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# *Whitman* and the Fiduciary Relationship Conundrum

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## INTRODUCTION

While the law on insider trading has been convoluted and, in Judge Jed S. Rakoff's words, "topsy turvy,"[1] the law on insider trading is supposedly clear on at least one point: insider trading liability is premised upon a fiduciary relationship. Thus, all three seminal U.S. Supreme Court cases articulating the necessary elements for demonstrating any form of insider trading liability under § 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934[2] made crystal clear that a fiduciary relationship represented the lynchpin for such liability.[3]

Alas, insider trading law is not clear about the *source* from which the fiduciary relationship arises.[4] Some insist that the source is federal law, while others insist that it is some aspect of state law.[5] Twenty-five years ago, Professor Stephen Bainbridge emphasized the relative lack of attention focused on this source question, noting that such inattentiveness "robbed the federal insider trading prohibition of coherence and predictability."[6]

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1. *See* United States v. Whitman, 904 F. Supp. 2d 363, 372 (S.D.N.Y. 2012), *aff'd*, 555 F. App'x 98 (2d Cir. 2014); Sung Hui Kim, *Insider Trading as Private Corruption*, 61 UCLA L. REV. 928, 931 (2014) (referencing insider trading law as a "theoretical mess," "seriously flawed," "ill-defined," and "astonishingly dysfunctional").
2. 15 U.S.C. §§ 78a–78qq.
3. *See* Donna M. Nagy, *Insider Trading and the Gradual Demise of Fiduciary Principles*, 94 IOWA L. REV. 1315, 1323–36 (2009).
4. *See Whitman*, 904 F. Supp. 2d at 367.
5. *See* SEC v. Mapp, 240 F. Supp. 3d 569, 582 (E.D. Tex. 2017) (noting a federal circuit split on this issue).
6. *See* Stephen M. Bainbridge, *Incorporating State Law Fiduciary Duties into the Federal Insider Trading Prohibition*, 52 WASH. & LEE L. REV. 1189, 1191 (1995).

Nevertheless, this inattentiveness persists, causing debate about the source to periodically remerge.

In *United States v. Whitman*,[7] Judge Rakoff sought to settle this debate in favor of federal law.[8] While the Second Circuit affirmed the holding,[9] other federal and state courts contend that the source of the fiduciary relationship stems from state law.[10]

This Article agrees with the result in *Whitman* but nevertheless argues that pinpointing appropriate rationales for the result is challenging primarily because the insider trading regime is riddled with mixed signals. On the one hand, as Judge Rakoff notes, the notion that state law should define the fiduciary relationship is highly problematic not only because of the potential variance from state to state[11] but also because of the considerable uncertainty regarding *which* state law controls the fiduciary relationship question.[12]

On the other hand, pinpointing a convincing rationale for the primacy of federal law poses difficulties. To be sure, Judge Rakoff advances rationales well-grounded in federal law and important and familiar policy goals, including the oft-cited goals of uniformity and promotion of disclosure in the federal securities law system.[13] Nonetheless—and precisely because of the confounding state of insider trading laws—it is possible to take issue with these rationales. First, these rationales sit uncomfortably with federal precedent clearly disfavoring federal common law as well as federal courts' clear reliance on state law when developing insider trading laws.[14] Second, these rationales center on policy goals associated with uniformity and disclosure that are also awash in mixed signals.[15] Third, these rationales fail to appropriately account for the existing and preexisting role of state law in policing insider trading claims.[16]

After highlighting the confounding nature of these rationales, this Article offers the principle of certainty as a possible rationale that more effectively justifies the federal preference while balancing the roles of state and federal law. Importantly, this Article contends that the resolution of this source issue is critical because of the centrality of the fiduciary relationship to insider trading law. Pinpointing appropriate rationales for this resolution is also critical. In other contexts, Supreme Court cases have focused on problematic

7. 904 F. Supp. 2d 363 (S.D.N.Y. 2012), *aff'd*, 555 F. App'x 98 (2d Cir. 2014).

8. *See id.* at 374.

9. *See* Steginsky v. Xcelera Inc., 741 F.3d 365, 371 (2d Cir. 2014).

10. *See, e.g.*, Mueller v. Thomas, 84 F. App'x 273 (4th Cir. 2003) (per curiam); Fortson v. Winstead, McGuire, Sechrest & Minick, 961 F.2d 469 (4th Cir. 1992); Abell v. Potomac Ins. Co., 858 F.2d 1104 (5th Cir. 1988); Barker v. Henderson, Franklin, Starnes & Holt, 797 F.2d 490 (7th Cir. 1986).

11. *See Whitman*, 904 F. Supp. 2d at 370.

12. *See infra* Part III.D.2 (discussing state law uncertainty).

13. *See generally* John C. Coffee Jr., *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 VA. L. REV. 717 (1984); Frank H. Easterbook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669 (1984).

14. *See infra* Parts II.B, II.C.

15. *See infra* Parts III.B, III.C.

16. *See infra* Part II.B.

reasoning to discard court rulings, including rulings based on well-settled and long-held principles.[17] These cases affirm this Article's core assertion that the reasoning we use matters.

Part I examines the primacy of fiduciary relationships to insider trading liability and highlights the divergent opinions related to the source of that relationship. Part II reveals the mixed messages undergirding our insider trading laws to demonstrate why reliance on those laws poses challenges for a convincing response to the source question. Part III evaluates policy goals animating the source debate and, after demonstrating some of the difficulties with those goals, focuses on the possibility of certainty as a guiding principle. Part IV concludes by offering the principle of certainty as a possible rationale that more effectively justifies the federal preference while balancing the roles of state and federal law.

## I. FIDUCIARY RELATIONSHIPS AND THE SOURCE SPLIT

### *A. Relationship Versus Duty*

The concepts of fiduciary relationship and fiduciary duty are often used interchangeably even though they focus on two distinct issues. The fiduciary relationship relates to the characteristics of a relationship that qualifies as "fiduciary" in nature.[18] The Supreme Court has referred to this relationship as one in which information is entrusted with an expectation that it be held in confidence, distinguishing the fiduciary relationship from one involving parties who are "complete stranger[s]."[19] Fiduciary duty refers to the obligations that arise from the fiduciary relationship.[20] For purposes of insider trading, people within a fiduciary relationship have a fiduciary duty to either disclose confidential information to those within their fiduciary relationship or abstain from trading on the information.[21] In addition to this "disclose or abstain" duty,[22] the Court has recognized a fiduciary duty to refrain from passing confidential information for a personal benefit.[23]

Although distinct, these two concepts are inextricably linked. This is because to violate the insider trading laws, a person must violate the fiduciary duty arising out of a fiduciary relationship.[24] In *Chiarella v. United States*,[25] the Supreme Court concluded that the trader did not have the necessary

17. *See* Knick v. Township of Scott, 139 S. Ct. 2162, 2178 (2019) (overturning Williamson Cnty. Reg'l Plan. Comm'n v. Hamilton Bank of Johnson City, 473 U.S. 172 (1985), because of "exceptionally ill founded" reasoning); Franchise Tax Bd. v. Hyatt, 139 S. Ct. 1485, 1499 (2019) (overturning Nevada v. Hall, 440 U.S. 410 (1979), based on the "quality of the decision's reasoning").

18. Chiarella v. United States, 445 U.S. 222, 228, 232–33 (1980).

19. *Id.* at 232–33.

20. *See id.* at 231–32; SEC v. Tex. Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968) (en banc).

21. *See Chiarella*, 445 U.S. at 231–32; *Tex. Gulf Sulphur*, 401 F.2d at 848.

22. *Tex. Gulf Sulphur*, 401 F.2d at 848.

23. *See* Dirks v. SEC, 463 U.S. 646, 662 (1983).

24. *See Chiarella*, 445 U.S. at 230; Bainbridge, *supra* note 6, at 1199.

25. 445 U.S. 222 (1980).

fiduciary relationship to expose him to insider trading liability.[26] In *Dirks v. SEC*,[27] while a fiduciary relationship existed, the Court could not establish that anyone had breached a fiduciary duty arising from the relationship.[28] Thus, the issues of duty and relationship are distinct but related. This Article focuses on the fiduciary relationship but recognizes that these concepts are interwoven and often discussed as if they are the same.

