

Erosion of the Fiduciary-Duty Requirement in Insider-Trading Actions

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Every decade or so, a new wave of interest in prosecuting insider trading emerges. We see this now. Just as the tides of interest in insider trading ebb and flow, so too do the contours of the offense itself. Given the present environment, of course, one would expect regulators to step up insider-trading enforcement, and they have.¹ This growing regulatory aggressiveness has coincided with judicial relaxation of the elements of insider-trading violations. Ensuring proper enforcement without inhibiting the free flow of information that regulators and the courts have historically recognized as vital to healthy markets truly has become a high-wire act.

Taken together, two insider-trading cases decided last year—*SEC v. Cuban*² and *SEC v. Dorozhko*³—are a product of the Securities and Exchange Commission’s (SEC) success in expanding the scope of insider-trading liability under, respectively, the so-called misappropriation theory of insider trading and an entirely new theory, affirmative misrepresentation. The cases are noteworthy because they depart from established Supreme Court precedent requiring the breach of a traditional fiduciary or similar duty as an element of the offense. That element had helped foster the “certainty and predictability” long considered necessary to enforcement of the securities laws.⁴ For example, under *Cuban*, a confidentiality agreement between an investor and a company may now be deemed sufficient to satisfy the fiduciary-duty requirement even where the parties lacked a preexisting fiduciary relationship, as long as the agreement contains a promise not to trade on the nonpublic information.⁵ Likewise, *Dorozhko* extends insider-trading liability to outsiders lacking a fiduciary or similar relationship to the company where the outsider misappropriates confidential information through an “affirmative misrepresentation.”⁶ Although *Cuban* is currently under Fifth Circuit review and may yet be cabined, the *Dorozhko* decision is unreviewable and remains the law of the Second Circuit.⁷

By undermining the duty requirement, these decisions also move insider-trading jurisprudence toward the parity-of-information theory of insider-trading liability that the Supreme Court has twice rejected as a basis for liability.⁸ And they move the law toward imposing a general duty on market participants to refrain from trading while in possession of material nonpublic information—a rule the Court has explicitly and repeatedly rejected.

Background of Insider-Trading Law

Section 10(b) of the Securities Exchange Act of 1934 makes unlawful the use, “in connection with the purchase or sale of any security . . . , [of] any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe”⁹ Rule 10b-5, the SEC’s primary regulation implementing section 10(b), makes it unlawful, in connection with the purchase or sale of a security, to “employ any device, scheme, or artifice to defraud,” to “make any untrue statement of material fact or [omission],” and to “engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.”¹⁰

The Supreme Court has embraced two complementary theories of insider trading interpreting section 10(b) and its implementing rules. The first, recognized in *Chiarella v. United States*¹¹ and known as the classical theory, provides that corporate insiders are forbidden to trade on confidential information in violation of a fiduciary duty to their company’s shareholders. The *Chiarella* Court emphasized that a central indication of corporate-insider status is whether the actor is under a fiduciary duty to the shareholders of his or her company. The Second Circuit, which was the court below, had adopted a broad definition of duty, assigning a fiduciary duty to “anyone,” not merely insiders, receiving material nonpublic information; the Supreme Court explicitly rejected that definition.¹² Three years later, in *Dirks v. SEC*, the Court reaffirmed that interpretation and reiterated that a predicate of insider-trading liability is “the existence of a fiduciary relationship.”¹³

The second theory of insider trading, known as the misappropriation theory, was recognized by the Supreme Court in *United States v. O’Hagan*¹⁴ and extended insider-trading liability to corporate outsiders: Those who misappropriate, and then trade on, confidential information in violation of a duty of trust or confidence owed to the source of the information may be found liable under section 10(b).¹⁵ Thus, the Court held, a law-firm partner who is aware of a regulated client’s still-private plans to acquire stock in another company may not trade on that information.¹⁶

These two theories of insider-trading liability share the common requirement of breach of a fiduciary or

fiduciary-like duty under section 10(b), a requirement now challenged by *Cuban* and *Dorozhko*. Under *Cuban*, a private contract may now be deemed sufficient to meet this requirement, and under *Dorozhko*, it may be discarded entirely.

