice Blackmun, the trend in the common law of fraud and misrepresentation was toward a more flexible and expansive application of the "special facts" doctrine to find a duty to disclose where one party's superior knowledge of material facts would make nondisclosure inherently unfair.

Justice Blackmun noted that, according to Congress, the purpose of the securities laws is to assure fairness of opportunity "without undue

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52. Id. at 251 (Blackmun, J., dissenting).
53. Id. at 246.
56. Id. at 247.
57. See id.
preferences or advantages among investors. More significantly, and contrary to the majority's interpretation of lower court cases, the existence of a fiduciary relationship had not been the deciding factor in applying Rule 10b-5. According to the SEC, the focus in Cady, Roberts was on the unfairness of permitting the defendant to convert nonpublic information to his personal benefit. In fact, in a later case, the Commission expressly rejected the proposition that a special relationship is required to create a duty to disclose.

Moreover, Supreme Court jurisprudence had seemingly adopted this stance. In Affiliated Ute Citizens v. United States, a bank was held liable under Rule 10b-5 because it failed to disclose material information it obtained as a result of its "strategic position in the marketplace" and its superior access to information. The Chiarella majority concluded, therefore, that since the Court found a fiduciary relationship in Affiliated Ute Citizens, a relationship of that kind must exist in order to establish a duty to disclose. However, in Affiliated Ute Citizens, the Court's analysis did not center on the fiduciary relationship, but on what duty Rule 10b-5 imposes, independent of the relationship.

After Chiarella, the law of insider trading was returned, in large part, to its pre-regulation position. Rule 10b-5 applied not to prevent the use of unfair informational advantage, but to prevent trustees and others in relationships of trust and confidence from overreaching in derogation of their common law fiduciary duties.

B. Who Has a Duty Under Chiarella

The radical theoretical reversals embodied in Chiarella did not, however, prevent the SEC from continuing to prosecute insider trading. Rather, the Chiarella doctrine merely forced the SEC and the lower federal courts to formulate new theories and new relationships to reach different kinds of "insiders."

1. Traditional Insiders

The term "insider" remains undefined by statute. Generally, insiders include officers, directors, and majority shareholders, but also may

60. See id. at 249 (Blackmun, J., dissenting); In re Cady, Roberts & Co., 40 S.E.C. 907, 912 (1961).
63. Chiarella, 445 U.S. at 251 (Blackmun, J., dissenting).
64. See id. at 229-30.
65. See Affiliated Ute Citizens v. United States, 406 U.S. 128, 151 (1972); White v. Abrams, 495 F.2d 724, 731-33 (9th Cir. 1974).
include any employee with access to confidential corporate information. Under section 16 of the 1934 Act, which regulates short-swing trading by insiders, a beneficial owner of more than ten percent of any class of security is also an insider. Moreover, under section 16, courts have construed an "officer" to include any executive employee who is likely to have access to confidential information which would aid that employee in a private transaction. The equal access cases prior to Chiarella naturally suggested a broader definition which included anyone in possession of nonpublic information.

2. Temporary Insiders

The obligation to disclose or abstain is not limited to traditional insiders or employees. It has been expanded to encompass the "temporary insider" who is an outsider "clothed" with insider status. First developed in Dirks v. SEC, the temporary insider theory of liability recognizes that, in many circumstances, management requires the advice of professionals—accountants, underwriters, lawyers, or consultants—to whom the disclosure of confidential information is necessary to conduct corporate business. Because they have entered into a "special confidential relationship" in the course of the firm's affairs and are "given access to information solely for corporate purposes," such professionals become "temporary insiders"; they are temporary fiduciaries to shareholders and subject to the same duty to disclose as traditional insiders.

According to Dirks, temporary insider status does not depend solely on the receipt of nonpublic information. Rather, the analysis focuses on the outsider's entrance into a special relationship of confidence for the purpose of conducting corporate business and to whom the corporation

68. See Moss, 719 F.2d at 10 n.8.
70. See Colby v. Klune, 178 F.2d 872, 873 (2d Cir. 1949).
74. See id.
75. Id.
gives access to information for corporate purposes only. Additionally, for the breach of such a duty to predicate a violation, the corporation must expect confidentiality such that the relationship implies a duty. Note that the equal access cases predicated liability, at least in part, on this express ground—the conversion of corporate information for personal gain.