### *B. Centrality of the Fiduciary Relationship*

Whether someone trades or passes on confidential information, the Supreme Court has made clear that insider trading liability exists only if that someone breaches a duty arising from a fiduciary relationship.[29] In *Chiarella*, the Court, led by Justice Lewis F. Powell Jr., took its first opportunity to address insider trading under Rule 10b-5 and link such liability to a fiduciary relationship.[30] The Court announced that insider trading liability could only arise from an insider's fiduciary relationship with the company in whose stock the insider trades, known as the "classical" or "traditional" theory of insider trading liability.[31] In the Court's view, fiduciary relationships under the classical theory included insiders, such as officers, directors, and controlling shareholders.[32] Later courts, including the Supreme Court, extended the classical theory to all corporate employees, regardless of their positions,[33] referring to such employees as "permanent insiders."[34] Fiduciary relationships under the classical theory also include "temporary" insiders such as attorneys, accountants, and consultants, entrusted with confidential corporate information.[35] Because the trader in *Chiarella* was neither a permanent nor a temporary corporate insider, the Court held that he did not have the necessary fiduciary relationship for insider trading liability.[36]

In *United States v. O'Hagan*,[37] the Supreme Court extended insider trading liability beyond individuals in a relationship with the specific corporation that is the subject of the stock trades but nevertheless tethered the extension to fiduciary relationships.[38] The "misappropriation theory" adopted in *O'Hagan* premises liability on a "fiduciary-turned-trader's deception of

26. *Id.* at 232–33.
27. 463 U.S. 646 (1983).
28. *Id.* at 662.
29. *See id.* at 646; *Chiarella*, 445 U.S. at 231–32.
30. *See Chiarella*, 445 U.S. at 235.
31. *See id.* at 228; *see also* United States v. O'Hagan, 521 U.S. 642, 651 (1997); Nagy, *supra* note 3, at 132.
32. *See Chiarella*, 445 U.S. at 228.
33. *See O'Hagan*, 521 U.S. at 652; *see also* Mark J. Loewenstein & William K. S. Wang, *The Corporation as Insider Trader*, 30 DEL. J. CORP. L. 45, 53–54 (2005).
34. *O'Hagan*, 521 U.S. at 652.
35. *Id.* at 652; *see also* Dirks v. SEC, 463 U.S. 646, 655 n.14 (1983).
36. *Chiarella*, 445 U.S. at 231.
37. 521 U.S. 642 (1997).
38. *See* Nagy, *supra* note 3, at 1339; *see also* Sung Hui Kim, *The Last Temptation of Congress: Legislator Insider Trading and the Fiduciary Norm Against Corruption*, 98 CORNELL L. REV. 845, 864 (2013).

those who entrusted him with access to confidential information."[39] While some of the Justices were willing to impose liability on misappropriators without a fiduciary relationship,[40] the *O'Hagan* majority limited the theory to those within a fiduciary relationship or a similar relationship of "trust and confidence."[41]

In focusing on fiduciary relationships, the *O'Hagan* majority significantly raised the importance of that element in the insider trading inquiry. It is notable that the relationship at the crux of *O'Hagan* was a prototypical fiduciary relationship.[42] James O'Hagan was a partner in a law firm representing Grand Metropolitan PLC ("Grand Met") in its potential tender offer for the Pillsbury Company ("Pillsbury").[43] O'Hagan purchased Pillsbury securities based on confidential information he learned through his firm, resulting in a $4.3 million profit once the tender offer was announced.[44] The Securities and Exchange Commission (SEC) brought suit against O'Hagan under Rule 10b-5.[45] No one disputed that O'Hagan was clearly in a fiduciary relationship with his law firm and Grand Met; the relationship among a lawyer, the law firm, and the client is the kind of typical fiduciary relationship in which confidential information is entrusted.[46] However, that fiduciary relationship was not with the company in whose stock O'Hagan had traded (i.e., Pillsbury), as required by the classical theory of insider trading.[47] Thus, for the SEC to impose liability on O'Hagan, it would have to advance a new theory. Expanding insider trading liability to include the misappropriation theory allowed the Court to capture people like O'Hagan who were in fiduciary relationships unconnected to the corporation in whose stock they traded.[48] More importantly, by shifting focus away from the corporation that is the subject of the trade, the misappropriation theory further elevated the importance of the fiduciary relationship.[49]

In *Dirks*, the Court again extended insider trading liability but to situations in which confidential information is passed by someone, i.e., the "tipper," and then ultimately traded upon by someone else, the "tippee."[50] Although the SEC and the other Justices urged the Court to find liability in the absence of a fiduciary relationship, the majority—led by Justice Powell—refused.[51] The Court proclaimed, "[w]e were explicit in *Chiarella*" that no insider

39. *See O'Hagan,* 521 U.S. at 652.
40. *See id.* at 680–701 (Thomas, J., dissenting); Nagy, *supra* note 3, at 1330.
41. *O'Hagan*, 521 U.S. at 652 (quoting *Chiarella*, 445 U.S. at 228).
42. *Id.* at 647.
43. *Id.*
44. *Id.* at 648.
45. *Id.*
46. *Id.*
47. *Id.*
48. *See id.* at 650–53 (adopting the misappropriation theory).
49. *See id.* at 652–53.
50. *See generally* Dirks v. SEC, 463 U.S. 646 (1983).
51. *See id.* at 655–59 (rejecting the SEC's position); *see also* Kim, *supra* note 38, at 863; Nagy, *supra* note 3, at 1327 (noting the *Dirks* majority used the word "fiduciary" thirty-three times).

trading liability could arise without a fiduciary relationship.[52] Thus, even though tippers merely pass information without trading, tippers must nonetheless breach a fiduciary relationship in order to be held liable for insider trading.[53] Tying the tippee's liability to a fiduciary relationship was not as straightforward because, as the mere recipient of information, the tippee is not a party to a fiduciary relationship.[54] The Court resolved this quandary by theorizing that the tippee assumes a fiduciary duty when the tipper breaches her fiduciary relationship and the tippee knows or should know about the breach.[55] In the Court's view, this made the tippee a participant after the fact in the tipper's breach of her fiduciary relationship.[56] In this way, the Court managed to "'fiduciarize' the tippee"[57] and tether tippee liability to a fiduciary relationship, albeit indirectly. The Court also made clear that a fiduciary relationship is the lynchpin for establishing any form of insider trading liability under Rule 10b-5.[58]

Some may dismiss the continued importance of the fiduciary relationship. There is considerable evidence revealing that many courts have been willing to ignore or loosen the fiduciary construct when deciding insider trading cases.[59] As Professor John Coffee suggests, this willingness is highlighted by recent Second Circuit cases that appear to have not only relaxed the importance of fiduciary duty in tipping cases[60] but also eliminated the necessity of proving fiduciary duty altogether.[61] Given the high volume of insider trading cases in the Second Circuit, its pronouncements on this issue—and seeming movement away from fiduciary concepts—are significant.

However, these movements in the Second Circuit do not signal a complete abandonment of the fiduciary relationship construct. First, these cases focus on tipping and thus may only be applicable to a subset of insider trading cases.[62] Second, these cases focus on fiduciary *duty* and thus do not directly

52. *See Dirks*, 463 U.S. at 654.
53. *See id.* at 654–55.
54. *See id.* at 655; Nagy, *supra* note 3, at 1328.
55. *See Dirks*, 463 U.S. at 659.
56. *See id.* at 658.
57. Nagy, *supra* note 3, at 1328.
58. *See Dirks*, 463 U.S. at 654.
59. *See* Nagy, *supra* note 3, at 1336–52.
60. *See generally* United States v. Martoma (*Martoma II*), 894 F.3d 64 (2d Cir. 2018) (relaxing the personal benefit rule); United States v. Martoma (*Martoma I*), 869 F.3d 58 (2d Cir. 2017), *amended by* 894 F.3d 64 (2d Cir. 2018).
61. *See* United States v. Blaszczak, 947 F.3d 19, 36 (2d Cir. 2019) (upholding liability for passing confidential information under Title 18 that does not have a fiduciary duty element).
62. The Second Circuit cases, *Martoma I* and *Martoma II*, both involved allegations related to tipping and held that, to be convicted of insider trading, the tipper did not need to have a "meaningfully close relationship" with the tippee. *See Martoma II*, 894 F.3d at 73; *Martoma I*, 869 F.3d at 69–70. Instead, the tipper could be held liable if the tipper had a fiduciary relationship and breached her duty by passing information for a personal benefit, which could include an intention to benefit the tippee—irrespective of the relationship between the tipper and the tippee. *See Martoma II*, 894 F.3d at 75; *Martoma I*, 869 F.3d at 69–70. *United States v. Blaszczak* also involved tipping liability. In that case, the Second Circuit held that the *Dirks* personal benefit test used for finding liability in the tipping context

speak to the significance of the relationship inquiry.[63] Third, and most importantly, even as courts (including the Second Circuit) appear willing to weaken the *fiduciary duty* constraint, courts have been very clear, in both tipping and trading cases, that a *fiduciary relationship* remains an essential element.[64] Such cases therefore reveal that a fiduciary relationship continues to play a pivotal role in the insider trading ecosystem.

### *C. The Federal Circuit Split*

#### 1. Understanding the Source Question

The source question refers to which law governs the issue of whether a fiduciary relationship exists. In other words, should courts look to state law or federal law when seeking to ascertain if a fiduciary relationship exists? Given the necessity of a fiduciary relationship, if a court determines that no such relationship exists, then no liability exists. Hence, which forum governs the question can be outcome determinative and thus has significant ramifications for assessing who is exposed to insider trading liability.