Cuban

Last year, the Northern District of Texas in *SEC v. Cuban* addressed whether a breach of a fiduciary duty arising by agreement can serve as the basis for insider-trading liability under the misappropriation theory.¹⁷ In March 2004, defendant Mark Cuban bought 600,000 shares of Mamma.com, becoming a 6.3 percent shareholder, the company's largest. According to the SEC, in the spring of 2004, the CEO of Mamma.com telephoned Cuban and told him that he had confidential information about the company to share; Cuban allegedly agreed that he would keep the information confidential. The CEO then told Cuban about a planned private investment in public equity (PIPE) offering and asked him whether he wanted to participate in it. Cuban reacted angrily to the news, stating that he disliked PIPEs because they dilute existing shareholders, and, at the end of the call exclaimed, "Well, now I'm screwed. I can't sell." The next day—and before the planned PIPE was publicly disclosed—Cuban sold his entire position in Mamma.com, avoiding losses that would have exceeded \$750,000.

The SEC brought an insider-trading complaint against Cuban under the misappropriation theory, alleging that he had agreed to maintain the information about the PIPE in confidence and then violated that agreement by selling his Mamma.com shares in advance of the PIPE announcement. Cuban responded that the SEC's claims were baseless because the alleged confidentiality agreement did not establish a fiduciary duty owed to the CEO, who had informed Cuban of the PIPE. To establish misappropriation liability by agreement, Cuban argued, the agreement must arise in the context of a preexisting fiduciary or fiduciary-like relationship, or it must create such a relationship.

In rejecting Cuban's argument, the district court held that a fiduciary duty can be implied by contract regardless of whether a fiduciary-like relationship preceded the agreement. The deception that underlies misappropriation-theory liability merely constitutes the undisclosed breach of a duty not to use another's information for personal gain; nothing in *O'Hagan* precludes the establishment of duty by agreement, the *Cuban* court concluded.¹⁸ The *Cuban* court held that a confidentiality agreement, coupled with a duty to refrain from trading on the confidential information, could give rise to the requisite

fiduciary duty. The court ultimately dismissed the SEC's complaint, finding that the SEC had failed to adequately plead that Cuban entered into the type of agreement necessary to establish a duty.¹⁹

While many commentators viewed the *Cuban* decision as a significant setback for the SEC, the court's acceptance of the SEC's view that a preexisting fiduciary-like relationship is not necessary to establish misappropriation liability may in the long term presage a significant opportunity for the commission. *Cuban* permits parties operating outside the confines of the traditional fiduciary relationship to be deemed to have assumed the functional equivalent if they enter a contract imposing duties of confidentiality and non-use of information.²⁰

In its opening brief to the Fifth Circuit, the SEC argued that a confidentiality agreement need not contain a non-use component because inherent in a promise to maintain confidentiality is a promise to abstain from trading on the information.²¹ The commission urges that the promise of confidentiality preserves the value of the information for its rightful owner, and the improper use of that information destroys its value. Accordingly, the SEC argues, such use constitutes misappropriation.²²

The SEC overreaches in its *Cuban* briefs. The commission first argues that fiduciary duties can be created by agreement. Then the commission argues that the relationship created by the agreement need not even be fiduciary per se, because parties can contract to the "functional equivalent" of such a relationship. Both of these arguments are a stretch on the facts pled in *Cuban*. By agreeing to keep confidential the information he was about to hear, the SEC argues, Cuban entered into a special relationship with the Mamma.com CEO. Yet all the pled facts suggest the two were in an arms-length business relationship lacking any of the traditional indicia of a fiduciary relationship, such as dominance or control. At a minimum, the relationship Cuban entered into with the Mamma.com CEO is not the type of relationship Congress, regulators, and courts have traditionally considered within the reach of section 10(b).²³

The SEC's expansionist views are not limited to its duty-by-agreement argument, however. In a footnote

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at the very end of its opening brief, the commission attempted to persuade the court that Cuban violated section 10(b) by communicating material nonpublic information about Mamma.com merely by selling a large block of shares.²⁴ While practitioners before the SEC know well that its staff frequently view large-block stock purchases, coupled with other factors, as circumstantial evidence of illicit trading based on inside information, the SEC contends here that a trade's large size alone can

support a "reasonable inference" that Cuban breached the alleged confidentiality agreement that would be sufficient to defeat a motion to dismiss. This argument—construing the act of trading as communication—should serve as a warning to the marketplace and practitioners that the SEC will continue to push the bounds of insider-trading liability as far as possible.