3. Tippee Liability

Although the Dirks Court created a new class of insiders, it also placed restrictions on when “tippees” are liable under Rule 10b-5 for trading on information received from an insider. The Court held that a tippee assumes an insider’s duty of disclosure when the tippee receives information from an insider in breach of that insider’s fiduciary duty and the tippee knows or should have known there has been a breach.

The SEC’s original formulation of tippee liability depended only on the tippee’s knowledge that the information was nonpublic and obtained “improperly.” Under Dirks, it is crucial that the tippee knows that the insider has breached a duty. Where the existence of a breach is not obvious—for instance, where disclosure is made by mistake or the insider is unsure whether the information is material—the purpose of the disclosure determines liability. Thus, if an insider personally has benefitted or will benefit from the disclosure, and in this manner, deceives, defrauds, or manipulates shareholders, there is a breach of fiduciary duty owed to the shareholders. According to the Court “[a]bsent some personal gain, there has been no breach of duty to shareholders. And absent a breach by the insider, there is no derivative breach.” Presumably,

78. See id.; see also Walton v. Morgan Stanley & Co., 623 F.2d 796, 799 (2d Cir. 1980) (no agreement of confidentiality).
80. See Dirks, 463 U.S. at 661. A “tippee” is an outsider who receives material nonpublic information (a “tip”) from an insider, who is then designated a “tipper.” See id. at 651.
81. See id. at 660, 671 n.5 (Blackmun, J., dissenting); United States v. Chestman, 947 F.2d 551, 565 (2d Cir. 1991), cert. denied, 112 S. Ct. 1759 (1992); SEC v. Materia, 745 F.2d 197, 200 n.3 (2d Cir. 1984), cert. denied, 477 U.S. 1053 (1985); In re Investors Management Co., 44 S.E.C. at 633, 651 (1971). When this test is satisfied, the tippee is said to have “inherited” a fiduciary duty to the corporation’s shareholders. See Chestman, 947 F.2d at 565.
82. Investors Management, 44 S.E.C. at 641. A tippee’s liability is derivative, see Dirks, 463 U.S. at 659, and arises from his “role as a participant after the fact in the insider’s breach of a fiduciary duty.” Chiarella v. United States, 445 U.S. 222, 230 n.12 (1980).
83. See Dirks, 463 U.S. at 660-61.
84. See id. at 662.
85. See id. at 662-63 (citing Aaron v. SEC, 446 U.S. 680, 686 (1980)).
86. Id. at 662. What constitutes personal gain may include direct or indirect pecuniary gain or even enhanced reputation that will lead to future monetary gains. See id. at 663. It may also include the transfer of a gift to the recipient of the information in the
given the Court's standard, a tipper will be able to assert a good faith defense, even where there is personal benefit, if such benefit was not the intent or purpose of disclosure.

In denying the SEC contention that anyone who receives material nonpublic information from an insider has a duty to disclose, the Court reaffirmed its rejection of the equal access theory. It recognized, however, that to permit insiders to circumvent insider trading proscriptions by acting through a third party would be antithetical to the purpose of the securities laws. However, the Court rejected the equal access theory with respect to tippee liability because such a rule might chill the incentive for investment analysts to investigate corporate matters and values by speaking with officers and directors.

While the Court apparently does no more than continue under the rule of Chiarella, the language of Dirks could be viewed as an entrenchment into the law of fiduciary obligations. In Chiarella, the Court was careful to characterize the duty-triggering relationship as one of "trust and confidence" without labelling it as fiduciary. In Dirks, the Court discusses only fiduciary relationships. The rule of Dirks would likely apply to one with a "special relationship of trust and confidence" but without a strict fiduciary relationship. Nonetheless, Justice Blackmun, joined by Justices Brennan and Marshall, took issue with the yet additional restriction on the scope of the securities laws reflected in the requirement of personal benefit as a predicate for breach of a fiduciary duty. According to the dissent, fiduciary duties—if they are to be the standard in securities cases—have never been premised on gain to the trustee. Rather, they exist to protect beneficiaries from harm or loss.