#### 2. *Whitman* and Federal Common Law

In *Whitman*, Judge Rakoff held that federal common law governed the source question.[65] In that case, the defendant, a lower-level employee, argued that state law determined the question of fiduciary relationship.[66] The defendant then argued that he was not in a fiduciary relationship for insider trading purposes because the law of the relevant state, California, did not consider low-level employees to be in a fiduciary relationship with their corporations.[67] Judge Rakoff concluded federal common law controlled the question of what constituted a fiduciary relationship.[68] Based on that conclusion, Judge Rakoff easily found that the defendant could be subject to insider trading liability because federal law not only characterizes all insiders as participants in a fiduciary relationship but also imposes upon such

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does not apply to the federal wire fraud and securities fraud statutes under Title 18. *Blaszczak*, 947 F.3d at 37.

63. *See Blaszczak*, 947 F.3d at 37 (focusing on the need to establish a personal benefit test, which is linked to the tipper's breach of fiduciary duty); *Martoma II*, 894 F.3d at 64, 67–68, 72–73 (focusing on the tipper's breach of her fiduciary duty and finding that the necessary breach centered on the purpose of the tip and that so long as the tipper's purpose was to benefit the tippee, a breach could be established); *Martoma I*, 869 F.3d at 63–64, 69–70 (focusing on elements needed to demonstrate that a tipper had breached her duty and finding that a breach did not require the existence of a meaningfully close relationship).

64. *See Martoma I*, 869 F.3d at 58–61, 63–64, 69–70 (noting that the tipper—Gilman—had a relationship where he was entrusted with confidential information and expected to refrain from disclosing such information); *see also Martoma II*, 894 F.3d at 64, 67–69, 72–73 (noting the same).

65. *See* United States v. Whitman, 904 F. Supp. 2d 363, 374 (S.D.N.Y. 2012), *aff'd*, 555 F. App'x 98 (2d Cir. 2014).

66. *See id.* at 368.

67. *See id.* at 369.

68. *See id.* at 374.

participants a duty to "disclose or abstain" that the defendant clearly violated.[69]

In *Steginsky v. Xcelera Inc.*,[70] the Second Circuit agreed with the *Whitman* holding.[71] *Steginsky* involved corporate insiders who had traded in shares of their corporation's stock.[72] The defendants argued that the law of the state in which the corporation was formed, the Cayman Islands, governed the question of whether they owed a fiduciary duty to the corporation.[73] The law of the Cayman Islands apparently did not recognize a fiduciary relationship or otherwise impose a fiduciary duty on corporate insiders in this context.[74] The defendants sought to rely on state law to refute the finding of a fiduciary relationship, thereby avoiding insider trading liability.[75] Citing *Whitman*, the Second Circuit held that federal common law controlled the issue.[76] In reaching its conclusion, the Second Circuit noted that it had not previously made the source of the fiduciary principle explicit and hence was correcting that oversight.[77]

At least two district courts in the Fifth Circuit have found that federal law governs the resolution of issues under the federal securities laws.[78] In 2017, a judge in the Eastern District of Texas, citing both *Whitman* and *Steginsky*, concluded that federal law governed the question of the existence of a fiduciary relationship under the federal securities laws.[79] This case involved securities fraud claims under Rule 10b-5, arising out of allegations of misstatements and omissions by a promoter of a corporation's stock, not insider trading.[80] However, the court focused on the fiduciary relationship requirement under Rule 10b-5 and relied on *Whitman* when assessing the law governing that requirement.[81] The SEC argued that state law controlled the question of whether the promoter owed a duty to purchasers of the stock.[82] Importantly, while federal law did not recognize a fiduciary relationship in this context, the SEC contended that state law did.[83] The court noted that the Fifth Circuit had not yet determined whether state or federal law applied to determine the existence of a fiduciary relationship and that the federal circuits were split on the issue.[84] After analyzing that split, the court announced its

69. *See id.*
70. 741 F.3d 365 (2d Cir. 2014).
71. *See id.* at 371.
72. *See id.* at 367.
73. *See id.* at 371.
74. *See id.*
75. *See id.*
76. *See id.*
77. *See id.*
78. *See generally* SEC v. Mapp, 240 F. Supp. 3d 569 (E.D. Tex. 2017); SEC v. Cuban, 634 F. Supp. 2d 713 (N.D. Tex. 2009), *vacated by* 620 F.3d 551 (5th Cir. 2010).
79. *See Mapp*, 240 F. Supp. 3d at 583.
80. *See id.*
81. *See id.* at 582–83.
82. *See id.* at 582.
83. *See id.* at 582–83.
84. *See id.* at 582.

agreement with *Whitman* and the Second Circuit.[85] The court then concluded that, because federal law did not recognize a fiduciary relationship, no insider trading liability could attach to the promoter's activities.[86]

Along these same lines, in *SEC v. Cuban*,[87] a judge in the Northern District of Texas held that federal law controlled the issue of fiduciary relationships under Rule 10b-5.[88] In that case, the SEC brought an insider trading action against Mark Cuban based on the misappropriation theory.[89] Cuban argued that state law governed the question of whether he had a fiduciary relationship for purposes of insider trading laws.[90] While not discounting state law, the court concluded that federal law was relevant to the issue concerning the source of the fiduciary relationship on which insider trading violations were predicated.[91] The decision was vacated and remanded on other grounds, so the Fifth Circuit never addressed the issue involving the appropriate source of the fiduciary relationship underlying the insider trading violation.[92] However, it is noteworthy that on remand, the district court addressed the issue of source solely with reference to federal law.[93]

### 3. Federal Court Reliance on State Law

Other federal courts interpreting § 10 and Rule 10b-5 have held that state law governs the source issue.[94] These cases do not involve insider trading violations.[95] Professors Donald C. Langevoort and Mitu Gulati have cautioned against importing the dicta and holdings of insider trading cases into noninsider cases, despite the fact that they rest on the same statute.[96] Mindful of that caution, this Article nonetheless contends that these cases have relevance to the fiduciary relationship inquiry. Indeed, their caution focuses on courts' attempts to apply the disclosure concepts embedded in insider trading cases to other securities law contexts.[97] The cases this section highlights directly involve interpretation of fiduciary relationships in the context of securities fraud claims under § 10 and Rule 10b-5.[98] Importantly, the cases often rely on insider trading cases such as *Chiarella* and *Dirks* for

85. *See id.* at 583.
86. *See id.*
87. 634 F. Supp. 2d 713 (N.D. Tex. 2009), *vacated by* 620 F.3d 551 (5th Cir. 2010).
88. *See id.* at 721–22.
89. *See id.* at 717.
90. *See id.* at 721.
91. *See id.* at 721–22.
92. *See generally Cuban*, 620 F.3d 551.
93. *See* SEC v. Cuban, No. 08-cv-2050-D, 2013 WL 791405, at *8–10 (N.D. Tex. Mar. 5, 2013).
94. *See generally* Mueller v. Thomas, 84 F. App'x 273 (4th Cir. 2003) (per curiam); Fortson v. Winstead, McGuire, Sechrest & Minick, 961 F.2d 469 (4th Cir. 1992); Abell v. Potomac Ins. Co., 858 F.2d 1104 (5th Cir. 1988); Barker v. Henderson, Franklin, Starnes & Holt, 797 F.2d 490 (7th Cir. 1986).
95. *See supra* note 94 and accompanying text.
96. *See* Donald C. Langevoort & G. Mitu Gulati, *The Muddled Duty to Disclose Under Rule 10b-5*, 57 VAND. L. REV. 1639, 1675 (2004).
97. *See id.* at 1646–73.
98. *See supra* note 94 and accompanying text.

the proposition that liability for securities fraud must be premised on a fiduciary relationship.[99] Thus, these cases implicitly embrace the contention that the principles related to the appropriate interpretation of a fiduciary relationship under insider trading rules are the same as those related to securities fraud claims more generally.[100] As such, these cases serve as a useful guide for understanding the nature of the disagreement concerning the source of fiduciary relationships under Rule 10b-5.