In his opposition brief, Cuban concedes that a confidentiality agreement may give rise to section 10(b) liability, but maintains that to create the requisite duty, it must impose a duty of disclosure to the source of the information.²⁵ Absent an affirmative obligation to inform the information source of plans to breach the agreement, the recipient of the information is free to trade on it, Cuban argues. He further maintains that even breach of such an agreement does

not automatically give rise to a federal securities-fraud charge; under section 10(b), the SEC must still prove deception in connection with the sale of a security, and mere "failure to perform a contractual promise, even without excuse, is not evidence of fraud." Finally, he argues that parties should be able to engage in efficient breaches of contracts without risking violations of the securities laws, and that the SEC is exceeding its regulatory authority by treating breach of a bare confidentiality agreement as insider trading and by seeking to use the federal securities laws to punish those with an unfair advantage in the marketplace regardless of how they acquired it.²⁶

Four prominent law professors submitted a brief as amici curiae in *Cuban*, expressing their concern that the district court's decision "could result in precedent with detrimental effects on corporate law and the national securities markets."²⁷ The amici argue that the Supreme Court has consistently required a breach of a fiduciary duty or similar duty of trust or confidence for insider-trading liability to arise, and that the SEC's attempt to impose liability in the absence of such a breach is an impermissible expansion of section 10(b)'s prohibition on insider trading. Stripped of its fiduciary duty element, the amici argue, a section 10(b) charge no longer properly alleges securities fraud: "The SEC's position in this case . . . essentially converts each breach of a confidentiality agreement into a fraudulent act, something that is beyond the SEC's power under the Exchange Act." They caution that allowing insider-trading liability to be predicated on a confidentiality agreement would lead to the potential that anyone who receives confidential information could be investigated or charged by the SEC. "One can anticipate that market participants will become more reluctant to receive confidential information if it brings an increased risk of liability or parties will attempt to address the regulatory uncertainty in their contractual terms."

Dorozhko

The *Dorozhko* action, perhaps even more than *Cuban*, reflects the SEC's efforts to weaken or even eliminate the fiduciary-duty requirement from insider-trading law. On October 17, 2007, Oleksandr Dorozhko, a Ukrainian national and resident, hacked into Thomson Financial's servers and accessed confidential quarterly earnings reports on a company called IMS Health. He gained access to the data while the markets were still open and purchased about \$42,000 worth of IMS "put" options.²⁸ Shortly after the market closed that day, IMS announced that its earnings were 28 percent below the expectations of Wall Street analysts. The next morning, the price of IMS stock sank 28 percent almost immediately, and within minutes after the market opened, Dorozhko sold all his IMS options. Dorozhko's trades—he realized a profit of nearly \$287,000 overnight—caught the attention of his brokerage house, which reported his activity to the SEC. After securing a temporary restraining order freezing the proceeds of Dorozhko's sales of IMS options, the SEC moved for a preliminary injunction against Dorozhko. The district court denied the SEC's motion, holding that "Dorozhko's alleged 'stealing and trading' or 'hacking and trading' does not amount to a violation of Section 10(b) because Dorozhko did not breach any fi-

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duciary or similar duty ‘in connection with’ the purchase or sale of a security.”²⁹ Without a breach of a fiduciary duty, the district court concluded, there was no deception under section 10(b).

In a decision that has attracted wide criticism from the securities bar, the Second Circuit reversed, holding that where insider-trading liability is predicated on an “affirmative misrepresentation,” there is no fiduciary-duty requirement. The court acknowledged that the SEC’s claim against *Dorozhko*, an outsider of IMS, was “not based on either of the two generally accepted theories of insider trading”³⁰—the classical and misappropriation theories, both of which require a fiduciary or similar duty. However, the court concluded that Supreme Court precedent did not “establish[] a fiduciary-duty requirement as an element of *every* violation of Section 10(b),”³¹ and held that the SEC’s claim could be proper if the fraud alleged was “deceptive” within the meaning of section 10(b).³² Thus, it blessed a new, third theory of section 10(b) liability: acquiring material, nonpublic information via an “affirmative misrepresentation” (here, by hacking into a computer’s security system) and then trading on it, with or without a duty exceeding the ordinary obligation in commercial dealings not to mislead.³³

By dispensing with the fiduciary-duty requirement of existing section 10(b) jurisprudence, the *Dorozhko* court’s “affirmative misrepresentation” theory removes the duty limitation from both currently accepted theories. A virtue of the classical theory is that it “center[s] on the fiduciary relationship between insiders and shareholders,” and in so doing, “it narrow[s] substantially the categories of persons covered by Rule 10b-5’s prohibition.”³⁴ Similarly, liability under the complementary misappropriation theory, the Court emphasized in *O’Hagan*, is “limited to those who breach a recognized duty.”³⁵ The *Dorozhko* court held that those Supreme Court precedents merely establish that nondisclosure in breach of a fiduciary duty is *sufficient* to satisfy section 10(b)’s “deception” element, not *necessary*, and found “no precedent of the Supreme Court or of our Court that forecloses or prohibits” what it termed “the SEC’s straightforward theory of fraud.”³⁶ It noted the general “obligation in commercial dealings not to mislead,” whether or not in the face of a duty, and approved “affirmative misrepresentation [a]s a distinct species of fraud” actionable under section 10(b).

