A Unified Theory of Insider Trading Law

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When an insider trades in his own corporation’s stock while in possession of material, nonpublic information, courts apply what is called the “classical theory” of insider trading. This theory is the foundation of U.S. insider trading law. It has been invoked in every court opinion on the subject for the past three decades. Yet, this Article argues that the theory is an unqualified failure. The reason? Because it fails to do what a theory must, which is to explain settled law and provide answers to unsettled law that are intuitively appealing.

We need a new theory for the classic case of insider trading, and the best candidate for the job is staring us in the face—the misappropriation theory, which historically has applied only to insider trading involving corporate “outsiders,” is superior to the classical theory. It does a better job of explaining what courts actually do in classical insider trading cases. And with respect to those issues that are still open, it yields results that are more intuitively appealing. Replacing the classical theory with the misappropriation theory would have the effect of unifying insider trading law, resulting in a single theory applicable to both insiders and outsiders alike.

To be sure, for some commentators, the misappropriation theory’s main drawback is its so-called “brazen fiduciary problem”—the fact that, under that theory, the trader can avoid insider trading liability simply by pre-disclosing to the board an intention to trade. However, I argue that this infirmity can be significantly mitigated with a simple disclosure rule, promulgated by the SEC, which would require boards of public companies to disclose any such notice received by the board.

The unified (misappropriation) theory of insider trading law that I argue for here would bring much needed clarity to this doctrinal area. It would also promote values, including consistency and predictability, which are essential for the rule of law.

Table of Contents

Introduction .................................................. 1227

I. Background .................................................. 1232

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II. THE FAILURE OF THE CLASSICAL THEORY ........................................... 1240

A. SETTLED LAW: THE CLASSICAL THEORY’S FAILURE TO EXPLAIN
   OBSERVED JUDICIAL OUTCOMES ............................................. 1240
1. Liability for Insider Trading in Impersonal Markets .... 1241
2. Insider Trading Liability for Tipping ...................... 1243
3. No Liability for Purchasers ................................. 1244

B. UNSETTLED LAW: THE CLASSICAL THEORY’S FAILURE TO YIELD
   INTUITIVELY APPEALING RESULTS ..................................... 1245
1. Insider Trading in Debt-Based Securities ............ 1245
2. Insider Trading Through Open Market Repurchases .... 1248

III. A UNIFIED THEORY OF INSIDER TRADING LAW .............................. 1252

A. THE MISAPPROPRIATION THEORY AND ITS APPLICATION BY THE
   LOWER COURTS ............................................................ 1252
1. Overview of the Misappropriation Theory ............ 1252
2. The Lower Courts Only Apply the Misappropriation
   Theory to Insider Trading Involving “Outsiders” ...... 1254

B. THE MISAPPROPRIATION THEORY DOES A BETTER JOB EXPLAINING
   SETTLED LAW ............................................................. 1255
1. The Misappropriation Theory Explains Liability for
   Trading in Impersonal Markets ................................. 1255
2. The Misappropriation Theory Explains Liability for
   Sales as Well as Purchases ................................. 1256
3. The Misappropriation Theory Explains Tipper–Tippee
   Liability ................................................................. 1256

C. THE MISAPPROPRIATION THEORY DOES A BETTER JOB GUIDING
   UNSETTLED LAW ............................................................ 1257
1. The Misappropriation Theory Would Result in a
   Cost–Benefit Approach to Insider Trading Liability
   Regarding Corporate Repurchases ........................... 1257
2. The Misappropriation Theory Would Create Liability for
   Insider Trading in Debt Securities ...................... 1259

D. CONCLUSION ................................................................. 1260

IV. A POLICY RECOMMENDATION ..................................................... 1261
INTRODUCTION

In the United States, the classic case of insider trading—where the corporate insider trades in his own corporation’s stock on the basis of material, nonpublic information belonging to his corporation—is governed by what is known, appropriately enough, as “the classical theory.” An invention of Supreme Court

1. In this Article, I use the term “insider trading” to refer broadly to trading in securities on the basis of material, nonpublic information.

2. There is a circuit split as to what plaintiffs must show to prove that a trade was made “on the basis of” material, nonpublic information. Some circuits take the view that the defendant must be shown to have actually used the information in deciding to trade, whereas other circuits view the relevant standard as one of mere possession. Compare, e.g., United States v. Anderson, 533 F.3d 623, 629 (8th Cir. 2008) (adopting “use” standard), with United States v. Teicher, 987 F.2d 112, 120–21 (2d Cir. 1993) (adopting “possession” standard). Still other circuits have suggested that a different standard might apply depending on whether the case in question is a civil or criminal one. See, e.g., Johnson v. Aljian, 394 F. Supp. 2d 1184, 1198–99 (C.D. Cal. 2004) (adopting the use standard in the criminal case, United States v. Smith, 155 F.3d 1051 (9th Cir. 1998)). The Securities and Exchange Commission (SEC), for its part, has adopted the broader standard of possession. See 17 C.F.R. § 240.10b5-1 (2017). However, as evidenced by the continuing circuit split, it appears that not all courts defer to the SEC’s interpretation of the statute. Many commentators are reluctant to defer to the SEC because they believe that Rule 10b5-1 exceeds the SEC’s statutory authority by eliminating the element of scienter that is typically required for a Rule 10b-5 claim. See Kimberly D. Krawiec & Richard W. Painter, New SEC Regulations Attempt to Clarify Approach to Insider Trading, 32 Sec. Reg. & L. Rep. (BNA) No. 45, at 1594 (Nov. 20, 2000) (asserting that “the awareness standard...arguably eliminates the scienter element from insider trading cases”); Stuart Sinai, A Challenge to the Validity of Rule 10b5-1, 30 Sec. Reg. & L. Rep. (BNA) No. 58, at 1594 (May 6, 2000) (arguing that Rule 10b5-1 removes the scienter requirement for insider trading, constitutes impermissible legislative action by the SEC, and effectively imposes strict liability for trading while in possession of material, nonpublic information); Carol B. Swanson, Insider Trading Madness: Rule 10b5-1 and the Death of Scienter, 52 U. Kan. L. Rev. 147, 196–200, 204 (2003) (criticizing Rule 10b5-1 as “duplicitous,” questioning whether a trader who is aware of information but does not use it acts with scienter, and suggesting that Rule 10b5-1 “eliminates fraud from the liability standard” under Rule 10b-5); Kevin E. Warner, Note, Rethinking Trades “on the Basis of” Inside Information: Some Interpretations of SEC Rule 10b5-1, 83 B.U. L. Rev. 281, 305–14 (2003) (suggesting that Rule 10b5-1 may eliminate the requirement of scienter for an insider trading violation and offering interpretations of Rule 10b5-1 that do not abrogate the scienter requirement).

3. See, e.g., SEC v. Obus, 693 F.3d 276, 284 (2d Cir. 2012) (“Under the classical theory of insider trading, a corporate insider is prohibited from trading shares of that corporation based on material non-public information in violation of the duty of trust and confidence insiders owe to shareholders.”).
Justice Lewis Powell, this theory is elegant in its simplicity: The common law of fraud provides that nondisclosure of material information is fraudulent when a party to a transaction owes a duty of disclosure to his counterparty, where the duty arises from a fiduciary relationship with that counterparty. Accordingly, under the classical theory, because the corporate insider owes a duty of disclosure to the corporation’s shareholders by virtue of his status as a fiduciary, he is prohibited from trading in the corporation’s stock unless he discloses material, nonpublic information that might be in his possession.

The classical theory forms the foundation of U.S. insider trading law. It has been invoked in every court opinion on the subject for the past three decades. Yet, this Article argues that the theory is an unqualified failure. The reason? Because it fails to do what a theory must, which is explain settled law and provide answers to unsettled law that are intuitively appealing.