The Fourth Circuit has been cited by litigants and other courts addressing the source issue under insider trading laws for the proposition that state law controls the source question. In *Fortson v. Winstead, McGuire, Sechrest & Minick*,[101] investors who purchased stock in a real estate venture brought a securities fraud action under § 10(b) against a law firm representing the venture, alleging that the law firm had breached its duty to disclose material information related to their investment.[102] Citing *Chiarella*, the Fourth Circuit noted that liability related to an omission could only be established based on a duty arising from a fiduciary relationship.[103] The Fourth Circuit concluded that "the federal securities laws are not the source" of the fiduciary relationship.[104] Instead, the Fourth Circuit insisted that the fiduciary relationship "arises only where there is some basis outside [of] the securities laws, such as state law, for finding a fiduciary or other confidential relationship."[105] Because state law did not impose such a relationship in this context, the Fourth Circuit concluded that the necessary fiduciary relationship did not exist and hence the securities law claim could not be maintained.[106]

In *Mueller v. Thomas*,[107] the Fourth Circuit grappled with a claim involving allegations of securities fraud based on material misstatements and omissions within a stock purchase agreement.[108] Citing *Fortson*, the Fourth Circuit reasoned that any duty to disclose had to arise from a fiduciary relationship under state law.[109] Because Virginia state law did not recognize a fiduciary relationship between sophisticated commercial parties transacting at arm's length, no duty existed upon which a securities fraud action could be premised.[110] These and other Fourth Circuit precedents have been cited by litigants and other courts when analyzing insider trading claims.[111]

99. *See infra* notes 101–23 and accompanying text.
100. *See supra* note 94 and accompanying text.
101. 961 F.2d 469 (4th Cir. 1992).
102. *See id.* at 472.
103. *See id.*
104. *See id.*
105. *See id.*
106. *See id.* at 475.
107. 84 F. App'x 273 (4th Cir. 2003) (per curiam).
108. *See id.* at 275 (finding that a contract between two sophisticated parties does not create a fiduciary relationship under state law).
109. *See id.*
110. *See id.*
111. *See* SEC v. Cuban, 634 F. Supp. 2d 713, 722 (N.D. Tex. 2009), *vacated by* 620 F.3d 551 (5th Cir. 2010) (citing Sw. Realty, Ltd. v. Daseke, No. CA3–89–3055–D, 1992 WL

The Seventh Circuit also has held that state law controls the source issue for purposes of federal securities laws.[112] In *Barker v. Henderson, Franklin, Starnes & Holt*,[113] purchasers of bonds and notes brought suit against a law firm under Rule 10b-5, seeking to hold the law firm liable for misstatements and omissions related to the purchase of those securities.[114] The Seventh Circuit cited *Dirks* and *Chiarella* for the proposition that the relevant duty to disclose must be based on a fiduciary relationship.[115] The court then emphasized that this duty does not come from the federal securities laws but "from a fiduciary relation[ship] outside securities law."[116] The court further noted that if the duty stemmed from federal law, "the inquiry would be circular."[117] While the case does not deal explicitly with insider trading, the references to *Dirks* and *Chiarella* indicate the court's belief that the laws of insider trading parallel the laws of securities fraud, at least with respect to the question of a fiduciary relationship.

The Fifth Circuit has similarly been cited for the proposition that state law governs this source issue. In *Abell v. Potomac Insurance Co.*,[118] bond purchasers brought a § 10(b) action against the developers whose companies issued the bonds.[119] In seeking to analyze whether the developers could be held liable, the inquiry focused on whether they had a duty arising out of a fiduciary relationship between the purchaser and the developers.[120] The Fifth Circuit asserted that this analysis must focus on state law.[121] The court proclaimed that for purposes of resolving the question of source, it "join[ed] the Seventh Circuit."[122] The court then cited *Barker* for the proposition that liability must stem from an *existing* duty, not one created by or arising out of the federal securities laws.[123] Given its citation to *Barker*, the court apparently agreed with the reasoning that otherwise the inquiry would be circular.

### *D. The Debate State Side*

Some state court judges and litigants have connected the source debate at the federal level to the analysis of fiduciary relationships at the state level because there are some breach of fiduciary duty claims under state law based

373166, at *10 (N.D. Tex. May 21, 1992)); *see also* SEC v. Mapp, 240 F. Supp. 3d 569, 583 (E.D. Tex. 2017) (citing *Mueller*, 84 F. App'x at 275).

112. *See* Barker v. Henderson, Franklin, Starnes & Holt, 797 F.2d 490, 496 (7th Cir. 1986).
113. 797 F.2d 490 (7th Cir. 1986).
114. *See id.* at 495.
115. *See id.* at 495–96.
116. *See id.* at 496.
117. *See id.*
118. 858 F.2d 1104 (5th Cir. 1988).
119. *See id.* at 1126.
120. *See id.*
121. *See id.*
122. *See id.*
123. *See id.*

on insider trading violations.[124] Those claims not only concern analysis of fiduciary relationships but also essentially piggyback off of relationships and duties germane to Rule 10b-5.[125] Thus, these state law claims implicate the same fiduciary relationship implicated by federal law.[126]

In Delaware, the heart of this debate is the continued viability of claims arising from the 1949 case of *Brophy v. Cities Service Co.*[127] (so-called Brophy claims). A *Brophy* claim is an action for breach of fiduciary duty arising out of an insider trading violation.[128] *Brophy* centered on Thomas Kennedy, an executive secretary to one of a company's directors.[129] Kennedy was privy to confidential company information, including information about the company's intention to purchase its own shares.[130] Based on that information, Kennedy purchased a large block of his company's shares and then resold them at a profit once the company repurchased shares.[131] A core issue in *Brophy* was whether a "mere employee" could be held liable for breach of a duty related to insider trading activities.[132] The court held that Kennedy could be held liable so long as he occupied a position of trust and confidence analogous to a fiduciary.[133] That is, so long as he breached a duty arising from a fiduciary relationship.[134] After concluding that Kennedy's position was fiduciary in nature because he was entrusted with access to confidential information, the court found that Kennedy could be held liable for breaching his fiduciary duty based on his insider trading activities.[135]

Thereafter, *Brophy*, later affirmed by the Delaware Supreme Court,[136] set the standard for fiduciary duty claims in Delaware arising out of insider trading violations.[137] Since 1949, Delaware courts have repeatedly relied on *Brophy* to prosecute breach of fiduciary duty claims involving insider trading.

In 2010, the source question collided with *Brophy* claims, triggering a debate about the continued validity of those claims. Based on the contention that federal law controlled the source question, some Delaware judges and

124. *See generally* Kahn v. Kolberg Kravis Roberts & Co., 23 A.3d 831 (Del. 2011); Pfeiffer v. Toll, 989 A.2d 683 (Del. Ch. 2010).
125. *See supra* note 124 and accompanying text.
126. *See supra* note 124 and accompanying text.
127. 70 A.2d 5 (Del. Ch. 1949).
128. *See id.* at 7–8.
129. *See id.* at 7.
130. *See id.*
131. *See id.*
132. *See id.*
133. *See id.* at 7–8.
134. *See id.*
135. *See id.*
136. *See* Kahn v. Kolberg Kravis Roberts & Co., 23 A.3d 831, 838 (Del. 2011); *In re* Oracle Corp., Derivative Litig., 867 A.2d 904, 904 (Del. Ch. 2004).
137. *See* Douglas M. Branson, *Choosing the Appropriate Default Rule—Insider Trading Under State Law*, 45 ALA. L. REV. 753, 770 (1994); Donald C. Langevoort, *Federalism in Corporate/Securities Law: Reflections on Delaware, California, and State Regulation of Insider Trading*, 40 U. S.F. L. REV. 879, 886 (2006).

litigants began to question whether *Brophy* claims should be considered good law.[138] These judges and litigants suggested that the controlling nature of federal law "arguably preempted" state law claims in this area.[139] These parties further contended that because federal law controlled the source question, federal law demanded uniformity that crowded out state law.[140]

In *Pfeiffer v. Toll*,[141] the Delaware Court of Chancery mounted a strenuous defense of *Brophy* claims rooted at least in part in the notion that state law controls the source debate.[142] Responding to the contention that *Brophy* claims were outdated and no longer relevant, the court insisted that state law fiduciary duty claims were relevant because the federal insider trading regime depended on state law.[143] "Federal law does not give rise to or establish the fiduciary duties of directors or officers. Those matters are governed by state law. Thus the federal insider trading regime as currently structured rests on a foundation of state law fiduciary duties."[144] The court further argued that state law served as the "cornerstone" of the federal insider trading regime.[145] The court then cited numerous insider trading cases, including *Chiarella*, *O'Hagan*, and *Dirks*, not only to illuminate the insider trading system's "dependence on [] underlying fiduciary relationships"[146] but also to support the contention that the Supreme Court had endorsed the notion that state law was the source of those underlying fiduciary relationships.[147] The *Pfeiffer* court concluded by arguing that the notion of federal law as the dictator of the source question would be inconsistent with how the law had developed and the vital role breach of fiduciary duty claims played in that development.[148] Hence, the *Pfeiffer* court upheld the viability of *Brophy* claims by rejecting the notion that federal law controlled the source debate.[149] However, mindful of uniformity concerns, the *Pfeiffer* court limited the potential damages associated with a *Brophy* claim to those not duplicative of federal law.[150]

The Delaware Supreme Court did not reject the *Pfeiffer* court's analysis regarding state law as the genesis of fiduciary relationships for purposes of federal insider trading laws.[151] In *Kahn v. Kolberg Kravis Roberts & Co.*,[152] the Delaware Supreme Court sought to put concerns about the viability of

138. *See* Pfeiffer v. Toll, 989 A.2d 683, 698 (Del. Ch. 2010) (citing statements from Chancellor Chandler); *see also Kahn*, 23 A.3d at 838.
139. *See Pfeiffer,* 989 A.2d at 698.
140. *See id.* at 704.
141. 989 A.2d 683 (Del. Ch. 2010).
142. *See id.* at 683.
143. *See id.* at 704.
144. *See id.*
145. *See id.*
146. *See id.*
147. *See id.* at 704–06.
148. *See id.* at 706.
149. *See id.* at 707–08.
150. *See id.* at 698–99.
151. *See generally* Kahn v. Kolberg Kravis Roberts & Co., 23 A.3d 831 (Del. 2011).
152. 23 A.3d 831 (Del. 2011).