The *Dorozhko* decision, which has attracted fierce criticism and was labeled “egregious” by a well-known securities-law professor,³⁷ is a major win for the SEC because it eliminates the fiduciary-duty requirement where the theory of insider trading is based on a misrepresentation. Furthermore, although the computer hacking involved in

Dorozhko constituted an obvious affirmative misrepresentation in the ordinary sense of those words, the Second Circuit did not give much guidance on what types of conduct might fall into that category. The decision thus helps push section 10(b) jurisprudence down the slippery slope: It permits the SEC to simply characterize alleged illegal trading as an “affirmative misrepresentation” whenever it cannot adequately establish the existence of a fiduciary relationship. Historically, the fiduciary-relationship element has required the SEC to meet exacting pleading standards; now, regulators have license to charge many acts of garden-variety fraud or financial unfairness under the nebulous rubric of “affirmative misrepresentation.” Conceivably, that could embrace any fraud involving the purchase or sale of securities, not merely the prototypical Section 10(b) charge where insiders exploit “inside information for personal advantage [a]s a normal emolument of corporate office.”³⁸

Moreover, the elimination of the fiduciary-duty requirement in cases where liability can be premised on misrepresentation has the potential to strain the scarce resources of regulators and the courts. Although there is no fiduciary duty element expressed in the text of section 10(b), insider-trading liability historically has required the existence of such a duty in part to reflect the judgment of regulators, the public, and the courts that it is the inappropriate and deceptive use of *special* relationships that the federal securities laws target. Many state and federal statutes prohibit theft, computer tampering, and other kinds of fraud, and could be used to bring cases against individuals like *Dorozhko* who hack computer systems to gain material nonpublic information on which they trade.

Conclusion

The *Cuban* and *Dorozhko* decisions evidence a shift in insider-trading jurisprudence away from its roots in deterring and punishing those who abuse special relationships at the expense of shareholders and into a murkier area where the SEC is policing general financial unfairness that has traditionally been considered beyond its authority to regulate. The *Cuban* decision allows for complete strangers in arms-length negotiations to be judicially determined to have become fiduciaries by agreement, and the *Dorozhko* decision allows for insider-trading liability to arise even in the complete absence of a fiduciary relationship. *Cuban* and *Dorozhko* have so weakened the fiduciary-duty element of the insider-trading offense that it is now unclear whether such a duty is even required for liability to apply. As it stands, this trend toward “duty-free” pleading requirements augurs greater uncertainty

for market participants, and the imprecision makes it more difficult for even sophisticated actors to “order[] their actions in accordance with legal requirements.”³⁹✱

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1. See, e.g., Robert Khuzami, Director, Division of Enforcement, U.S. SEC, “Remarks at AICPA National Conference on Current SEC and PCAOB Developments (Dec. 8, 2009), available at www.sec.gov/news/speech/2009/spch120809rsk.htm (extolling expanded enforcement of insider trading laws).
2. 634 F. Supp. 2d 713 (N.D. Tex. 2009).
3. 574 F.3d 42 (2d Cir. 2009).
4. See *Cent. Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164, 180 (1994) (quotation marks omitted).
5. 634 F. Supp. 2d at 725.
6. 574 F.3d at 51.
7. The Second Circuit remanded the case to the Southern District of New York; Dorozhko failed to reply to the SEC’s motion for summary judgment, and the district court granted the SEC’s motion on March 24, 2010.
8. See *Chiarella v. United States*, 445 U.S. 222, 233 (1980) (rejecting parity-of-information argument as “depart[ing] radically from the established doctrine” without support in requisite “explicit congressional intent”); *Dirks v. SEC*, 463 U.S. 646, 656–57 (1983) (“reaffirm[ing]” validity of this principle); see also Brief of Allen Ferrell et al. as Amici Curiae at 10–12, *SEC v. Cuban*, No. 09-10996 (5th Cir. filed Apr. 2, 2010) (discussing the Court’s consistency on this issue) (“*Cuban* Amicus Appellate Brief”).
9. Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (Section 10(b)).
10. SEC Employment of Manipulative and Deceptive Devices Rule, 17 C.F.R. § 240.10b-5 (Rule 10b-5).
11. 445 U.S. 222 (1980).
12. *Chiarella*, 445 U.S. at 231–32; see *id.* at 231 n.14 (“A duty arises from the relationship between parties, . . . and not merely from one’s ability to acquire information because of his position in the market.”).
13. 463 U.S. 646, 653 (1983) (internal quotation marks omitted). This decision also extended the classical theory of liability to tippees of insiders.
14. 521 U.S. 642 (1997).
15. *Id.*; see Tyler J. Bexley, *Reining in Maverick Traders: Rule 10B5-2 and Confidentiality Agreements*, 88 TEXAS L. REV. 195, 195 (2009). Rule 10b5-2 supplies a non-exhaustive definition of circumstances in which a person has a such a duty. SEC Selective Disclosure and Insider Trading Rule, 17 C.F.R. § 240.10b5-2 (10b5-2).
16. See *O’Hagan*, 521 U.S. at 648–49.