Although admittedly harsh, this criticism should not come as a complete surprise. Despite its elegance and distinguished pedigree, the classical theory of insider trading has been the source of conceptual and practical problems from the very beginning. Early on, commentators recognized that the logic of the classical theory created gaps in insider trading liability that seemed curious at best. For example, because the consensus among state courts has always been that corporate insiders owe no duties to counterparties when trading over impersonal markets, the classical theory implies, as a practical matter, that there is no liability for insider trading in the stock of publicly traded companies. Additionally, because the deception underlying the classical theory occurs only when the insider trades on material, nonpublic information, the classical theory implies there is no liability when the insider simply passes such information along to a third party who then completes the trade. Moreover, because

5. See Chiarella v. United States, 445 U.S. 222, 227–28 (1980) (“At common law, misrepresentation made for the purpose of inducing reliance upon the false statement is fraudulent. But one who fails to disclose material information prior to the consummation of a transaction commits fraud only when he is under a duty to do so. And the duty to disclose arises when one party has information ‘that the other [party] is entitled to know because of a fiduciary or other similar relation of trust and confidence between them.’” (alteration in original) (quoting RESTATEMENT (SECOND) OF TORTS § 551(2)(a) (1976)). As we will see below, this account of the common law of deceit is revisionist at best. See infra notes 102–13 and accompanying text.
7. A Westlaw search finds that the classical theory, as articulated in Chiarella, has been cited in over 1,000 federal court opinions.
8. See infra Section II.A.
9. See infra Section II.B.
10. See Pritchard, Justice Powell’s Legacy, supra note 4, at 22–29.
12. See Sung Hui Kim, Insider Trading as Private Corruption, 61 UCLA L. REV. 928, 940–41 (2014) (explaining how in the case in which the doctrine of tipper–tippee liability was created, the
corporate insiders owe a duty of disclosure, at most, only to current shareholders, the classical theory implies that the insider trading ban extends only to sellers, and not purchasers, of the corporation’s stock. Furthermore, because insiders do not owe fiduciary duties to bondholders, the classical theory means that the insider trading ban does not apply to trading in the corporation’s debt securities. Finally, because the corporate entity itself cannot be said to owe these types of duties to shareholders, under the classical theory, the insider trading ban would not extend to a corporation’s repurchases of its own stock.

The Supreme Court quickly filled many (although not all) of these gaps, extending insider trading liability to tippers, purchases, and trading over impersonal markets. But the Court did so without explaining how these results would be reconciled in light of the classical theory. Of course, all of this might have been purely academic—the securities law version of angels dancing on the head of a pin—if it were not for the fact that even after the Court’s gap-filling exercise, the theory was and still is expected to drive outcomes in insider trading cases. The result is a theory that cannot explain settled law and, with respect to unsettled law (and particularly with respect to the perennial issues of liability for debt trading and corporate repurchases), points in directions that conflict with intuition.

If the classical theory is so problematic, then what is the alternative? Is there a better theory that might be adopted in its place? As it happens, there is, and it is a theory that already has considerable mileage under the hood, although in a

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13. It is common these days to talk about fiduciary duties running to the shareholders. This view likely comes from the concept that shareholders are residual claimants, and therefore maximizing shareholder value also results in maximizing firm value, at least in most circumstances. Thus, as a rule of thumb, it makes sense to think of directors and management owing fiduciary duties to shareholders themselves. However, as a technical legal matter, fiduciary duties are actually owed to the corporate entity itself. See United Teachers. Assocs. Ins. Co. v. MacKeen & Bailey Inc., 99 F.3d 645, 650–51 (5th Cir. 1996) (stating that a director owes a fiduciary duty “to the corporation”); Bawden v. Taylor, 98 N.E. 941, 942 (Ill. 1912); Goodwin v. Agassiz, 186 N.E. 659, 660 (Mass. 1933); Restatement (Second) of Agency § 14C cmt. a (A.M. Law. Inst. 1958) (stating that directors owe duties to “the corporation itself rather than to the shareholders individually or collectively”); see also Margaret M. Blair & Lynn A. Stout, A Team Production Theory of Corporate Law, 85 Va. L. Rev. 247, 293 (1999) (“In recent years, it has become common in both the legal and the economic literature for directors’ fiduciary obligations to be described as being owed to shareholders.’ Yet case law makes clear that directors owe their fiduciary duties primarily to the corporation itself.”).

14. See Pritchard, Justice Powell’s Legacy, supra note 4, at 26–27.

15. See id. at 28.

16. See, e.g., Deborah A. DeMott, Beyond Metaphor: An Analysis of Fiduciary Obligation, 1988 Duke L.J. 879, 884 (noting that “[t]he notion that a corporation owes a fiduciary obligation to its own shareholders poses analytic challenges of heroic dimensions”); Jesse M. Fried, Insider Trading Via the Corporation, 162 U. Pa. L. Rev. 801, 813–14 (2014) (explaining that although the SEC takes the position that corporate repurchases are subject to insider trading liability, the doctrinal grounds for this position are “shaky”).


slightly different context. The theory that I am referring to is the misappropriation theory, which provides that it is illegal to trade in securities while in possession of material, nonpublic information acquired from a person or entity to whom the trader owes a duty of loyalty and confidentiality. The differences between the classical and misappropriation theory are subtle but significant. Under the misappropriation theory, there is liability only if the trader breaches a duty of loyalty by failing to disclose to the source of the information that he is engaged in insider trading. Under the classical theory, by contrast, there is liability only if the trader fails to disclose material, nonpublic information to the counterparty to the trade. Thus, where a lawyer acquires information from a client about a company with which he has no relationship, and subsequently uses such information to profit from trading in that company’s stock, the lawyer violates insider trading law under the misappropriation theory (because he has a duty to the source of the information, his client), but not the classical theory (because he does not have a duty to the shareholders against whom he is trading in the market).

The misappropriation theory has historically been applied only to cases of insider trading involving corporate outsiders, meaning nonemployees of the corporation whose stock forms the basis of the trade. Although courts do not apply the misappropriation theory to the classic case of insider trading (possibly because of an accident of history), there is certainly no conceptual barrier to

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20. See infra notes 75–81 and accompanying text.
21. This hypothetical tracks the facts of United States v. O’Hagan, where the Supreme Court adopted the misappropriation theory. See United States v. O’Hagan, 521 U.S. 642 (1997). The lower court had held that the lawyer was not liable for insider trading under the classical theory. Id. at 649.
22. See, e.g., Steginsky v. Xcelera Inc., 741 F.3d 365, 370 n.4 (2d Cir. 2014) (acknowledging the inapplicability of the misappropriation theory to a case involving insiders); United States v. McGee, 763 F.3d 304, 311 (3d Cir. 2014) (“The misappropriation [theory] focuses on deceptive trading by outsiders who owe no duty to shareholders.”); SEC v. Talbot, 530 F.3d 1085, 1091 (9th Cir. 2008) (“The misappropriation theory reaches trading by corporate outsiders, not insiders . . . .”); SEC v. Maio, 51 F.3d 623, 631 (7th Cir. 1995) (“The relationship between the corporation whose stock is traded and the person who breaches a fiduciary duty by trading or tipping determines which theory is applied. Classical theory applies to trading by insiders (or their tippees) in the stocks of their own corporations. Misappropriation theory ‘extends the reach of Rule 10b-5 to outsiders [or their tippees] who would not ordinarily be deemed fiduciaries of the corporate entities in whose stock they trade.’” (alteration in original) (citation omitted)); SEC v. Bauer, 42 F. Supp. 3d 923, 931 (E.D. Wis. 2014) (“This court is not aware of any authority supporting the extension of the [misappropriation] theory to the facts of this case where, at all times, [the defendant] was a corporate insider.”); Wehrenberg v. Fed. Signal Corp., No. 06 C 487, 2008 WL 2787438, at *8 (N.D. Ill. Apr. 29, 2008) (finding that the misappropriation theory “plays no role” in the present case because the defendant “was not an outsider as O’Hagan was”). But see SEC v. Yun, 327 F.3d 1263, 1275–76 (11th Cir. 2003) (arguing that distinguishing between outsiders and insiders “constructs an arbitrary fence between insider trading liability based upon classical and misappropriation theories” and interpreting O’Hagan as requiring courts to “synthesize, rather than polarize, insider trading law”).
23. The SEC advanced the misappropriation theory in its brief to the Supreme Court in Chiarella, where the Court ultimately articulated the “classical theory.” Brief for the United States, Chiarella v. United States, 445 U.S. 222 (1980) (No. 78-1202), 1979 WL 199454. However, because the misappro-
doing so. Under the misappropriation theory, the corporate insider who trades in the corporation’s securities on the basis of material, nonpublic information would be viewed as violating a duty of loyalty or confidentiality owed to the corporation itself.24 This is how courts should analyze these cases. This unified approach to insider trading law would have two important advantages over the classical theory. First, applying the misappropriation theory to the classic case of insider trading would do a better job explaining what courts actually do in such cases.25 And second, with respect to those classical insider trading cases where the law is unsettled, the misappropriation theory would lead to more intuitively appealing results than the classical theory.26

Of course, the misappropriation theory is not perfect. Specifically, it gives rise to what I call a “unilateral” default rule: it would allow the fiduciary to remove himself from the reach of federal insider trading law simply by providing the principal with prior notice of the trader’s intent to trade on the principal’s information.27 To answer this objection, I propose that this unified approach to insider trading law be accompanied by a new disclosure rule adopted by the Securities and Exchange Commission (SEC).28 This disclosure rule would require public company boards to disclose whether an insider, either actual or constructive, has notified the board of its intention to trade on the corporation’s material, nonpublic information, and the board’s response to such notification.29 This type of disclosure rule would minimize the incidence of fiduciaries unilaterally opting out of the law.