*Brophy* to bed and upheld its broad application and holding.[153] The court invalidated the portion of the *Pfeiffer* opinion that sought to narrow *Brophy's* reach.[154] In doing so, the court clearly rejected the notion that state law could not play a role in policing insider trading violations and defining the fiduciary parameters related to those duties.[155] However, the court did not directly address the *Pfeiffer* court's analysis of the source issue, thereby leaving open the issue of source and how it impacts the state fiduciary claim.

## II. DEBATING THE DEBATE

In concluding that federal law controls the source issue, Judge Rakoff relies heavily on the foundational federal cases.[156] However, those who disagree rely on those same foundational cases.[157] As this part highlights, this fact underscores the mixed signals that may be broadcast by relying on those cases.

### *A. The Reality and Fiction of Federal Common Law*

Both Judge Rakoff and the Second Circuit note that the Supreme Court's insider trading cases have implicitly assumed the fiduciary relationship question to be a matter of federal common law.[158] Importantly, after his comprehensive review of Justice Powell's notes and the history of *Chiarella*, Professor A. C. Pritchard concluded that in formulating the fiduciary relationship under *Chiarella*, Justice Powell "creat[ed] a federal fiduciary principle" akin to federal common law.[159] Justice Powell wrote the majority opinions in both *Chiarella* and *Dirks* and, according to Pritchard, had become the Court's "securities law leader."[160] Pritchard's conclusion therefore reflects compelling evidence that federal common law represents the source of the fiduciary relationship.[161]

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153. *See id.* at 837.

154. *See id.* at 840.

155. *See id.*

156. Judge Rakoff also focuses on Rule 10b5-2. *See* United States v. Whitman, 904 F. Supp. 2d 363, 370 (S.D.N.Y. 2012), *aff'd*, 555 F. App'x 98 (2d Cir. 2014). Rule 10b5-2 does not focus on traditional fiduciary relationships or address relationships outside of the misappropriation theory. *See* 17 C.F.R. § 240.10b5-2 (2019). Thus, Rule 10b5-2 may not significantly advance the federal law case.

157. *See* Pfeiffer v. Toll, 989 A.2d 683, 704 (Del. Ch. 2010); *see also* SEC v. Cochran, 214 F.3d 1261, 1264–65 (10th Cir. 2000); Fortson v. Winstead, McGuire, Sechrest & Minick, 961 F.2d 469, 472 (4th Cir. 1992); Barker v. Henderson, Franklin, Starnes & Holt, 797 F.2d 490, 495 (7th Cir. 1986); Bainbridge, *supra* note 6, at 1207 (noting insider trading cases that reference state law).

158. *See Whitman*, 904 F. Supp. 2d at 369; *see also Steginsky v. Xcelera Inc.*, 741 F.3d 365, 371 (2d Cir. 2014) (pinpointing the Supreme Court's assumption that relevant fiduciary duty "springs from federal law").

159. *See* A. C. Pritchard, *Justice Lewis F. Powell, Jr., and the Counterrevolution in the Federal Securities Laws*, 52 DUKE L.J. 841, 933 (2003).

160. *See id.* at 846.

161. *See id.*

However, numerous courts and commentators have noted that such a conclusion appears inconsistent with Supreme Court precedent.[162] Pritchard concedes this inconsistency, noting that *Chiarella* "sits in considerable tension" with the "rejection of a federal fiduciary standard in *Santa Fe*."[163] *Santa Fe Industries, Inc. v. Green*[164] arose out of a Second Circuit holding that a short-form merger that ran afoul of state corporate law also violated Rule 10b-5.[165] The Second Circuit concluded that federal common law, rather than state law, governed the existence of a fiduciary breach triggering federal liability.[166] Overruling the Second Circuit, the Supreme Court asserted that courts should be reluctant to "federalize" portions of state corporate law dealing with securities transactions.[167] Commentators contend that the message from *Santa Fe* was that federal courts were not to create federal common law in the area involving state fiduciary duties.[168] Thus, the creation of federal law in *Chiarella* seems contrary to *Santa Fe*.

This contradiction is especially notable in light of Justice Powell's sentiments regarding the Second Circuit's holding in *Santa Fe*. As Pritchard notes, Powell found the holding "startling enough" that he "dictated a nine-page memorandum summarizing it" and referred to the opinion as "obviously wrong."[169] Indeed, Justice Powell expressed a belief that § 10(b) was not intended "to create a federal common law."[170] These sentiments reveal that Powell's creation of a federal common law in *Chiarella* was in tension with *Santa Fe* and Powell's own views regarding the impropriety of federal common law. More importantly, they highlight the mixed messages, and thus the considerable tension, associated with using *Chiarella* as support for the propriety of federal common law as a guiding principle.

Relying on *Chiarella* for the proposition that federal law controls is especially problematic when one considers the clear fact that Justice Powell essentially ignored at least two sources of federal law in order to reach the holding in *Chiarella*. First, *Chiarella* ignored or sidestepped *Santa Fe*. Second, it ignored federal law embodied in *SEC v. Texas Gulf Sulphur Co.*,[171] when it rejected the Second Circuit's equal access theory in favor of a fiduciary principle.[172] The one and only time the Supreme Court cited

162. *See* Bainbridge, *supra* note 6, at 1201; Stephen M. Bainbridge, *Insider Trading Regulation: The Path Dependent Choice Between Property Rights and Securities Fraud*, 52 SMU L. REV. 1589, 1589 (1999); Langevoort & Gulati, *supra* note 96, at 1655.

163. *See* Pritchard, *supra* note 159, at 933.

164. 430 U.S. 462 (1977).

165. *See id.* at 465–77.

166. *See id.* at 470.

167. *See id.* at 479.

168. *See* Langevoort & Gulati, *supra* note 96, at 1655.

169. *See* Pritchard, *supra* note 159, at 871.

170. *See id.* at 872. These sentiments are consistent with Pritchard's overarching assessment that Powell sought to narrow the scope of the federal securities laws and to check the growth of federal law encroachment into state corporate law. *See id.* at 846, 860.

171. 401 F.2d 833 (2d Cir. 1968) (en banc).

172. Bainbridge, *supra* note 162, at 1599; Lisa M. Fairfax, *From Equality to Duty: On Altering the Reach, Impact, and Meaning of the* Texas Gulf *Legacy*, 71 SMU L. REV. 729, 736 (2018).

*Texas Gulf Sulphur* was to note that other courts had validated insider trading related to undisclosed information.[173] This cursory reference, despite the fact that *Texas Gulf Sulphur* was viewed as the leading authority on insider trading law at the time,[174] reveals that *Chiarella* essentially refused to even acknowledge the only existing federal law on this issue. Using *Chiarella* as support for the primacy of federal law when the Court appeared to give short shrift to federal law seems problematic.

This analysis begs an important question: why did Justice Powell ignore his deep concern for state law and create federal common law? Pritchard's extensive research reveals that Justice Powell was simply determined to reject the equal access theory articulated in *Texas Gulf Sulphur*.[175] Powell's determination was so significant that he was willing to sidestep the dictates of *Santa Fe* and his strong concerns about the importance of state law.[176]

Justice Powell also ignored several state laws in his rush to focus on those aspects of state law rooted in fiduciary relationships,[177] a point Justices Harry Blackmun and Thurgood Marshall make in their dissent to *Chiarella*.[178] Indeed, the admittedly state law principle Powell adopted was not even a majority principle. At the time of the decision, most states did not recognize a duty that extended from directors and officers to shareholders, and even those jurisdictions that did recognize such a duty did not extend it to cover lower-level employees or temporary insiders in the manner that *Chiarella* announced.[179] *Chiarella's* cherry-picking of state laws can only be understood in the context of Powell's strong desire to craft a principle that would overturn *Texas Gulf Sulphur*.[180] It is important to remember that when the Justices sought to establish the contours of an insider trading violation, unless they looked to state law, they were essentially writing on a blank slate. This is because the bulk of insider trading prohibitions does not arise from any specific statute; it therefore has to be a creature of judge-made law.[181]

What does this mean for purposes of this Article's thesis? It simply further illuminates the mixed messages that pervade insider trading laws. First, it underscores the unsatisfactory nature of relying on federal common law when the creator of federal common law had his own concerns about its propriety.[182] Second, it highlights the problematic nature of relying on

173. *See* Chiarella v. United States, 445 U.S. 222, 229 (1980); *see also* Fairfax, *supra* note 172, at 736.

174. *See* Fairfax, *supra* note 172, at 736.

175. *See* Pritchard, *supra* note 159, at 931–33.

176. *See id.*

177. *See* Nagy, *supra* note 3, at 1326–27.

178. *See Chiarella*, 445 U.S. at 248 (Blackmun, J., dissenting); *see also* Fairfax, *supra* note 172, at 744–45.