The effect of these developments is difficult to assess. On one hand, the Court expanded the reach of insider trading prohibitions to prevent temporary insiders from profiting from their access to nonpublic information. Conversely, much of the flexibility of tippee liability was eliminated, leaving this formidable enforcement tool somewhat weakened. The most significant post-Chiarella development, however, came in the form of the misappropriation theory.

form of profits from use of the information. See id. at 664. The SEC takes a broad view of what is a gain. See United States v. Chestman, 947 F.2d 551, 572 (2d Cir. 1991) (citing Complaint, SEC v. Phillip J. Stevens, No. 91 Civ. 1869 (S.D.N.Y., filed Mar. 19, 1991)) (sole benefit to insider is enhanced reputation).
88. See id. at 659-61; 15 U.S.C. § 78t(b) (1988) (unlawful to do indirectly "through or by means of any other person" any act made unlawful by the securities laws); cf. Mosser v. Darrow, 341 U.S. 267, 272 (1951) (one who participates with a fiduciary in a breach is as forbidden as the trustee himself).
89. See Dirks, 463 U.S. at 658-59.
90. See id. at 667-68, 671-73.
91. See id. at 673-74.
III. Misappropriation Theory

The misappropriation theory, which grew out of Chief Justice Burger's dissent in Chiarella, has been adopted by at least four circuit courts as a means of getting at insider trading which cannot otherwise be reached under the Chiarella duty formula. Under the misappropriation theory, "it is fraud in connection with the purchase or sale of a security—and therefore a violation of Rule 10b-5—for a person to trade in securities in breach of fiduciary duty by secretly converting for personal use, information which has been entrusted to him."93

The traditional theory, as structured by Chiarella, with its corollary theories of temporary insiders and tippee liability, left significant gaps in insider trading enforcement.94 For example, there was no sanction for trading in one company on information emanating from another source.95 Since Chiarella had breached no duty to the shareholders of the companies in which he traded, he did not violate Rule 10b-5.96 Nor was it a violation to trade on material nonpublic information received from an insider whose disclosure was not made in breach of a duty. In Dirks, petitioner, who was an officer of a broker-dealer, traded on information that a company's assets were overstated.97 An officer of the company had communicated the information to him. Since the company officer received no benefit, but rather made the disclosure to uncover a fraud, the Court held there was no violation.98

In response to Chiarella and Dirks, the SEC, federal prosecutors and lower federal courts searched for a way to reach "bad" behavior which did not rise to Rule 10b-5 fraud as limited by the Chiarella duty requirement.99 The result of their search was the misappropriation theory. Ac-


93. Langevoort, supra note 1, § 6.01, at 6-1.
94. See id. § 6.02, at 6-2.
98. See id. at 667.
According to the Ninth Circuit, under the misappropriation theory,

Rule 10b-5 is violated when a person (1) misappropriates material non-public information (2) by breaching a duty arising out of a relationship of trust and confidence and (3) uses that information in a securities transaction, (4) regardless of whether he owed any duties to the shareholders of the traded stock.100

While the misappropriation theory draws generally on the dissent of Chief Justice Burger in Chiarella,101 the breadth of his theory of liability—an absolute duty to disclose and resulting fraud upon failure to do so102—has been rejected in favor of basing fraud on the breach of a duty of confidentiality itself.103 The significant uniqueness of the misappropriation theory is that, analytically, the predicate fraud is not in a failure to disclose information to the marketplace, nor is it grounded in a duty to shareholders of the traded stock. Rather, it is a fraud perpetrated upon the person who entrusted the information to the trustee.104 The theory of fraud draws on the “upon any person” language of Rule 10b-5.105 In some ways, then, it resembles the fraud found in Cady and TGS which was based, at least in part, on a trustee’s duty not to convert confidential information to her own use.106 Although arguably motivated by an equal access goal, in application, the theory is distinguishable from the equal access theories of Cady and TGS. The misappropriation theory molds itself to the Chiarella duty requirement and locates a breach of duty in the misappropriation of nonpublic information. In Chiarella, for example, the defendant committed a fraud upon the owners of the information—the bidders who had entrusted confidential information to

deficiency in Chiarella), cert. denied, 464 U.S. 863 (1983); Langevoort, supra note 1, § 2.01, at 2-2 to 2-3; see also Note, Insider Trading in Junk Bonds, 105 Harv. L. Rev. 1720, 1734 (1992) (discussing that in response to Chiarella, courts and commentators proposed the misappropriation theory).

100. SEC v. Clark, 915 F.2d 439, 443 (9th Cir. 1990) (citations omitted); see SEC v. Materia, 745 F.2d 197, 201-03 (2d Cir. 1984), cert. denied, 471 U.S. 1053 (1985).