Ultimately, adopting this new approach to insider trading law would have important real-world effects. It would result in extending liability to insider trading in debt securities—a move that is intuitively appealing but logically foreclosed by the classical theory.30 And, unlike the classical theory, the new
approach would acknowledge not only the costs, but also the benefits, of corporate repurchases in determining insider trading liability.\(^{31}\) Finally, this approach would bring much needed order to the law of insider trading, while at the same time furthering values of predictability and consistency that are central to the rule of law.\(^{32}\)

This Article proceeds as follows: Part I provides a brief background of insider trading law, and the classical theory in particular. Part II addresses how the classical theory fails to explain the settled law of classical insider trading cases and how, with respect to certain unsettled issues, the classical theory leads to intuitively unappealing results. Part III argues that the misappropriation theory does a better job explaining these observed judicial outcomes and results in more intuitive outcomes with respect to unsettled law. Part IV proposes that courts adopt the misappropriation theory as the unified theory of insider trading law, applicable to cases involving both corporate outsiders and insiders. It also proposes a new SEC disclosure rule to address the most oft-cited infirmity of the misappropriation theory: its status as a “unilateral” default rule that can be altered by way of contract.

I. BACKGROUND

The SEC adopted Rule 10b-5\(^{33}\) as a means of implementing section 10(b) of the Securities Exchange Act of 1934.\(^{34}\) Rule 10b-5 makes it unlawful, among other things, “[t]o employ any device, scheme, or artifice to defraud, [or] . . . [t]o engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.”\(^{35}\) Both the SEC rule and statutory provision are antifraud rules adopted for the purpose of ensuring the accuracy of the affirmative disclosures required of issuers under the federal securities law regime.\(^{36}\)

Needless to say, neither the statutory text nor the SEC rule mentions insider trading, nor is it obvious that these laws have anything to do with insider

\(^{31}\) See infra Section III.C.1.
\(^{32}\) See infra Section IV.A.
\(^{33}\) 17 C.F.R. § 240.10b-5 (2017).
\(^{34}\) 15 U.S.C. § 78j(b) (2012) (authorizing the SEC to prescribe rules “necessary or appropriate in the public interest or for the protection of investors”).
\(^{35}\) 17 C.F.R. § 240.10b-5. Section 10(b) of the Securities Exchange Act provides in pertinent part:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange . . . [t]o use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [Securities and Exchange] Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.


trading. However, as early as the late 1940s, courts began to view rule 10b-5 as a source for an insider-trading ban.\footnote{37. See, e.g., Myzel v. Fields, 386 F.2d 718, 735–36 (8th Cir. 1967); Royal Air Properties, Inc. v. Smith, 312 F.2d 210, 212 (9th Cir. 1962); Speed v. Transamerica Corp., 99 F. Supp. 808, 812–14 (D. Del. 1951); Kardon v. Nat’l Gypsum Co., 73 F. Supp. 798, 800 (E.D. Pa. 1947).} Importantly, however, the early cases dealt only with an insider’s nondisclosure of material facts in connection with a face-to-face securities transaction.\footnote{38. See Myzel, 386 F.2d at 735–36; Royal Air Properties, 312 F.2d at 211–12; Speed, 99 F. Supp. at 848; Kardon, 73 F. Supp. at 800.} They did not involve insider trading over securities exchanges.\footnote{39. See cases cited supra note 37.}

That distinction began to break down, however, in 1961 with the SEC’s opinion in \textit{Cady, Roberts & Co.}.\footnote{40. Exchange Act Release No. 6,668, 40 SEC Docket 907 (Nov. 8 1961).} In that opinion, the Chairman of the SEC, William Cary, articulated the abstain-or-disclose rule at the heart of the classical theory:

\begin{quote}
We, and the courts have consistently held that insiders must disclose material facts which are known to them by virtue of their position but which are not known to persons with whom they deal and which, if known, would affect their investment judgment. Failure to make disclosure in these circumstances constitutes a violation of the anti-fraud provisions. If, on the other hand, disclosure prior to effecting a purchase or sale would be improper or unrealistic under the circumstances, we believe the alternative is to forego the transaction.\footnote{41. Id. at 911.}
\end{quote}

Although part of this statement would ultimately receive the endorsement of the Supreme Court,\footnote{42. See \textit{Chiarella v. United States}, 445 U.S. 222, 227 (1980) (quoting \textit{Cady, Roberts}, 40 SEC Docket at 911).} one would have been forgiven for questioning its durability at the outset. For one thing, the statement was factually inaccurate when made.\footnote{43. See, e.g., Pritchard, \textit{Justice Powell’s Legacy}, supra note 4, at 22–26.} As explained in greater detail below, it is simply not true that a majority of courts recognized an insider-disclosure duty when trading over impersonal exchanges.\footnote{44. See infra notes 104–13 and accompanying text.} In fact, few courts did and, notwithstanding Chairman Cary’s claim to the contrary, it did not appear that the courts were changing their minds on that point.\footnote{45. See infra note 112.}

Additionally, \textit{Cady, Roberts} was ambiguous regarding what body of law this abstain-or-disclose rule emerged from. On the one hand, Chairman Cary suggested it sounded in fraud—a sort of variation on the common law rule of fraudulent nondisclosure as applied to the corporate context.\footnote{46. See In the Matter of Cady, Roberts & Co., Exchange Act Release No. 6,668, 40 SEC 907, 912 (1961) (“We have already noted that the anti-fraud provisions are phrased in terms of ‘any person’ and...\right.} But Chairman
Cary also included language in Cady, Roberts suggesting that the abstain-or-disclose rule derived from the well-known agency law rule that a fiduciary should not be allowed to profit from the property of the principal.47

Nevertheless, the Cady, Roberts opinion proved hugely influential.48 In fact, not seven years after the opinion was issued, the SEC relied on Cady, Roberts to expand insider trading liability further by advocating for an insider trading prohibition applicable not just to insiders, but to anyone in possession of material, nonpublic information. Under this “equal access theory,” there would be liability for a CEO to trade in the stock of his company based on a confidential memo obtained as a result of the CEO’s position within the company. But liability would also extend to the CEO’s dry cleaner who happens to discover the memo in the CEO’s suit coat pocket and then proceeds to trade in the company’s stock. The Second Circuit adopted this “equal access theory” in SEC v. Texas Gulf Sulphur Co.49 There, the insiders who purchased company stock while in possession of not-yet-disclosed information about valuable ore deposits beneath the company-owned land were found guilty of insider trading.50 But under the equal access theory, insider trading liability would also extend, for example, to a nonemployee helicopter pilot who comes into possession of the information about ore deposits while flying company employees over the relevant property and who subsequently trades in the company’s stock.

The equal access theory had potentially far-reaching implications, but they were never fully borne out because the Supreme Court rejected the theory in the watershed decision of Chiarella v. United States.51 At the same time, the Chiarella Court formally adopted the Cady, Roberts abstain-or-disclose rule as that a special obligation has been traditionally required of corporate insiders, e.g., officers, directors and controlling stockholders. These three groups, however, do not exhaust the classes of persons upon whom there is such an obligation. Analytically, the obligation rests on two principal elements; first, the existence of a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone, and second, the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing. In considering these elements under the broad language of the anti-fraud provisions we are not to be circumscribed by fine distinctions and rigid classifications. Thus our task here is to identify those persons who are in a special relationship with a company and privy to its internal affairs, and thereby suffer correlative duties in trading in its securities. Intimacy demands restraint lest the uninformed be exploited.”)