179. *See* Nagy, *supra* note 3, at 1337.

180. *See id.* at 1340–41.

181. *See id.* at 1322.

182. *See* Pritchard, *supra* note 159, at 871–72 (referencing Powell's assertion that he did not believe § 10 was intended to create a federal common law); *see also supra* note 170 and accompanying text (noting that Pritchard's research revealed Powell's desire to protect state law and check the growth of federal law).

*Chiarella* as theoretical support for the propriety of federal common law when the theory was simply a means to an end, and *Chiarella* overlooked sources of federal law to get to that end.[183] Third, it reveals that the Justices at the time (including the author of *Chiarella*) had significant concerns that a federal common law would undermine the need to protect the role of state law.[184] Justice Powell was simply willing to subordinate those concerns to achieve a particular outcome. Taken together, this analysis highlights the challenges posed by reliance on federal common law as advanced under *Chiarella*.

### *B. The Role and Relevance of State Common Law*

The conclusion that federal law should be given primacy in relation to the source question also sits uncomfortably with the Supreme Court's clear reliance on state law.

*Chiarella* clearly relied on state law. *Chiarella* noted that the concept that fiduciary relationships give rise to insider trading violations was not a novel twist.[185] What was the only case law that *Chiarella* cited for this concept? *Brophy*.[186] In this regard, the *Chiarella* court borrowed from state law to create the very foundation of the fiduciary relationship principle that governs all insider trading cases.[187] Confirming this borrowing, commentators have noted that *Chiarella* appears to be based on a concept akin to the state law fiduciary duty of loyalty.[188]

Similarly, in *Dirks*, the Supreme Court both acknowledged and relied upon state law. The *Dirks* court recognized that fiduciary relationships on which insider trading breaches were premised arose from state law, noting that insiders have independent fiduciary duties that form the basis of the fiduciary relationship required for insider trading purposes.[189] The *Dirks* court clearly affirmed that one way to establish a fiduciary relationship was through the preexisting fiduciary one rooted in state law.[190] *Dirks* also premised its analysis related to violations of fiduciary duty by the tippee on concepts of agency law rooted in state law.[191] Indeed, both the concept that a tipper violation occurs as a result of improperly communicating a fiduciary's information and the concept that a violation occurs when a tippee receives confidential information that the tippee knows arises from improper communication, stem from state law concepts of agency and unjust enrichment.[192] Pritchard observes that Justice Powell used *Dirks* to ensure

183. *See* Langevoort & Gulati, *supra* note 96, at 1676.
184. *See supra* note 182 and accompanying text.
185. Chiarella v. United States, 445 U.S. 222, 227 (1980).
186. *See id.* at 228 n.10 (citing Brophy v. Cities Serv. Co., 70 A.2d 5 (Del. Ch. 1949)).
187. *See* Bainbridge, *supra* note 6, at 1208–09.
188. *See id.* at 1200–01; Langevoort & Gulati, *supra* note 96, at 1655 (noting that *Chiarella* focuses on state fiduciary duty).
189. *See* Dirks v. SEC, 463 U.S. 646, 656 (1983).
190. *See id.* at 665.
191. *See id.* at 660.
192. *See id.* at 660 n.20.

that "the federal common law of insider trading was brought into line with the traditional distinction in state corporate law between breaches of care and loyalty."[193]

A similar pattern emerges with respect to *O'Hagan*. *O'Hagan* referenced state law concepts of agency law when articulating its broadening of the fiduciary relationship to include relationships of trust and confidence.[194] Langevoort and Gulati contend that *O'Hagan* incorporated state law fiduciary concepts in such an extensive manner that it made those laws play a "front and center" role in the insider trading landscape.[195]

It is undeniable that each of the three foundational insider trading cases heavily relies on state law. This clear reliance on state law in the origins of the insider trading prohibition muddies the waters, making it difficult to rely on these cases to provide clarity on the source question. Even Judge Rakoff notes that general state law principles are helpful guides for determining the parameters of the applicable federal common law.[196] This heavy reliance undercuts the notion that federal courts do not and should not look to state law. It also begs an important question: if federal courts have historically looked to state law to understand the parameters of the fiduciary relationship, why can they no longer do so?

### *C. The Conundrum of State Fiduciary Law*

The embrace of federal law in this area also sits in tension with the fact that insider trading laws appear to condone, if not approve, state law claims that arise from insider trading violations like *Brophy*. How do we align the conclusion that federal law controls with these state law claims?

First, there are important policy reasons why state law should continue to engage fiduciary duty claims based on insider trading. For example, Delaware courts have emphasized the state's strong public policy interest in policing loyalty violations, including those related to protecting the corporation's interest in its confidential information and preventing the misuse of that information.[197] Justice Leo E. Strine Jr. insisted that utilizing state fiduciary law to tackle insider trading serves the critical state interest of policing violations of the duty of loyalty.[198] Other Delaware opinions similarly pinpoint states' interest in preventing insiders from exploiting material private information to make trading profits[199] or otherwise abusing their positions of trust and confidence.[200]

State law is also valuable because it allows for recoveries distinct from those associated with insider trading prohibitions. This includes "costs and

193. *See* Pritchard, *supra* note 159, at 942; *see also* Bainbridge, *supra* note 6, at 1208.
194. *See* United States v. O'Hagan, 521 U.S. 642, 654 (1997).
195. *See* Langevoort & Gulati, *supra* note 96, at 1655–56.
196. *See* United States v. Whitman, 904 F. Supp. 2d 363, 370 (S.D.N.Y. 2012), *aff'd*, 555 F. App'x 98 (2d Cir. 2014).
197. *See* Pfeiffer v. Toll, 989 A.2d 683, 707 (Del. Ch. 2010).
198. *See In re* Oracle Corp., Derivative Litig., 867 A.2d 904, 929 (Del. Ch. 2004).
199. *See* Guttman v. Huang, 823 A.2d 492, 505 & n.28 (Del. Ch. 2003).
200. *See* Kahn v. Kolberg Kravis Roberts & Co., 23 A.3d 831, 840 (Del. 2011).

expenses for regulatory proceedings and internal investigations, fees paid to counsel and other professionals, fines paid to regulators, and judgments in litigation."[201] This also includes any costs incurred by the corporation as a result of the loyalty breach, such as investigation and litigation expenses associated with defending against a stockholder suit.[202]

Both federal courts and commentators have acknowledged the important role of state law, and federal courts have consistently recognized the validity of those state law claims. In singling out *Brophy*, the *Chiarella* court can be viewed as approving the fiduciary duty claims at the heart of *Brophy*.[203] Other courts interpreting federal securities laws related to insider trading have noted and assumed the existence of state law claims for a breach of fiduciary duty.[204] In *O'Hagan*, the Supreme Court made specific reference to the fact that the misappropriator may have a breach of fiduciary duty claim under state law.[205] Moreover, even as the Second Circuit adopted *Whitman*, it recognized the potential breach of fiduciary duty claims under state law.[206]

Acknowledging the importance of state law in this arena has implications for those seeking to settle the source debate in favor of federal law. If, as the *Pfeiffer* court suggests, the viability of a *Brophy* claim is dependent on the recognition that state law governs the source question, how do we reconcile that suggestion with the conclusion that federal law controls? Even if that suggestion is invalid, there remains the problem that the notion that federal law controls the fiduciary relationship question may be causing some courts to question the viability of these state claims or otherwise to curtail their efforts related to fiduciary duty breaches in the realm of insider trading. Here again, we may be sending mixed signals if we are not clear about why federal law controls and how that control should be reconciled with state law in this area.

## III. IN SEARCH OF GUIDING PRINCIPLES

### *A. Why It Matters*

This Article asserts that federal law should control the source question. This Article also asserts that rationales matter. The clarity of our rationales impacts how other courts assess any conclusions we make, including their willingness to accept those conclusions. Several Supreme Court cases have essentially ruled that if decisions are based on convoluted, problematic, or "ill founded" reasoning, then the Court need not uphold those decisions.[207]

201. *See Pfeiffer,* 989 A.2d at 700; Thorpe *ex rel*. Castleman v. CERBCO, Inc., 676 A.2d 436, 445 (Del. 1996). The *Pfeiffer* court discussed payments to resolve lawsuits, legal fees, civil penalties, disgorged profits, and recovery of compensation forfeited by employees. *See Pfeiffer*, 989 A.2d at 700.

202. *See In re* Primedia, Inc. S'holders Litig., 67 A.3d 455, 472 (Del. Ch. 2013).

203. *See* Chiarella v. United States, 445 U.S. 222, 228 n.10 (1980).

204. *See Pfeiffer*, 989 A.2d at 704.

205. *See* United States v. O'Hagan, 521 U.S. 642, 655 (1997); *Pfeiffer*, 989 A.2d at 706.

206. Steginsky v. Xcelera Inc., 741 F.3d 365, 372 (2d Cir. 2014).

207. *See supra* note 17 and accompanying text.