102. See id.

103. See id.; SEC v. Cherif, 933 F.2d 403, 409 (7th Cir. 1991), cert. denied, 112 S. Ct. 966 (1992); Clark, 915 F.2d at 445 & n.8; Moss v. Morgan Stanley Inc., 719 F.2d 5, 15-17 (2d Cir. 1983), cert. denied, 465 U.S. 1025 (1984); Langevoort, supra note 1, § 6.01, at 6-1.

104. See United States v. Chestman, 947 F.2d 551, 566 (2d Cir. 1991), cert. denied, 112 S. Ct. 1759 (1992); United States v. Carpenter, 791 F.2d 1024, 1032 (2d Cir. 1986), aff'd by equally divided Court, 484 U.S. 19, 24 (1987). For this reason, it is also known as the “fraud on the source” theory. See Langevoort, supra note 1, § 6.02, at 6-3.


Chiarella's employer.\textsuperscript{107}

Nonetheless, the theory is supported \textit{post hoc} by Congress in its observations concerning the goals of the securities laws: “In the view of the Committee, . . . securities fraud [by misappropriation] should be encompassed within section 10(b) and Rule 10b-5.”\textsuperscript{108} Notably, this formulation of the goals of the securities laws emphasizes the misuse of confidential information rather than the breach of a duty.

The result of the misappropriation theory is that some Rule 10b-5 violations are premised on harms to those who are not investors. Investor protection—the intended goal of antifraud laws—becomes merely derivative. For instance, in \textit{United States v. Newman},\textsuperscript{109} a misappropriator and tippees were liable where their acts “sull[ied] the reputations” of the broker-dealers “as safe repositories of client confidences” as if they had stolen their employer's money.\textsuperscript{110} Also injured by the trading were the broker-dealer and its clients.\textsuperscript{111} While the court acknowledged harm to the acquiring companies due to a rise in the market price of target company stocks,\textsuperscript{112} it did not base its holding on that harm. Similarly in \textit{SEC v. Materia},\textsuperscript{113} the court found injury where defendant, by his fraud, had undermined the integrity of his employer—a financial printer.\textsuperscript{114} Finally, in \textit{SEC v. Cherif},\textsuperscript{115} a breach of duty to defendant’s former employer may have “eroded client confidence . . . by suggesting the company’s susceptibility to treachery from within.”\textsuperscript{116} From these decisions, it would appear that the class to be protected by the securities laws, specifically Rule 10b-5, are those who are active players in the securities markets—broker-dealers, underwriters and dealers—rather than the “ordinary” investor.

This result was not merely a theoretical inconsistency, however. For a time, in Rule 10b-5 civil actions brought under the misappropriation the-

\begin{footnotes}
\item[109] 664 F.2d 12 (2d Cir. 1981).
\item[110] \textit{Id.} at 17; \textit{see SEC v. Cherif}, 933 F.2d 403, 409 (7th Cir. 1991), \textit{cert. denied}, 112 S. Ct. 966 (1992).
\item[112] \textit{See Newman}, 664 F.2d at 17.
\item[114] \textit{See id.} at 202; \textit{see SEC v. Cherif}, 933 F.2d 403, 409 (7th Cir. 1991), \textit{cert. denied}, 112 S. Ct. 966 (1992).
\item[115] 933 F.2d 403 (7th Cir. 1991), \textit{cert. denied}, 112 S. Ct. 966 (1992).
\item[116] \textit{Id.} at 412.
\end{footnotes}
ory, the duty to disclose affected the question of standing. If the misappropriation and, therefore, the predicate fraud, was upon a third-party source and not the corporation or shareholders, shareholders had no standing to sue for a 10b-5 violation. The misappropriation theory was thus available only to the government until Congress expressly created a private cause of action in the Insider Trading and Securities Fraud Enforcement Act ("ITSFEA"). This act provided that any violator of the antifraud laws is liable to those who buy or sell the security contemporaneously with the purchase or sale of the violator. Note that when it came time to cure this defect for private plaintiffs, the Congress was led—inexorably—by an information theory as evidenced by the legislative history which emphasized the possession of information, rather than the breach of duty. By the ITSFEA, Congress apparently reintroduced the parity of information rule into securities regulation.

IV. THE "DUTY-GAP" OF NON-EQUITY SECURITIES

With respect to equity securities, the Chiarella duty requirement posed a significant, but surmountable obstacle to insider trading prosecutions. Regarding non-equity securities, however, the lack of any duty owed by insiders to the holders of such instruments threatened to bar any cause of action.