47. See id. at 916 n.31. Indeed, for this reason, some commentators have observed that Cady, Roberts might have as much intellectual affinity with the agency-based theory of insider trading liability that the Supreme Court ultimately adopted in O’Hagan as it does with the fraud-based classical theory of insider trading announced in Chiarella. See Donald C. Langevoort, Rereading Cady, Roberts: The Ideology and Practice of Insider Trading Regulation, 99 Colum. L. Rev. 1319, 1320 (1999).

48. See, e.g., id. at 1319 (characterizing Cady, Roberts as “set[ting] in motion the modern law of insider trading”).

49. 401 F.2d 833 (2d Cir. 1968).

50. See id. at 843–47, 864.

51. 445 U.S. 222, 233–34 (1980). The one exception is in the tender offer context, where the SEC has effectively adopted a version of the equal access theory in the form of Rule 14e-3. See 17 C.F.R. § 240.14e-3 (2017) (creating liability for anyone who trades on material, nonpublic information relating to a tender offer, regardless of the relationship between the trader and anyone else).

1234 [Vol. 105:1225 THE GEORGETOWN LAW JOURNAL
it applies to insiders.\textsuperscript{52} In \textit{Chiarella}, the defendant, Vincent Chiarella, was an employee of a financial printer in New York City that printed disclosure documents for tender offers and other corporate transactions.\textsuperscript{53} During the course of his employment, Chiarella came across the identities of various companies that were to become the target of takeover bids.\textsuperscript{54} Chiarella responded to this discovery by quietly buying stock in the target companies that he had identified, a strategy that earned him substantial profits once the planned takeovers were finally announced.\textsuperscript{55} The strategy also earned Chiarella an SEC lawsuit that ultimately wound up in front of the U.S. Supreme Court.\textsuperscript{56}

Writing for the majority, Justice Lewis Powell, a former corporate lawyer,\textsuperscript{57} rejected the Second Circuit’s equal access theory on the ground that it had no basis in the text or legislative history of section 10(b).\textsuperscript{58} Rather, Justice Powell held that, if the insider trading ban were to be grounded in section 10(b), then the ban must be rooted in notions of fraud, and the common law of fraudulent nondisclosure requires that there be a fiduciary or fiduciary-like relationship with the counterparty before there is a duty to disclose material, nonpublic information to that counterparty.\textsuperscript{59} In reaching this conclusion, Justice Powell and the majority relied on the \textit{Cady, Roberts} opinion.\textsuperscript{60} Although they took Chairman Cary’s claim about the common law at face value,\textsuperscript{61} they clearly interpreted the \textit{Cady, Roberts} rule as emerging out of the common law of fraud rather than as an agency-based rule.\textsuperscript{62} Armed with this rule, the Court concluded that Chiarella had not violated rule 10b-5 because he had no fiduciary or fiduciary-like relationship with the shareholders against whom he traded, and therefore he had no duty to disclose the material information he possessed regarding the planned takeovers.\textsuperscript{63}

\begin{thebibliography}{99}
\bibitem{52} See \textit{Chiarella}, 445 U.S. at 226–30.
\bibitem{53} See \textit{id.} at 224.
\bibitem{54} See \textit{id.}
\bibitem{55} See \textit{id.}
\bibitem{56} See \textit{id.} at 225 (“[P]etitioner was indicted on 17 counts of violating § 10(b) of the Securities Exchange Act of 1934 (1934 Act) and SEC Rule 10b-5. After petitioner unsuccessfully moved to dismiss the indictment, he was brought to trial and convicted on all counts.”).
\bibitem{57} For a discussion of Powell’s influence in the development of insider trading law, see generally Pritchard, \textit{Counterrevolution}, supra note 4; Pritchard, \textit{Justice Powell’s Legacy}, supra note 4.
\bibitem{58} See \textit{Chiarella}, 445 U.S. at 233–34.
\bibitem{59} See \textit{id.} at 234–35; \textit{id.} at 232 (“[T]he element required to make silence fraudulent—a duty to disclose—is absent in this case.”)
\bibitem{60} \textit{Id.} at 226–28.
\bibitem{61} See \textit{id.} at 227.
\bibitem{62} See \textit{id.} at 234–35 (“Section 10(b) is aptly described as a catchall provision, but what it catches must be fraud. When an allegation of fraud is based upon nondisclosure, there can be no fraud absent a duty to speak.”). The fraud-based rule is rooted in the law of fraudulent nondisclosure, where liability is premised on a failure to disclose in the face of a duty to do so. The agency-based rule, by contrast, is rooted in the notion that liability arises from the unauthorized use of a principal’s property. See supra notes 46–47 and accompanying text.
\bibitem{63} See \textit{Chiarella}, 445 U.S. at 232–33 (explaining that “[n]o duty could arise from petitioner’s relationship with the sellers of the target company’s securities, for petitioner had no prior dealings with
The rule of *Chiarella* came to be known as the “classical theory”—that actual insiders, and certain constructive insiders, 64 have a duty to disclose or abstain from trading against the shareholders with whom such insiders enjoy a fiduciary or fiduciary-like relationship. 65 But what about noncorporate insiders? An insider trading law based solely on the classical theory would allow outsiders to the corporation to engage in insider trading with impunity. Could that possibly be the right result?

In *Chiarella*, the government certainly did not think so, and it even proposed a theory, called the misappropriation theory, that would extend insider trading liability to corporate outsiders. 66 The *Chiarella* Court, however, did not weigh in on the validity of that theory because the theory had not been submitted to the jury at trial, and precedent prevented the Court from affirming a criminal conviction under such circumstances. 67 If the government’s theory had been addressed in *Chiarella*, perhaps the Supreme Court would have sidestepped the classical theory altogether and adopted the misappropriation theory as the unified law of insider trading, which is what courts should do as a normative matter, as this Article argues.

The Court finally had the opportunity to evaluate, and ultimately adopt, the misappropriation theory in *United States v. O’Hagan*, 68 decided seventeen years after *Chiarella*. The defendant, James O’Hagan, was a partner in the law firm of Dorsey & Whitney. 69 At the time, O’Hagan’s law firm was representing Grand Metropolitan PLC in a tender offer for Pillsbury Company—a transaction that, once announced publicly, would cause the price of Pillsbury stock to increase significantly. 70 Although O’Hagan was not actually working on the tender offer itself, he allegedly came into possession of nonpublic information concerning the acquisition by virtue of his relationship with his law firm. 71 O’Hagan purchased a substantial amount of Pillsbury stock and call options that, upon announcement of the tender offer, netted O’Hagan over $4.3 million in profit, which O’Hagan apparently used to conceal his prior embezzlement and conversion of unrelated client trust funds. 72

64. A constructive insider is technically an outsider to the corporation, but one who has “entered into a special confidential relationship in the conduct of the business of the enterprise and [is] given access to information solely for corporate purposes.” Dirks v. SEC, 463 U.S. 646, 655 n.14 (1983). Typical constructive insiders would include lawyers, accountants, investment bankers, and consultants.

65. See *Chiarella*, 445 U.S. at 232–33 (explaining that silence is only fraudulent in the insider trading context if there is a duty to disclose arising from a fiduciary relationship).

66. See id. at 235–37.

67. See id. at 236–37.


69. Id. at 647.

70. Id. at 647–48.

71. See id.

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

The Supreme Court, however, reversed the Eighth Circuit and articulated a new theory of liability for corporate “outsiders” like O’Hagan. The misappropriation theory that the O’Hagan Court adopted extends rule 10b-5 liability to defendants who owe a duty of loyalty or confidentiality to the source of the nonpublic information that forms the basis of the trade. This represented a departure from the classical theory in at least three significant ways. The first departure has to do with the nature of the duty underlying each theory. Under the misappropriation theory, the duty of loyalty or confidentiality that the trader owes the information’s source is only violated if the trader profits from that information or discloses it to someone else. By contrast, the duty underlying the classical theory is a duty to disclose to a trading counterparty all material information concerning the transaction at issue. This means that the duty is only violated when the trader fails to disclose material, nonpublic information to the trading counterparty, assuming a fiduciary relationship with that trading counterparty. Second, the two theories are rooted in different sources of law; the duty of disclosure derives from common law fraud, whereas