Importantly, the Supreme Court has used this notion of problematic reasoning to ignore long-held and well-settled doctrines.[208] Hence, the Court has made clear that the reasoning on which we base conclusions matters. Part II revealed that rationales based on case law are murky; this next section sheds light on the murkiness of some of the policy rationales heretofore advanced.

### *B. The Illusiveness of Uniformity*

At first glance, uniformity seems like an alluring guiding principle. As Judge Rakoff notes, the history of insider trading suggests that the requirements associated with those rules were not designed to vary from state to state.[209] Thus, the "idiosyncratic differences between the laws of various states cannot be allowed to trump the federal interest in combating insider trading."[210] The Second Circuit agreed that focusing on state law would thwart the goal of promoting national uniformity in the securities market.[211] Similarly, the SEC contended that focusing on state specific standards would serve to "balkanize" the insider trading laws, leading to "divergent outcomes under the federal securities laws depending on the state of jurisdiction in a particular insider trading case."[212] Indeed, based on the cases cited in this Article, the fiduciary relationship question could turn on the laws of California, Nevada, New York, Oklahoma, Texas, Virginia, or the Cayman Islands. Importantly, these laws are outcome determinative. For example, in *Whitman*, the relevant California state law limited fiduciary relationships to upper-level employees, while New York extended the duty to all employees.[213] Given that the existence of the fiduciary duty is necessary to establish insider trading liability, if state law determines the duty question, then that law is outcome determinative to the insider trading liability question. Because those laws differ, those outcomes can be different. Pritchard notes that even Justice Byron White, who authored *Santa Fe* and "went out of his way" to defend state corporate law, insisted that state law would need to give way to "ensure uniformity within the federal system."[214] Thus, the concept of uniformity seems to align nicely with the goals and history of the federal securities laws.

However, the uniformity rationale seems to provide another set of mixed messages. First, it is arguable that you can achieve uniformity by adopting a "uniform rule" that federal courts should look to state courts to determine the content of fiduciary relationships. A uniform rule that allows reliance on

208. *See supra* note 17 and accompanying text.
209. *See* United States v. Whitman, 904 F. Supp. 2d 363, 369 (S.D.N.Y. 2012), *aff'd*, 555 F. App'x 98 (2d Cir. 2014).
210. *Id.* at 370.
211. *See Steginsky*, 741 F.3d at 371.
212. SEC v. Cuban, 634 F. Supp. 2d 713, 721–22 (N.D. Tex. 2009), *vacated by* 620 F.3d 551 (5th Cir. 2010).
213. *See Whitman*, 904 F. Supp. 2d at 369.
214. *See* Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 479 (1977); Pritchard, *supra* note 159, at 871–72.

state law aligns with the goal of allowing state laws to define the parameters of their preexisting state law relationships while having "uniformity" in the system. This means that uniformity may not require an embrace of federal law. Second, if the uniformity rationale is intended to ensure uniform impact or results, the rationale is inconsistent with insider trading laws because the fiduciary relationship concept guarantees that those laws will not have uniform impacts. Instead, only those with a fiduciary relationship will be liable for insider trading, even if people trade on the same confidential information. How does that promote the goal of uniform impact or results? And if the fiduciary relationship principle sacrifices uniformity, then how can uniformity be an appropriate goal on which we rely to dictate federal law's propriety? Finally, the concern for uniformity creates tension for state law concerns. Clearly the notion that we need a unified system was a primary motivator of the concerns around the legitimacy of state law fiduciary claims.[215] The claim for uniformity has no good answer for why these two regimes can and must be able to operate together.

### *C. The Trouble with Disclosure*

At first glance it makes sense for disclosure to serve as a policy goal when resolving critical insider trading questions. The Supreme Court has specifically acknowledged that the purpose of Rule 10b-5 was to implement the philosophy of full disclosure.[216] The federal securities law purpose of providing a uniform system of disclosure would be undermined if state law, with its many different vagaries, controlled the source issue.[217] As Judge Rakoff notes, where the issue is a duty to disclose, federal law must be paramount to ensure transparency in the markets.[218]

Unmasked, however, disclosure becomes a very problematic guiding principle. This is because the fiduciary relationship principle narrows rather than expands disclosure, creating challenges with reliance on disclosure to support that principle. It is clear that the general federal securities regime focuses on disclosure. It is less clear that the insider trading rules are firmly premised on disclosure, at least not disclosure for all market participants. Instead, the fiduciary relationship principle only evidences concern about disclosure as it relates to those within a fiduciary relationship. Those outside of the fiduciary relationship have no disclosure obligation. In the context of the misappropriation theory, concern for disclosure is actually further devalued because disclosure is not even required to be made to the general public but only to the source of confidential information. This analysis demonstrates that insider trading rules in general, and the fiduciary relationship principle in particular, are not necessarily overly concerned about disclosure. As Langevoort and Gulati note, disclosure may just be a

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215. *See* Pfeiffer v. Toll, 989 A.2d 683, 698–99 (Del. Ch. 2010) (seeking to reconcile *Brophy* claims with the potential for duplication of federal law recoveries).
216. *See Santa Fe*, 430 U.S. at 478.
217. *See Whitman*, 904 F. Supp. 2d at 369.
218. *See id.* at 370.

tool being used to facilitate policing self-dealing transactions.[219] This undermines the promise of disclosure as a guiding principle.

Further, disclosure does not capture all of the goals associated with insider trading. Disclosure as a goal works best when viewed in the context of traders because they can only trade with full disclosure. Indeed, the tipper does not have a duty to disclose information.[220] Moreover, disclosure does not absolve the tipper of responsibility or liability.[221] Instead, the only thing that absolves the tipper is either abstaining from passing information or passing it for an appropriate purpose.[222] This analysis only buttresses the view that disclosure in the context of insider trading is just a tool used to ensure that a breach of duty does not arise.[223] Disclosure thus appears to be riddled with as many inconsistencies as the other rationales considered in this Article.

### *D. Certainty*

In revisiting and further considering why *Whitman* resonated, two principles emerge. First, perhaps it is too much to ask that some broad principle can be used to answer all of the problems that arise in the insider trading ecosystem. Second, perhaps, at least in this context, the real concern is certainty.

#### 1. The Viability of Certainty

What does certainty have to offer? At its core, certainty facilitates reliance, including reliance on judicial decisions.[224] Certainty promotes confidence in outcomes and decisions, credibility, and predictability and it signals fairness, all of which encourage reliance on judicial decisions.[225] In other words, certainty ensures that people are not made to feel like the ground is "shifting beneath their feet."[226] Empirical evidence reveals that when the level of certainty in a court opinion increases, lower courts are more likely to positively treat the decision.[227] As a result, "certainty stands for something that can help tip the scales in a case."[228]

Certainty is closely linked to the principle of stare decisis. Stare decisis has been defended on grounds of certainty, i.e., the importance of making sure that the law will not change erratically and thus that society can presume

219. *See* Langevoort & Gulati, *supra* note 96, at 1676.
220. *See* Dirks v. SEC, 463 U.S. 646, 659 (1983).
221. *See id.* at 659–67.
222. *See id.*
223. *See* Bainbridge, *supra* note 6, at 1200; Langevoort & Gulati, *supra* note 96, at 1675–76.
224. *See* Pamela C. Corley & Justin Wedeking, *The (Dis)Advantage of Certainty: The Importance of Certainty in Language*, 48 LAW & SOC'Y REV. 35, 35 (2014).
225. *See id.* at 39; *see also* Randy J. Kozel, *Statutory Interpretation, Administrative Deference, and the Law of Stare Decisis*, 97 TEX. L. REV. 1125, 1131 (2019).
226. *See* Kozel, *supra* note 225, at 1133.
227. *See* Corley & Wedeking, *supra* note 224, at 35.
228. *See id.* at 55.

that there are bedrock principles that will not be overturned lightly.[229] Thus, stare decisis promotes the predictable and coherent development of legal standards.[230] In other words, it promotes certainty.

Even Bainbridge has acknowledged the importance of certainty in this area. While he believes in the propriety of state law as the source of the fiduciary question, Bainbridge essentially concedes that certainty may require the acceptance of preferring federal law.[231] As he noted, "we have gone too far down the federal path to turn back."[232] Bainbridge also indicated that certainty has created expectations and interests that essentially solidify the case for preserving the status quo.[233]

### 2. Certainty and Coverage

Certainty supports the preference for federal law over state law. Federal insider trading laws are certain with respect to *who* is covered by the fiduciary relationship. It is true that the concept of the fiduciary relationship had its genesis in a hodgepodge of state law. Nevertheless, federal law has evolved into a relatively certain state. As a consequence, there is really no uncertainty with respect to who federal law covers in the traditional fiduciary relationship. Importantly, unlike other areas of insider trading law where federal courts struggle for clarity, there is very little dispute about how federal courts define a fiduciary relationship for purposes of the classical theory. In this regard, federal law on the coverage issue is relatively stable and certain.