A. Options

Just as the courts have stretched the Chiarella duty requirement to enforce Rule 10b-5 against "outside" insider traders, so too have they strained to reach insider trading in options. From the very beginning, legislators recognized that "[m]any of the most flagrant abuses upon

118. See Moss v. Morgan Stanley Inc., 719 F.2d 5, 13, 15-16 (2d Cir. 1983) (arising from the same facts as Newman, shareholders have no cause of action since fraud was upon broker-dealer and its clients), cert. denied, 465 U.S. 1025 (1984).
122. See SEC v. Clark, 915 F.2d 439, 452, 453 n.25 (9th Cir. 1990).
123. An option is a contract to buy ("call") or sell ("put") a certain number of shares at a certain price within a fixed period of time. While options provide a form of "insurance" for investors, allowing them to hedge against future fluctuations in a security's market price, they are more often used as a means of speculation since they require little capital outlay (the contract price). See Louis Loss, Fundamentals of Securities Regulation 251 & n.4 (1983). Options are securities under, and subject to, the restrictions of, the Securities and Exchange Act of 1934. Section 3(a)(10) of the Act, 15 U.S.C. § 78c(a)(10), states "[a] security means any . . . stock . . . or warrant or right to subscribe to or purchase, any of the foregoing." Courts have had no difficulty concluding that these terms embrace options. See Collins v. Rukin, 342 F. Supp. 1282, 1287 (D. Mass. 1972); Globus, Inc. v. Jaroff, 271 F. Supp. 378, 380 (S.D.N.Y. 1967); SEC v. Texas Gulf Sulphur Co., 258 F. Supp. 262, 292 (S.D.N.Y 1966), modified on other grounds, 401 F.2d 833 (2d Cir. 1968) (en banc), cert. denied, 394 U.S. 976 (1969).
Despite this clear intent to prohibit abuses in the options markets, the Chiarella duty requirement threatened the viability of Rule 10b-5 actions for insider trading in options. As distinct from equity securities, options are mere contracts, issued independently of the firm and "stand[] alone, claiming no equity in the corporation, entitled to no vote, and with no fiduciary obligation of the management to the optionholder's interest." The seller of an option is not usually a shareholder of the issuer and, therefore, is not in a relationship of confidence and trust giving rise to a duty to disclose on the part of an insider.

In the wake of Chiarella, a number of courts declared that the disclose or abstain rule was inapplicable to options trading. This apparent loophole defied common sense: "[i]f insider trading in equities is forbidden to prevent insiders from reaping secret profits, 'then insider trading in options—designed to capture the same secret profits—must also have been prohibited.'" The Insider Trading Sanctions Act of 1984 ("ITSA") closed this gap by making the jurisprudence of insider trading applicable also to options and similar securities.

The ITSA, however, creates an anomaly in the law of insider trading: the courts have concluded that the abstain or disclose rule is triggered only where a fiduciary duty is owed; they also have concluded that option sellers and holders are owed no fiduciary or other duty by corporate insiders; nonetheless, Congress, in the ITSA, has made clear that the disclose or abstain rule should apply in some situations absent a fiduciary duty. This inconsistency is subject to varied interpretations. At first blush, it might seem that by overcoming the duty requirement with respect to options, but ignoring other securities, Congress has manifested an intent that only equity securities and options should be regulated. A similar conclusion is sometimes reached with respect to Congress' reluc-

125. See Pitt & Groskaufmanis, supra note 9, at 1.
127. In the case of standardized options trading, the Options Clearing Corporation, a commonly-owned transfer agent for options, is usually the seller. See Langevoort, supra note 1, § 3.03[1], at 3-14 to 3-15.
128. See id.
131. Insider Trading Sanctions Act of 1984, Pub. L. No. 98-376, 98 Stat. 1264 (1984) (codified as amended at 15 U.S.C. § 78(t) (1988)) ("Wherever communicating, or purchasing or selling a security while in possession of, material nonpublic information would violate . . . any provision of this chapter . . . such conduct in connection with a purchase or sale of a put, call, straddle, option or privilege . . . shall also violate [the Act]."); see also Langevoort, supra note 1, § 3.03[1], at 3-15; Thel, supra note 3, at 575.
132. See Langevoort, supra note 1, § 3.03[1], at 3-15.
tance to statutorily define insider trading in order to cure the gaps in equity and debt securities left by the Chiarella formulation. 133 However, with respect to debt securities, there was—and still is—a fundamental reluctance to create any obligation to bondholders. 134 Above all, the SEC feared that defining insider trading would weaken its enforcement power and create a roadmap to risk-free profits for sophisticated traders. 135 One commentator has noted that Congress' action reflects a fundamental belief that allowing corporate insiders to trade on material nonpublic information is simply unfair (the equal access theory) because if insider trading is wrong only when it is breach of some duty, it would not be objectionable in options. 136 Another concluded that while Congress was willing to adopt the flexible tests of the lower courts, it believed the resulting prohibition must be extended to options. 137