73. See id. at 649.
74. See id. at 649, 660; United States v. O’Hagan, 92 F.3d 612 (8th Cir. 1996).
76. See id. at 652–53.
77. The SEC has tried to expand these duties to include not only fiduciary duties, but contractual obligations as well, through the promulgation of Rule 10b-5. See 17 C.F.R. § 240.10b5-2(b)(1) (2017). Many courts have endorsed the SEC’s rule. See, e.g., United States v. McGee, 892 F. Supp. 2d 726, 730–34 (E.D. Pa. 2012); SEC v. Northern, 598 F. Supp. 2d 167, 174–75 (D. Mass. 2009); SEC v. Kirch, 263 F. Supp. 2d 1144, 1150 (N.D. Ill. 2003). However, other courts have raised questions about its validity. For example, in 2009, a federal district court in Texas found that Rule 10b-5 was valid, but only if the contractual obligation included not only a disclosure prohibition, but a non-use provision as well. See SEC v. Cuban, 634 F. Supp. 2d 713, 730–31 (N.D. Tex. 2009). Although the Fifth Circuit remanded the case for determination of whether the defendant, billionaire Mark Cuban, had indeed agreed to a non-use provision, it did not disagree with the trial court’s view that a contractual obligation is sufficient to give rise to insider trading liability under the misappropriation theory. See SEC v. Cuban, 620 F.3d 551, 557–58 (5th Cir. 2010). The jury subsequently handed Cuban a victory, finding that he did not agree to refrain from using the confidential information for personal gain. See, e.g., Natalie Posgate & Mark Curriden, Jury Finds No Proof Mark Cuban Engaged in Insider Trading, DALL. MORNING NEWS (Oct. 2013) www.dallasnews.com/business/business/2013/10/16/jury-finds-no-proof-mark-cuban-engaged-in-insider-trading, [https://perma.cc/RZ73-Z82D]. For a discussion of the optimal scope of the fiduciary-like duty under the misappropriation theory, see Thomas Lee Hazen, Identifying the Duty Prohibiting Outsider Trading on Material, Nonpublic Information, 61 HASTINGS L.J. 881 (2010).
78. See O’Hagan, 521 U.S. at 652 (“Under [the misappropriation] theory, a fiduciary’s undisclosed, self-serving use of a principal’s information to purchase or sell securities, in breach of a duty of loyalty and confidentiality, defrauds the principal of the exclusive use of that information.”).
79. See id. at 651–52.
the duty of loyalty or confidentiality derives from the law of agency. Finally, the beneficiary of the duty is different depending on the theory in question. Whereas the classical theory requires a showing that the defendant owed a duty to the shareholders against whom he traded, the misappropriation theory requires a showing of a duty to the source of the information.

The O’Hagan decision ushered in a new era of insider trading law with the introduction of a new theory of liability that differed markedly from the classical theory. But O’Hagan left open many questions, perhaps the most significant practical question concerned the relationship between these two theories: Were they alternative theories that could be applied to the same set of facts? Or were they separate theories that only applied in a particular factual context? At the time O’Hagan was decided, these might have been open questions. However, that is no longer the case. It is now fairly well established among the lower courts that the two theories are distinct, a result that has (perhaps unwittingly) been encouraged by the SEC itself. In other words, the

80. See Pritchard, Justice Powell’s Legacy, supra note 4, at 17 (“The two theories [(the classical and misappropriation theories)] draw on different sets of common law principles: the classical theory draws heavily on the common law of deceit, whereas the misappropriation theory draws primarily on the common law of agency.”). This is not to say that the misappropriation theory does not involve fraud. After all, the Supreme Court had been clear that section 10(b) requires as much. See Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 472–74 (1977) (explaining that “[t]he language of § 10(b) gives no indication that Congress meant to prohibit any conduct not involving manipulation or deception”). However, the Court seemed to reason in O’Hagan that under the misappropriation theory, the trader’s fraud derived from his failure to provide the principal with prior notice of his intention to breach his duty of loyalty and confidentiality. See 521 U.S. at 653–55.

81. See O’Hagan, 521 U.S. at 652–53 (“The classical theory targets a corporate insider’s breach of duty to shareholders with whom the insider transacts; the misappropriation theory outlaws trading on the basis of nonpublic information by a corporate ‘outsider’ in breach of a duty owed not to a trading party, but to the source of the information.”).

82. See, e.g., Carol B. Swanson, Reinventing Insider Trading: The Supreme Court Misappropriates the Misappropriation Theory, 32 Wake Forest L. Rev. 1157, 1160 (1997) (arguing that O’Hagan left “too many open questions”).

83. See cases cited supra note 22.

84. The SEC has not taken an official position that the two theories are separate and distinct. However, this view is implicit in the SEC’s occasional litigation position that a misappropriating tipper (unlike a classical insider tipper) does not need to derive a personal benefit from his tip to be subject to tipper–tippee liability. See, e.g., Brief of the Securities and Exchange Commission, Appellee at 40–46, SEC v. Yun, 327 F.3d 1263 (11th Cir. 2003) (No. 01-14490-HH), 2001 WL 34455703, at *40–46. The SEC’s reasoning in these cases is that the classical insider’s disclosure of material, nonpublic information is not in and of itself a breach of the insider’s duty to his corporation’s shareholders. It is only when the insider receives a personal benefit from the disclosure that the insider breaches that duty. See id. at 40–42. By contrast, in the case of the misappropriation theory, the misappropriator’s duty is one of confidentiality, and therefore the misappropriating tipper does breach that duty by the mere disclosure of material, nonpublic information to a third party. In other words, the misappropriating tipper does not need to receive a personal benefit from the disclosure for the tip to constitute a breach of his duty. See id. at 42–46. Although the SEC takes this position because it makes it easier for them to prevail in cases involving a misappropriating tipper, the logical implication is that the classical theory and the misappropriation theory are distinct. Otherwise, the SEC could simply recharacterize a classical tipper as a misappropriating tipper, thereby avoiding the tipper benefit requirement. See, e.g., SEC v. Yun, 327 F.3d 1263, 1275–76 (11th Cir. 2003) (“[W]e think the SEC is unduly dichotomizing the two theories of insider trading liability. The SEC’s approach essentially would allow the SEC and the courts
classical theory applies to one set of facts (trading by the corporate insider) and the misappropriation theory applies to another (trading by the corporate outsider). And from the lower courts’ perspective, never the twain shall meet.

To be clear, as a conceptual matter, this is not the only conceivable result. In particular, the misappropriation theory could readily be applied to a classical insider case. Nor is this result required as a legal matter. It is true that in *O’Hagan*, the Court referred to the “complementary” nature of the two theories. And the lower courts typically point to this language in support of the holding that the theories are related, but distinct. This language, however, is almost certainly dicta because it is included in the section of the opinion where the Court merely describes the government’s argument, not in the section where the Court explains its reasoning for adopting that argument. Indeed, given the dissent’s view that the misappropriation theory is inconsistent with section 10(b) itself, it seems relatively clear that the majority’s “complementary” language is an attempt to tie the misappropriation theory to the classical theory and by extension to the statute. In other words, the “complementary” language seems to be more about emphasizing the theories' similarities, not their differences.

This state of the doctrine in the lower courts is unfortunate, if for no other reason than because it perpetuates the relevance of the classical theory. Although the classical theory is almost certainly cited in every classical insider trading case for the past thirty-plus years, the theory has simply outlived its usefulness. In particular, the theory fails to explain what courts actually do, even in the very cases—those involving classical insiders—where the theory is intended to apply. Moreover, with respect to certain unsettled issues of classical insider trading, the classical theory yields results that are simply not intuitively

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85. *See infra* notes 180–83 and accompanying text.
86. *See United States v. O’Hagan*, 521 U.S. 642, 652 (1997) (“The two theories are complementary, each addressing efforts to capitalize on nonpublic information through the purchase or sale of securities.”).
88. *See O’Hagan*, 521 U.S. at 652; *see also* Steginsky v. Xcelera Inc., 741 F.3d 365, 370 n.4 (2d Cir. 2014) (citing the page in *O’Hagan* where the “complementary” language appears, but not citing the language itself).
89. *See id.* at 680–92 (Thomas, J., dissenting).
90. To be sure, the *O’Hagan* majority has a theory as to why the misappropriation theory involves fraud. According to the majority, the failure to disclose the breach of the underlying duty of loyalty is fraudulent. *See id.* at 654–55 (majority opinion). But the notion that it is fraudulent to fail to give notice of the breach of a duty is unheard of in the common law. Hence, Justice Thomas’s dissent.
91. It is difficult to verify this claim, although a Westlaw search reveals that the classical theory has been cited in over 1,000 cases.
appealing. For these reasons, I argue that courts should adopt the misappropriation theory, with some slight modifications, as the unified theory of insider trading law.