17. 634 F. Supp. 2d at 722.
18. *Id.* at 725 (*O’Hagan* does not prevent a misappropriator from being “held to [confidentiality] terms created by his own agreement rather than to a duty triggered merely by operation of law due to his relationship with the information source”).
19. The SEC alleged only that Cuban had agreed to keep the PIPE information confidential, not that he had agreed to abstain from trading on it. *Id.* at 730–31.
20. The result is troubling because it allows the establishment of duty by contract under the misappropriation theory in that breach of that contract is no ordinary breach, (i.e., one capable of triggering ordinary contract liability). Instead, under *Cuban*, such a breach now constitutes a violation of the federal securities laws, which may even include criminal penalties.
21. Brief of Securities and Exchange Commission at 23, *SEC v. Cuban*, No. 09-10996 (5th Cir. filed Jan. 25, 2010) (SEC opening brief).
22. See SEC opening brief at 23. The SEC argues that a confidentiality agreement induces another party to provide property (i.e., confidential business information), which the provider has the exclusive right to use and therefore comprehends an expectation that the recipient of the information will not exploit the information for his or her own benefit. Brief of Securities and Exchange Commission at 2, *SEC v. Cuban*, No. 09-10996 (5th Cir. filed Apr. 12, 2010) (SEC reply brief). “All that is needed for potential liability under the misappropriation theory is a duty to the provider not to use the information for personal benefit, such that a duty of disclosure arises and makes the undisclosed trading deceptive.” *Id.* at 4.
23. See, e.g., *Dirks*, 463 U.S. at 655 n.14 (“The basis for recognizing [a] fiduciary duty [of outsiders] is not simply that such persons acquired nonpublic corporate information, but rather that they have entered into a special confidential relationship in the conduct of the business of the enterprise and are given access to information solely for corporate purposes.”).
24. SEC opening brief at 40 n.10.
25. Brief of Mark Cuban at 8, *SEC v. Cuban*, No. 09-10996 (5th Cir. filed Mar. 26, 2010).
26. *Id.* at 20–23. See also *Chiarella*, 445 U.S. at 232 (“[N]ot every instance of financial unfairness constitutes fraudulent activity under § 10(b).”).
27. *Cuban* Amicus Appellate Brief at 1. These amici were part of the group of five law professors who filed an amicus curiae brief in the district court.
28. *Dorozhko*, 574 F.3d at 44. “Put” options convey the right, but not the obligation, to sell a particular asset at a predetermined price by a certain date. *Id.* at 44 n.1.
29. *SEC v. Dorozhko*, 606 F. Supp. 2d 321, 324 (S.D.N.Y. 2008).
30. *Dorozhko*, 574 F.3d at 45.
31. *Id.* at 48 (emphasis added).
32. *Id.* at 45. The court remanded the case for consideration of whether the defendant’s conduct “dece[iv]ed” Thomson Finan-

cial's computers or merely exploited a weakness in their security.

33. *See id.* at 49–50.

34. Nagy, *Insider Trading* article, at 1326; see also *Cuban* Amicus Appellate Brief at 11.

35. *O'Hagan*, 521 U.S. at 666.

36. *Dorozhko*, 574 F.3d at 49.

37. *See* Stephen M. Bainbridge, *The Second Circuit's Egregious Decision in SEC v. Dorozhko*, July 29, 2009, ProfessorBainbridge.

com, available at www.professorbainbridge.com/professorbainbridgecom/2009/07/the-second-circuits-recent-decision-in-sec-v-dorozhko-available-here-dealt-with-one-of-the-questions-left-open-by-the.html. Professor Bainbridge is one of the amici who filed briefs in support of Cuban in the district court and Fifth Circuit.

38. *In re Cady, Roberts & Co.*, 40 S.E.C. 907, 912 n.15 (1961).

39. *Dirks*, 463 U.S. at 658 n.17.