Interestingly, by overcoming the duty requirement, but still tying liability in options to the prevailing judicial theory in equity securities, Congress has allowed for a shift in judicial philosophy that might create a less stringent duty requirement. Additionally, since the loophole was not entirely open, 138 it can be argued that Congress, while approving of the misappropriation theory, recognized its weaknesses. It thus moved, as a matter of policy, to close the gap completely in a field so susceptible to abuses. 139

B. Debt Securities

The Chiarella duty gap that created a loophole in options trading likewise created opportunities for insider trading in debt securities and a corresponding (and continuing) strain by the lower federal courts to reach such activity under Rule 10b-5. While there are some ways to reach insider trading in debt securities, 140 the conclusion that the insider trading

133. See Fisch, supra note 1, at 181 n.7.
135. See Fisch, supra note 1, at 181 n.7.
137. See Langevoort, supra note 1, § 2.04[2], at 2-21 to 2-22.
139. See Langevoort, supra note 1, § 3.03[1], at 3-15.
140. First, because the misappropriation theory does not depend on a relationship between the trader and the security-holder, but rather on some other relationship of confidence and trust, the theory appears to be applicable to misappropriation trading in debt securities. See Pitt & Groskaufmanis, supra note 9, at 1. Second, Rule 14e-3 is not dependent on any special relationship and remains a valid tool to prosecute insider trading in connection with tender offers. Third, the SEC has taken the position that members of a creditor committee are “temporary insiders” and subject to the same insider trading
laws do not apply to debt securities is largely accurate and has been widely recognized in both legal and non-legal writing.\footnote{141}

Generally, because bonds are fixed obligations whose market prices do not fluctuate as sharply as stocks, there is not as much opportunity for exploitation by trading on inside information.\footnote{142} Junk bonds, however, trade more like common stock than the usual debt security,\footnote{143} and their volatile nature makes them far more susceptible to insider trading gains. Reports also suggest that insider trading in junk bonds has been widespread.\footnote{144}

Traditionally, an issuer, its officers, and directors owe no duty to bondholders outside those delineated by the indenture.\footnote{145} Conversely, stockholders, whose interests are created in the corporate charter and articles of incorporation are viewed as owners of the corporation.\footnote{146} They have a relationship with insiders which gives rise to implied duties of care, loyalty, honesty, and disclosure, beyond the rights set out in any written instrument. Moreover, courts rarely find implied covenants of fair dealing in indentures. This is so because courts look to the instrument itself to find the duty rather than the relationship between debtholders and the corporation.\footnote{147} Absent a duty, there can be no breach. Absent a breach, there can be no fraud. And absent a fraud, there can be no Rule 10b-5 violation.

Several commentators have criticized the conclusion that bondholders are owed no duty; they have called for the recognition of duties of care and loyalty and a cause of action for abuses by corporate management with respect to bondholders. They note that the law sometimes imposes restrictions as true insiders. See Memorandum of the Securities and Exchange Commission, Amicus Curiae at 5, \textit{In re Federated Dep't Stores} (Bankr. S.D. Ohio Mar. 7, 1991) (No. 1-90-00130) (quoted in Pitt & Groskaufmanis, supra note 9, at 1).

141. See Michael Lewis, \textit{Liar's Poker} 217 (1989) ("Now it is quite illegal to trade in stocks on inside information . . . . But there is no such law regarding bonds."); Langevoort, \textit{supra} note 1, § 3.03[2], at 3-16.

142. See Langevoort, \textit{supra} note 1, § 3.03[2], at 3-16.

143. See Morey W. McDaniel, \textit{Bondholders and Corporate Governance}, 41 Bus. Law. 413, 417 (1986). Junk bonds are "subinvestment grade securities" rated less than BB+ by Standard and Poor's or Baa by Moody's.