II. THE FAILURE OF THE CLASSICAL THEORY

The classical theory fails to explain settled law and, with respect to unsettled law, fails to yield intuitively appealing results. The classical theory has a difficult time explaining why insider trading liability should apply to trading in impersonal markets, illegal tips, and purchases and sales alike. Yet, these are settled results in the Court’s insider trading jurisprudence. Additionally, the classical theory implies that there is no liability for insider trading in debt securities, and it takes a binary approach in deciding whether there is insider trading liability for corporate repurchases. Neither of these results seem normatively correct.

A. SETTLED LAW: THE CLASSICAL THEORY’S FAILURE TO EXPLAIN OBSERVED JUDICIAL OUTCOMES

Under the Supreme Court’s insider trading jurisprudence, there are many factual issues that are legally relevant to the liability determination: the trader must be a fiduciary of the shareholders on the other side of the trade, the trader’s state of mind must meet the scienter requirement, and the information must be material. However, there are three factual distinctions that are completely irrelevant for purposes of determining liability. Specifically, it does not matter whether the insider trades on material, nonpublic information in a face-to-face transaction or over an impersonal exchange. Similarly, liability does not turn on whether the insider himself trades on the material, nonpublic information or, in exchange for a personal benefit, transmits that information to a third party who then trades on it. Nor is it legally relevant whether the insider’s trade is a purchase or sale of securities. Indeed, if there are any fixed stars in the insider trading law firmament, it is these three propositions: insider trading liability extends to trading in impersonal markets, illegal tips, and purchases and sales alike. The problem is that the classical theory is utterly incapable of explaining these results.

92. See Langevoort, supra note 19, § 3:2.
93. See id. § 3:13.
94. See id. § 5:2.
95. See id. § 2:3.
96. See id. § 2:4.
97. See id. § 2:2.
98. See Langevoort, supra note 19, § 1:8.
1. Liability for Insider Trading in Impersonal Markets

In *Chiarella*, the Supreme Court made clear that insider trading liability extends to trading in impersonal markets in virtually the same breath it used to create the classical theory in the first place.\(^{99}\) Although Chiarella bought the stock of the takeover targets over national securities exchanges,\(^{100}\) that was not the reason why Justice Powell, writing for the majority, reversed Chiarella’s rule 10b-5 conviction. On the contrary, Chiarella avoided liability because he was not an insider and therefore lacked any fiduciary relationship with the transaction counterparties whatsoever.\(^{101}\) As to the issue of exchange-based insider trading, the Court clearly assumed that the nature of the transaction—face-to-face or impersonal—was irrelevant and that the common law of fraudulent nondisclosure applied to impersonal and face-to-face transactions alike.\(^{102}\)

However, the Supreme Court was just plain wrong on this score. At common law, it is true that corporate insiders owed a duty of disclosure to shareholder counterparties when trading in face-to-face transactions.\(^{103}\) However, this was an exception to the majority rule that insiders did not generally owe such disclosure duties;\(^{104}\) the widespread view among state courts was that insiders’

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100. *Id.* at 232–33.

101. *See id.* at 231–35.

102. *See id.* at 227–28 (“At common law, misrepresentation made for the purpose of inducing reliance upon the false statement is fraudulent. But one who fails to disclose material information prior to the consummation of a transaction commits fraud only when he is under a duty to do so. And the duty to disclose arises when one party has information ‘that the other [party] is entitled to know because of a fiduciary or other similar relation of trust and confidence between them.’” (alteration in original) (citation omitted)).

103. In reality, there were two approaches at common law to a corporate insider’s disclosure duties when transacting with shareholders. There was the simple rule that corporate insiders did in fact owe such duties. There was also the “special facts” doctrine, which held that corporate insiders owed such duties only when there were special facts at play, such as if the insider attempted to conceal his identity from the shareholder. However, both of these rules applied only to face-to-face transactions, not impersonal transactions over exchanges. *See Barbara A. Ash, State Regulation of Insider Trading—A Timely Resurgence?*, 49 Ohio St. L.J. 393, 399–400 (1988) (“[L]ong before even the promulgation of rule 10b-5, the majority rule [providing that insiders have no duty to disclose when trading with shareholders] had been effectively rendered a minority position by two developments. First, a substantial number of states adopted the ‘special facts’ doctrine, first articulated by the Supreme Court in 1909 in the landmark case of *Strong v. Repide*, 213 U.S. 419 (1909)]. Under that approach, officers and directors have had an affirmative duty to disclose nonpublic information when, in a face-to-face transaction, special circumstances or special facts render nondisclosure unconscionable. Second, several jurisdictions went so far as to require disclosure of nonpublic information to shareholders in all face-to-face transactions irrespective of any special facts or circumstances.”); *see also* Stephen M. Bainbridge, *Incorporating State Law Fiduciary Duties Into the Federal Insider Trading Prohibition*, 52 Wash. & Lee L. Rev. 1189, 1220 (1995) (opining that the special facts doctrine was more prevalent than the duty to disclose rule); Pritchard, *Justice Powell’s Legacy*, supra note 4, at 22–26.

104. *See Ash, supra* note 103, at 399 (“Under what has been referred to as the ‘majority rule,’ an officer or director owed no duty to disclose any information even when the trading transaction was with an existing shareholder.”); Bainbridge, *supra* note 103, at 1221 (“The uniform state law approach in the secondary market context remained a no duty rule.”); Charles C. Cox & Kevin S. Fogarty, *Bases of Insider Trading Law*, 49 Ohio St. L.J. 353, 361 (1988) (noting that when the “Securities Act and the Securities Exchange Act were passed, classic insider trading—transactions between uninformed share-
fiduciary duties did not run to the individual shareholders but to the corporate entity itself.\textsuperscript{105} Therefore, at common law, corporate insiders did not owe a disclosure duty to shareholders with whom they were transacting over impersonal markets.\textsuperscript{106} In fact, in the opinion of the Massachusetts high court—in the most famous case on the matter, and one that still reflects the majority state law view today—this proposition was "supported by an imposing weight of authority in other jurisdictions."\textsuperscript{108} To be sure, Chairman Cary in the \textit{Cady, Roberts} opinion claimed that the duty was owed directly to shareholders,\textsuperscript{109} but he seemed to acknowledge in a footnote that this was not really the case.\textsuperscript{110} And the \textit{Chiarella} Court relied on this portion of the \textit{Cady, Roberts} opinion,\textsuperscript{111} with nary a word regarding Cary’s qualifying footnote.\textsuperscript{112} The result is that the

\begin{enumerate}
\item See supra note 13.
\item See supra note 104.
\item Goodwin v. Agassiz, 186 N.E. 659 (Mass. 1933); see Bainbridge, supra note 103, at 1222 ("Although it is now of considerable antiquity, at least by corporate law standards, Goodwin apparently remains the prevailing state law view.").
\item Goodwin, 186 N.E. at 660. In Goodwin, two insiders of the Cliff Mining Company purchased their company’s stock over the Boston Stock Exchange while in possession of information regarding the existence of copper deposits on some of the property owned by Cliff Mining. See id. at 659–60. The Cliff Mining shareholder who had sold the stock to Agassiz and his colleague sued on the basis that the insiders had a duty to disclose that information to the plaintiff before proceeding with the transaction. See id. at 660. The trial court agreed that the plaintiff’s claim was valid as a theoretical matter but found that there was no disclosure duty in this particular case. See id. The Massachusetts high court, however, disagreed with the plaintiff’s claim, finding that no such duty could ever exist. See id. Assuming the information was material to the stock price, an assumption required in light of the procedural posture of the case, the court nevertheless concluded that the defendants’ failure to disclose the information was not fraudulent or unlawful. See id. at 660–61. Nor could it be, for, as the court explained, corporate directors do not owe fiduciary duties to the individual shareholders. See id. at 660. Rather, they owe these duties to the corporation itself. See id.
\item See id. at 911 n.13 ("Although the ‘majority’ state rule apparently does not impose an affirmative duty of disclosure on insiders when dealing in securities, an increasing number of jurisdictions do impose this responsibility either on the theory that an insider is generally a fiduciary with respect to securities transactions or ‘special facts’ may make him one.").
\item The \textit{Chiarella} Court quoted the part of \textit{Cady, Roberts} where Chairman Cary opined that “the courts have consistently held that insiders must disclose material facts which are known to them by virtue of their position but which are not known to persons with whom they deal and which, if known, would affect their investment judgment.” Chiarella v. United States, 445 U.S. 222, 227 (1980) (quoting \textit{Cady, Roberts}, 40 SEC Docket at 911).
\item It is well known that when William Cary became the Chairman of the SEC in 1961, one of his primary policy goals was to overturn the decision in \textit{Goodwin v. Agassiz}. See, e.g., Langevoort, supra note 47, at 1319. It was no coincidence that Cary himself authored the \textit{Cady, Roberts} opinion, which effectively overturned \textit{Agassiz}. See \textit{Cady, Roberts}, 40 SEC Docket at 907. But he did so simply by ignoring the majority rule articulated in \textit{Agassiz}. In support, Cary cited three cases: two state court cases from 1945 and 1932, and a Supreme Court case from 1909. See id. at 911 n.13. Whatever one
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classical theory, as conceived by Chiarella, does not explain why there is liability for insider trading over impersonal markets.113