By very sharp contrast, state law would introduce a level of uncertainty that would be unacceptable in at least two respects. First, *which state* governs this issue? The possibilities are numerous. One is the law of the state in which the trading activity occurred. Of course, if trading activities occur in multiple states, then uncertainty would arise based on how best to choose among those states. A second possibility is the law of the state where the corporation is doing business. A third possibility is the law of the state where the employees or those engaging in the trading activity are located. In *Whitman*, the defendant combined these second and third possibilities, urging the court to focus on the law of the state where the tippers and their employers were located.[234] This may not be the same place. What if the employees worked or were located in a state different from where the corporation was located?

A fourth possibility is the law of the state of incorporation. Several scholars have noted that the internal affairs doctrine dictates that any question

229. *See* Kozel, *supra* note 225, at 1131.
230. *See id.*
231. *See* Bainbridge, *supra* note 162, at 1650.
232. *See id.*
233. *See id.*
234. *See* United States v. Whitman, 904 F. Supp. 2d 363, 369 (S.D.N.Y. 2012), *aff'd* 555 F. App'x 98 (2d Cir. 2014).

of fiduciary duty gets determined by the state of incorporation.[235] Of course, even this could implicate multiple states. In *Whitman*, the confidential information at issue stemmed from three different companies:[236] two companies incorporated in Delaware and one company incorporated in Bermuda.[237]

A second area of uncertainty is *which state law* governs this issue. Potential contenders range from state laws on agency to unjust enrichment. The government in *Whitman* focused on the state's agency law. Other courts focus on fiduciary duty law.[238] Still others have focused on state property law.[239] Some courts have focused on the state law related to fiduciary relationships more broadly.[240] Some focus on the laws of unjust enrichment.[241] In *Whitman*, Judge Rakoff noted the many potential state law avenues.[242] One can imagine that the specter of uncertainty raised by these varying avenues played a role in how he resolved the issue.

This analysis reveals that certainty provides a clear answer to the source question: federal law.

### 3. Certainty and State Fiduciary Claims

Certainty also may serve as a useful guide in navigating the issues surrounding the proper balance between state and federal law. Both explicitly and implicitly, federal courts have always acknowledged the important role states play in policing problematic behaviors of fiduciaries based on insider trading activity.[243] State claims predated the articulation of insider trading rules.[244] They also were at the heart of the type of claims that the Supreme Court made efforts to protect when crafting its jurisprudence related to securities fraud actions.[245] And they, of course, formed the basis of the fiduciary principles on which the insider trading laws rest. Given their historical presence on the corporate and securities law landscape, it could produce significant levels of uncertainty to proclaim that state law does not have a continued role in policing these claims.

235. *See* Bainbridge, *supra* note 6, at 1267.
236. *See Whitman*, 904 F. Supp. 2d at 369.
237. *See id.* at 386 n.3.
238. *See* Kahn v. Kolberg Kravis Roberts & Co., 23 A.3d 831, 838 (Del. 2011) (citing cases); Pfeiffer v. Toll, 989 A.2d 683, 696 n.4 (Del. Ch. 2010) (citing cases and noting a state law duty of loyalty); *In re* Force Prot., Inc. Derivative Litig., No. 08-1907, 2012 WL 12985420, at *15 (D.S.C. Mar. 30, 2012) (remarking the same).
239. *See* Bainbridge, *supra* note 162, at 1644–45.
240. *See* Mueller v. Thomas, 84 F. App'x 273, 275 (4th Cir. 2003); United States v. Chestman, 947 F.2d 551, 569 (2d Cir. 1991); SEC v. Mapp, 240 F. Supp. 3d 569, 583 (E.D. Tex. 2017).
241. *See Kahn*, 23 A.2d at 837–38; Brophy v. Cities Serv. Co., 70 A.2d 5, 8 (Del. Ch. 1949).
242. *See Whitman*, 904 F. Supp. 2d at 369.
243. *See supra* notes 203–06 and accompanying text.
244. *See Whitman*, 904 F. Supp. 2d at 369.
245. *See supra* Part II.

Relying on certainty also may provide greater comfort to state law advocates around the issue of preemption. The goals of uniformity and mandated disclosure may be viewed as in tension with the state system, which explains why some in the state system suggest that those goals require a focus on federal law *coupled with* a rejection of state law. However, dual systems do not raise certainty issues. At the federal level, as a result of the certainty related to coverage, federal courts no longer depend upon state courts to resolve the issue of a fiduciary relationship. This means that the two systems need not merge or otherwise intertwine around this issue. Moreover, because the rationale for the federal preference is not tied to some form of uniform result or disclosure regime, state regimes can police state law violations in other or different ways so long as it does not negate the needed certainty associated with ensuring that federal law determines the coverage question. To be sure, at the state level, at least with respect to coverage, it appears that state law actually draws upon federal law for purposes of pinpointing coverage related to insider trading claims linked to state fiduciary duty breaches. Indeed, it has not been the case that these state fiduciary claims emerge based on relationships outside the parameters established by federal law. Instead, they merely draw on the fiduciary relationships already established under federal law. This not only demonstrates that the two systems can coexist but also suggests that there could be considerable uncertainty if federal law does not take the lead in pinpointing coverage. While this does not undermine the state's ability to extend or limit coverage in the context of its own state law claims, it does suggest that it would produce more (rather than less) uncertainty if the federal regime's coverage role were supplanted entirely by state law.

### *D. Is Policy Good Policy?*

At the 2020 Institute for Law and Economic Policy (ILEP) conference, Judge Gerard E. Lynch raised concerns about relying primarily, if not exclusively, on policy rationales to support court decisions. Judge Lynch noted that such reliance increases the possibility that judges will make decisions based on their own personal preferences rather than ensuring that decisions are tethered to a specific legal standard. Professor Jill Fisch noted that the underlying policy goals of the insider trading laws may be as convoluted as the case law itself. This is because the Justices disagreed about the appropriate policy goals of insider trading. Other commentators have similarly noted that there are multiple policy goals animating insider trading laws, and some of those policy goals are in conflict with one another. Thus, relying on policy goals could be as problematic and confusing as relying on the insider trading doctrine itself.

While these sentiments certainly have merit, focusing on policy, at least in this limited context, is valid for several reasons. First, as a general matter, focusing on policy is even more critical when the law itself is ad hoc and messy. Second, focusing on policy is valuable when that focus can provide greater clarity. While other policy goals may prove more vexing, the policy goal associated with certainty provides clarity. Indeed, this policy goal is one that is straightforward and avoids some of the boggy ground that is associated not only with other policy rationales but also with the foundational insider trading cases. Third, focusing on this policy may have merit because certainty is a policy around which we likely can get some agreement. Courts and commentators have suggested that this policy goal is actually important for all judicial doctrines. Finally, so long as we are mindful that this policy goal may not be appropriate for all purposes, it may prove valuable. Most of the ILEP panelists agreed that it is ill-advised to refrain from seeking to use a comprehensive principle to answer all of the vexing problems associated with the insider trading laws. To that end, while policy could prove challenging as an answer to other issues, it may be that this policy works to resolve this issue.

## CONCLUSION

The law of insider trading makes it abundantly clear that demonstrating liability requires the existence of a fiduciary relationship. Yet there is less clarity on whether state or federal law governs the question about what types of relationships are included in the definition of a fiduciary relationship. The centrality of the fiduciary relationship to all forms of insider trading violations under Rule 10b-5 makes the lack of clarity on this issue especially concerning.

In *Whitman*, Judge Rakoff waded into the debate regarding the appropriate source, holding that federal law controls the inquiry regarding what constitutes a fiduciary relationship.[246] On the other side of that debate are those insisting that state law should control this inquiry.

This Article firmly agrees with the central holding in *Whitman*. However, this Article worries about mixed messages. First, while the foundational cases clearly purport to create federal common law, that creation sits in considerable tension with other federal decisions and the sentiments of many of the Justices, including Justice Powell—the author of two of the seminal insider trading cases. Moreover, the key cases both ignore state law and rely upon it, enhancing the confusing nature of those cases and making it difficult to rely on such cases to refute claims that state law should not dictate the contours of fiduciary relationships. Second, the rationales being uplifted to support federal law—taken to their logical extensions—could crowd out important state law rules and resources. States have a legitimate policy interest in policing fiduciary breaches stemming from insider trading violations. Justifications that do not appropriately account for that interest may be particularly problematic. The ultimate goal should be to pinpoint some rationale that acknowledges the important role of state law while uplifting the goals of the federal securities laws in general and the insider trading laws in particular. The "topsy turvy" nature of insider trading law makes this a vexing task.

246. *See Whitman*, 904 F. Supp. 2d at 374.

This Article's core thesis highlights the difficulties with pinpointing a convincing rationale for the presumption of federal law on the question of the fiduciary relationship. The Article offers the possibility of certainty as an alternative rationale. In making this offering, this Article notes that perhaps we should refrain from seeking to pinpoint a guiding principle that answers all of the insider trading conundrums. In this spirit, this Article indicates that certainty may provide a workable answer to the fiduciary relationship question, at least to the extent that the question involves an issue of coverage.