146. See McDaniel, \textit{supra} note 143, at 416.

147. See Mitchell, \textit{supra} note 145, at 1175.
extra-contractual duties on parties to contractual relationships. Like shareholders, bondholders entrust investments to corporate management for extended periods, and subject their investments to the same risks of devaluation due to careless management or expropriation. Moreover, the bondholder/management relationship has all the earmarks of a fiduciary relationship and bondholders should be afforded the same protections as shareholders in the duties of care and loyalty.

Not only do bondholders lack any extra-contractual protection, they also lack protection in the contract formation stage. The terms of the indenture are negotiated among the corporation, the underwriters, and the indenture trustee, none of whom, as a practical matter, adequately represent the interests of potential/prospective bondholders. This lack of bondholder representation destroys the premise that the bond agreement is the result of arm's-length negotiations. And individual investors—who have become increasingly involved in the bond market—have even less power to negotiate indentures than traditional institutional investors.

1. When Bondholders Deserve a Duty

There are, however, exceptions to the general rule. These are not true exceptions, though, in that they constitute situations where bondholders' interests become sufficiently similar to shareholders' interests that the bondholders are afforded some protections. As bondholders become, or are about to become, "owners" of the corporation—through corporate insolvency or at the exercise of a conversion right—insiders are found to owe them a duty.

a. Insolvency

Insolvency has long been recognized as imputing upon a corporation certain duties to its bondholders. Defined generally, insolvency is the

149. See Mitchell, supra note 145, at 1187.
150. See id.
151. See id. at 1188 (arguing for a cause of action and derivative cause of action by bondholders against management). Mitchell notes that, in all respects, the rights of bondholders against management also should apply against controlling shareholders. See id.
152. See Mitchell, supra note 145, at 1179. Even theoretically, the trustee owes bondholders no fiduciary duty until the execution of the indenture. Id.
154. See McDaniel, supra note 144, at 415.
155. See Manufacturers Trust Co. v. Becker, 338 U.S. 304, 310 (1949); Pepper v. Litton, 308 U.S. 295, 307 (1939) ("fiduciary obligation is designed for the protection of the entire community of interests in the corporation—creditors as well as stockholders") (citation omitted); In re STN Enterprises, 779 F.2d 901, 904 (2d Cir. 1985) (insolvent corporation owes duty to creditors).
inability of a corporation to pay its debts as they fall due. Technical insolvency is the inability to meet current obligations, even though assets exceed liabilities. Presumably then, the corporate officer of an insolvent firm, who trades in the firm’s debt issues without disclosing material nonpublic information, may be held liable for insider trading under Rule 10b-5, since upon insolvency the officer owes a duty to the bondholders. The problem for officers is that they may have no notice that the firm is insolvent and, indeed, that status can vary from day to day, making the duty to bondholders turn on what time of day assets become available or a credit line is approved.

When the person desiring to trade is the insolvent issuer itself, the issue of insolvency is less clear. While such transactions ordinarily invoke the disclosure requirements of the Securities Act of 1933, a corporation that decides to proceed on existing disclosures may expose itself to additional liability under Rule 10b-5. Against the threat of the heightened sanctions of Rule 10b-5, a firm’s officers must weigh the chance that disclosure of the state of the corporation may accelerate its demise by “prematurely” alerting creditors and potential lenders.

b. Convertible Bonds

When the bond is convertible—giving the holder the right to convert it into common stock—some courts have found that the corporation (and insiders) owe some duty to the security holders since they are potential shareholders. In Van Gemert v. Boeing Co., convertible bondholders who failed to convert prior to the redemption date of the bonds sued Boeing, claiming it failed to give adequate notice of the redemption date. The court held that underlying the indenture was a duty of fair treatment which obligated the corporation to give adequate notice. However, in a later phase of the case, a different panel of the Second Circuit limited the scope of the duty to one of good faith and fair dealing, arising out of the contract alone. Other courts have acknowledged similar duties to give bondholders notice of matters material to the conversion decision.

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157. See id.
159. See Pitt & Groskaufmanis, supra note 9, at 1 (issuers near insolvency should disclose before purchasing debt securities).
161. 520 F.2d 1373 (2d Cir. 1975).
162. See id. at 1383.
163. See Van Gemert v. Boeing Co., 553 F.2d 812, 815 (2d Cir. 1977); see also William W. Bratton, Jr., The Economics and Jurisprudence of Convertible Bonds, 1984 Wis. L. Rev. 667, 721 (rights limited to contract).
164. See Pittsburgh Terminal Corp. v. Baltimore & Ohio R.R. Co., 680 F.2d 933, 939-42 (3d Cir.), cert. denied, 459 U.S. 1056 (1982). Pittsburgh Terminal was brought under Rule 10b-5. The court, per Gibbons, J., held that the predicate duty to speak consistent with Chiarella could be found in the issuer’s contractual duty to speak. See id.
C. The New Frontier?