2. Insider Trading Liability for Tipping

The Supreme Court developed a doctrine of tipper–tippee liability in a case decided not long after Chiarella. In Dirks v. SEC, the defendant, Raymond Dirks, was a financial analyst who received a tip from Ronald Secrist, a former executive at an insurance company called Equity Funding of America, regarding widespread fraud at the company.114 In the course of investigating these claims, Dirks passed along the fraud-related information to some of his clients, who then traded on the information, presumably by shorting the stock of Equity Funding of America.115 The Court reversed Dirks’s conviction, but not because of the problems that arise when trying to apply the classical theory to tipper—tippee liability.116 Rather, the Court ostensibly117 held that the classical theory would give rise to such liability.118 The Court explained its logic in the following way: the tipper violates his duty of disclosure to shareholders when he transmits material, nonpublic information belonging to the corporation to a third-party for personal gain.119 Assuming the tippee has knowledge of the tipper’s duty and breach, the tipper’s duty then redounds to the tippee, who breaches that duty when he trades in the corporation’s securities.120

This reasoning, however, makes little sense in light of the classical theory. Tipper—tippee liability is a species of derivative liability, meaning that the tippee’s liability derives from the wrongdoing of the tipper.121 But in the case of tipping, what is the nature of the tipper’s wrongdoing? Under the classical theory, one must be able to say that by tipping, the tipper is breaching her duty of disclosure to the shareholders.122

might think of these citations as evidence of “an increasing number of jurisdictions” departing from the majority rule, see id., none of the cited cases actually dealt with the Agassiz issue of open market purchases by insiders. See Strong v. Repide, 213 U.S. 419 (1909); Hobart v. Hobart Estate Co., 159 P.2d 958 (Cal. 1945); Hotchkiss v. Fischer, 16 P.2d 531 (Kan. 1932).

113. See Pritchard, Justice Powell’s Legacy, supra note 4, at 22–26.
115. See id. at 649.
116. See id. at 665–67 (reversing the conviction on the ground that tipper—tippee liability requires that the tipper obtain a “personal benefit” in exchange for the tip, a benefit that was lacking in the case of the whistleblower who had tipped off Dirks).
117. I say “ostensibly” because at the time of Dirks, the only theory of primary liability for insider trading was the classical theory. In reality, however, Dirks is the first case where we begin to see the Court moving from a fraud-based theory of insider trading to the agency-based theory that was finally articulated in O’Hagan v. United States. The tipper’s duty is clearly an agency-based duty, not a fraud-based duty. See infra notes 124–25 and accompanying text.
118. See Dirks, 463 U.S. at 661–64.
119. See id.
120. See id.
121. See Pritchard, Justice Powell’s Legacy, supra note 4, at 27.
122. See Langevoort, supra note 19, § 1:8 (“After Chiarella, it can safely be said that a person violates Rule 10b-5 by trading on material, nonpublic information without disclosing that information
However, that is not what the tipper is doing because she is not actually trading in any securities and, under the classical theory, the deception only occurs if there is insider trading. Instead, the tipper seems to be breaching a duty of confidentiality to the corporation itself by passing that information along to the tippee, and therefore the tippee’s liability should logically derive from this breach of confidentiality. But of course, that view is inconsistent with the classical theory, which bases insider trading liability on the breach of a fraud-based duty to the shareholders rather than the breach of an agency-based duty to the corporation. Consequently, the classical theory does not explain the existence of tipper–tippee liability.

3. No Liability for Purchasers

Finally, the Supreme Court suggested in *Chiarella* that insider trading liability applies regardless of whether the insider is purchasing or selling securities in connection with the fraud. In support of this seemingly obvious proposition, the Court relied on a quote by Judge Learned Hand concerning the absurdity of to the marketplace—the essence of the abstain or disclose theory—if [and presumably only if] he owes a fiduciary duty to marketplace traders.

123. See id.

124. For this reason, the duty at issue in *Dirks* is more readily seen as the duty of confidentiality that the insider owes to the corporation rather than the duty of disclosure owed to the shareholders. See, e.g., Stephen M. Bainbridge, *Insider Trading Regulation: The Path Dependent Choice Between Property Rights and Securities Fraud*, 52 SMU L. Rev. 1589, 1615 (1999) (arguing that in tipping cases, the relevant duty is not a duty to disclose, but rather a duty of confidentiality owed to the corporation); Kim, supra note 12, at 940–41; Pritchard, *Justice Powell's Legacy*, supra note 4, at 27. In fact, the language that the *Dirks* Court uses to describe the duty owed by the tipper bears a much closer resemblance to the duty of confidentiality the insider owes the corporation than the duty of disclosure a fiduciary owes a counterparty. See *Dirks*, 463 U.S. at 659 (“Not only are insiders forbidden by their fiduciary relationship from personally using undisclosed corporate information to their advantage, but they also may not give such information to an outsider for the same improper purpose of exploiting the information for their personal gain.”). In other words, the tipper’s duty seems less like the fraud-based duty of disclosure that forms the basis of the classical theory of insider trading and more like a duty rooted in agency law. See Kim, supra note 12, at 940–41 (comparing the tipper’s duty in *Dirks* to the agency-based duty of confidentiality that the Court developed in *United States v. O'Hagan*). And yet, the *Dirks* Court is also clear that the duty the tippee inherits from the tipper by virtue of the derivative nature of tipper–tippee liability is the *Chiarella* duty of disclosure owed to the shareholders. See *Dirks*, 463 U.S. at 660 (“[A] tippee assumes a fiduciary duty to the shareholders of a corporation not to trade on material, nonpublic information only when the insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee and the tippee knows or should know that there has been a breach.”). Thus, the *Dirks* Court uses the classical theory to create a doctrine of tipper–tippee liability. But it does so by grafting onto that fraud-based classical theory a new agency-based theory of insider trading, while at the same time casually overlooking how this doctrinal move might conflict with the derivative nature of tipper–tippee liability in the first place. See Kim, supra note 12, at 941 (“In *Dirks*, the insider–tipper’s breach of his duty of loyalty and confidentiality, which is owed to the corporation, was then transformed back into a breach by the tippee of a duty of disclosure owed to the corporation’s shareholders.”).

125. See, e.g., Pritchard, *Justice Powell's Legacy*, supra note 4, at 27 (observing that “the tipper’s breach is more readily seen as a breach of his duty of confidentiality owed to the corporation,” rather than a breach of the fraud-based duty of disclosure owed to shareholders under the classical theory).

an insider trading regime that reaches purchases but not sales.\footnote{127}

Although Judge Hand was surely correct on this point, the absurdity lies with the classical theory itself because, under that theory, it is not clear why insider trading liability should apply to purchases of securities. After all, the classical theory is rooted in the common law of fraudulent nondisclosure and therefore requires a fiduciary-like relationship between the insider and the shareholders who are counterparties to the trade.\footnote{128} This requirement poses no problem when the insider is purchasing securities from a current shareholder to whom he owes such a duty. But what about when the insider’s trade is a sale of securities made to someone who is not currently a shareholder of the company? An insider does not owe fiduciary duties to nonshareholders.\footnote{129} Accordingly, the classical theory cannot explain why insider trading liability should apply to purchases of securities by insiders.\footnote{130}

\section*{B. UNSETTLED LAW: THE CLASSICAL THEORY’S FAILURE TO YIELD INTUITIVELY APPEALING RESULTS}

Of course, it would be bad enough if the classical theory simply failed to explain the results of these settled cases. Predictability and consistency, two key characteristics of the rule of law, would be undermined if courts could say one thing but do something entirely different.\footnote{131} However, the state of affairs is even worse than it appears, because the classical theory also fails when it comes to unsettled law. With respect to these open issues, the classical theory results in outcomes that simply lack intuitive appeal.