One court, however, has found that a corporation owes bondholders a duty, which, if breached, is sufficient to support a Rule 10b-5 insider trading claim. In In re Worlds of Wonder Securities Litigation, convertible bondholders sued insiders who traded only in common stock. Their claim was based on the text of Rule 10b-5 and the policy goals of section 10(b). While plaintiffs held securities convertible into common stock, the case did not concern the exercise of conversion rights. The court found, however, that the market price of stock was connected to the value of bonds and insider trading in stocks distorts the market for debentures. Noting that the Supreme Court has emphasized the broad coverage of Rule 10b-5’s terms, the court concluded that the plain language of the Act and the 1982 amendment which broadened the Act’s definition of “security” to include options manifested an intent to extend standing to holders of convertible bonds against inside traders of stock. Notwithstanding that there was no possibility of unfair advantage in a transaction between the corporation and its bondholders, the court held that plaintiffs had standing due to the goal of securities law to ensure “that no investor regardless of individual risk preferences, has to risk fraud.”

Like critics of the no duty rule, the court reasoned that bondholders have the same functional relationship with the corporation as shareholders. They contribute capital and support the corporation in its ability to attract equity. Both shareholders and bondholders are “justified in presuming that corporate insiders are not abusing their positions by profiting from undisclosed corporate information.” The court refused defendant’s motion to dismiss, holding by analogy, that insiders have a “fiduciary duty” to bond purchasers and can be liable to the bondholders when trading in breach of that duty.

The reasoning of the court harks back to the original insider trading

166. See id.
167. See id.
168. See Herman & MacLean v. Huddleston, 459 U.S. 375, 382 (1983) ("a § 10(b) action can be brought by a purchaser or seller of 'any security' against 'any person' who has used 'any manipulative or deceptive device'"); Affiliated Ute Citizens v. United States, 406 U.S. 128, 151 (1972) ("[P]roscriptions . . . by statute and rule are broad and, by repeated use of the word 'any,' are obviously meant to be inclusive.").
171. No unfair advantage was possible since upon exercise of the conversion option, shares would issue from authorized reserves, not in market purchases. See id.
172. Id.
173. See id. at 98,239.
174. See id.
175. Id.
176. See id.
theory of equal access espoused in *Cady, Roberts* and *TGS* and focuses on the "structural" disparity between investors and insiders in their ability to obtain information lawfully.\(^{177}\) The *Worlds of Wonder* court is the only court to find a duty to disclose or abstain in the absence of a fiduciary-type duty and in the face of clear Supreme Court doctrine. However, the *Worlds of Wonder* decision may also mark a return in securities law to a more flexible interpretation of the statutory prohibitions.

**CONCLUSION**

The history of insider trading liability suggests that the SEC and lower federal courts continue to think with an "equal access" mindset, though they operate within the constraints of a strictly-read, common law fraud-based Rule 10b-5, as set forth in *Chiarella*. The inconsistencies that result from this tension can be remedied by a return to a more expansive and flexible reading of the Rule as embodied by the equal access theory. Under the equal access theory, persons who have regular access to material nonpublic information not legally available to others—an "unremediable informational advantage[\(^{178}\)]"—are prohibited from reaping the benefits of their position at the expense of uninformed investors. The prohibition would apply equally to outsiders or tippees who receive information from such persons and who know, or had reason to know, it is nonpublic. In the context of debt securities, the imposition of the disclose or abstain duty would not disrupt management’s duty to shareholders. It would require only that they deal fairly with the corporation's bondholders. Moreover, such a theory more accurately reflects Congress' intent in enacting the securities laws and section 10(b), by protecting the ordinary investor and ensuring a level playing field. Section 10(b) and Rule 10b-5 were not meant merely to codify the law of fiduciary obligations in the field of securities transactions. Rather, they were designed to "substitute a philosophy of full disclosure for the philosophy of *caveat emptor* and thus to achieve a high standard of business ethics in the securities industry."

\(^{177}\) See *Chiarella v. United States*, 445 U.S. 222, 251 (1980) (Blackmun, J., dissenting) ("structural disparity . . . is critical factor under Rule 10b-5").