1. Insider Trading in Debt-Based Securities

Insiders do not generally owe a duty to creditors outside of what courts refer to as the “zone of insolvency.”\footnote{132} Accordingly, the classical theory implies that

\footnotesize{
127. \textit{See id.} (“The Commission embraced the reasoning of Judge Learned Hand that ‘the director or officer assumed a fiduciary relation to the buyer by the very sale; for it would be a sorry distinction to allow him to use the advantage of his position to induce the buyer into the position of a beneficiary although he was forbidden to do so once the buyer had become one.’” (citation omitted)).
128. \textit{See supra} notes 59–63 and accompanying text.
130. \textit{See Pritchard, Justice Powell’s Legacy, supra} note 4, at 26 (“Another doctrinal problem with the classical theory is that the fiduciary obligation of corporate officers and directors generally extends only to current shareholders. That obligation does not extend to prospective shareholders who may purchase their shares for the first time when an insider sells. The classical theory fails to account adequately for this inconsistency with the common law.”).
132. \textit{See Katz v. Oak Indus., Inc.}, 508 A.2d 873, 879 (Del. Ch. 1986) (premising its decision regarding the permissibility of a bond indenture amendment on the principle that bondholders are owed no fiduciary duties outside of insolvency).
}
there could be no insider trading with respect to debt securities. Thus, under the
logic of the classical theory, although the insider is prohibited from trading in
the corporation’s stock while in possession of material, nonpublic information,
this prohibition does not extend to trading in the corporation’s publicly traded
debt while in possession of the same information. Given these facts, it is no
surprise that the majority of courts that apply the classical theory to the issue
find that there is no insider trading liability with respect to trading in debt-based
securities. Yet, this should be deeply unsettling because information that
affects the value of a corporation’s stock can also affect the value of its
publicly-traded debt. Thus, an exception for insider trading in debt seems
wildly ill-conceived, if for no other reason than because of the opportunities it
creates for massive regulatory arbitrage.

To be sure, in analyzing this question, courts typically look to how state law
treats fiduciary duties owed to debtholders. And state courts typically view
debtholders to be protected by contract rather than fiduciary duty law. However,
this reasoning is far from satisfying. After all, shareholders could also
negotiate for protections in the corporate contract (that is, the certificate of
incorporation or bylaws). Of course, one might argue that such a negotiation

133. See Pritchard, Justice Powell’s Legacy, supra note 4, at 28 (“The failure to prevent insider
trading in bonds is a large loophole in the classical theory.”)
134. See, e.g., Lorenz v. CSX Corp., 1 F.3d 1406, 1417–18 (3d Cir. 1993); Broad v. Rockwell Int’l
Corp., 642 F.2d 929, 958–59, 963 (5th Cir. 1981); Alexandra Global Master Fund, Ltd. v. Ikon Office
Sols., Inc., No. 06 Civ. 5383 (JGK), 2007 WL 2077153, at *5 (S.D.N.Y. July 20, 2007); see also
Harvey L. Pitt & Karl A. Groskaufmanis, A Tale of Two Instruments: Insider Trading in Non-Equity
Securities, 49 BUS. LAW. 187, 213 (1993) (“[T]he prevailing notion of debt securities expressly rules out
the fiduciary relationship that gives rise to a duty to abstain or disclose.”). Courts applying this
approach would also presumptively find that convertible noteholders, who are typically not owed fiduciary
duties under state law, are similarly not covered by the classical theory of insider trading. See, e.g.,
Lorenz, 1 F.3d at 1417; Page Mill Asset Mgmt. v. Credit Suisse First Bos. Corp., No. 98 Civ. 6907
N.E. 891, 892 (1889) (Holmes, J.)); Simons v. Cogan, 549 A.2d 300, 303–04 (Del. 1988). But see In re
Worlds of Wonder Sec. Litig., No. C 87 5491 SC, 1990 WL 260675, at *5 & n.6 (N.D. Cal. Oct. 19,
1990).
135. See, e.g., Pitt & Groskaufmanis, supra note 134, at 215–16 (explaining how trading in
high-yield debt resembles trading in equity).
136. See Victor Fleischer, Regulatory Arbitrage, 89 TEX. L. REV. 227, 244 (2010) (construing
“regulatory arbitrage” to include situations where “the same transaction receives different regulatory
treatment under different regulatory regimes”).
137. See, e.g., Lorenz, 1 F.3d at 1417; Salovaara v. Jackson Nat’l Life Ins. Co., 66 F. Supp. 2d 593,
599 (D.N.J. 1999).
(applying Delaware and New York law); Haberman v. Wash. Pub. Power Supply Sys., 744 P.2d 1032,
1061 (Wash. 1987); Simons v. Cogan, 542 A.2d 785, 786 (Del. Ch. 1987) (noting that “[i]t has now
become firmly fixed in our law” that directors and officers do not owe the corporation’s bondholders
any “duty of the broad and exacting nature characterized as a fiduciary duty”).
139. See FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW
16–17 (1991) (discussing how the corporate contract includes the certificate of incorporation, which
reflects the corporation’s choice of governance mechanisms).
is unrealistic in light of collective action costs. But it is far from clear that shareholders could not overcome these collective action costs in the same way that dispersed bondholders have.

Perhaps in light of these considerations, a small minority of courts avoid applying the classical theory to this issue and take a more policy-driven approach. These courts have shown a willingness to look beyond state fiduciary duty law in determining the applicability of the classical theory, taking into account any features that might make the debt security look more like equity. For example, these courts tend to reason that, like equity holders, debt holders

invest capital into the corporation, and...contribute to its ability to attract equity. Both [stockholders and debt holders] rely on the corporation to keep them apprised of its affairs, and both are justified in presuming that corporate insiders are not abusing their position by profiting from undisclosed corporate information.

Of course, the problem with this approach is that under this reasoning, it is difficult to identify corporate borrowing that would not entail such a fiduciary relationship.

Perhaps for this reason, most courts tend to take an alternative approach in these cases. As an alternative, some commentators have advocated for an approach that would take into account more specific contextual factors, while at the same time articulating a limiting principle that would avoid extending fiduciary duties to all creditors. For example, it has been suggested that courts should account for the extent to which investors in debt instruments are

141. See, e.g., Kelli A. Alces, Debunking the Corporate Fiduciary Myth, 35 J. CORP. L. 239, 278–80 (2009) (proposing an “equity trustee” can represent shareholder interests in the same way that an indenture trustee represents the interests of bondholders).
143. See cases cited supra note 142.
145. See, e.g., Alexandra Global Master Fund, Ltd. v. Ikon Office Sols., Inc., No. 06 Civ. 5383 (JGK), 2007 WL 2077153, at *6 (S.D.N.Y. July 20, 2007) (“[The] Green decision is no longer good law to the extent that it holds that Delaware recognizes a fiduciary duty owed by an issuer to convertible debenture holders.”).
motivated by something other than just the contractually provided-for principal and interest. Under this approach, if investors in a debt instrument are, like equity investors, motivated by the gains from trading the security, for example, then perhaps the duty to abstain or disclose under the classical theory should apply to such debt instruments. Presumably, such an approach would find that the classical theory applies to heavily-traded debt instruments like junk bonds.

2. Insider Trading Through Open Market Repurchases

When a corporation repurchases its own securities while in possession of material, nonpublic information, the view of the SEC (and many commentators) is that the repurchase represents an example of indirect insider trading by the corporate directors themselves. In that case, application of the classical theory implies that the corporation must disclose any material, nonpublic information to shareholders or abstain from the repurchase. To be sure, this approach is not entirely without appeal. After all, a corporate repurchase reduces the number of shares outstanding, and therefore it has the same effect on an insider’s stock holdings in the corporation as a purchase of stock by that insider (assuming the insider does not sell into the repurchase). Therefore, failure to disclose material, nonpublic information prior to the repurchase looks a lot like indirect insider trading.

In reality, however, things are probably more complicated than this analogy would suggest. There is well-developed literature addressing why corporations might favor repurchases over the payment of dividends as a way of returning cash to shareholders. These reasons include minimizing the tax impact,
preserving financial flexibility.\textsuperscript{154} and signaling market undervaluation.\textsuperscript{155} Although directors surely benefit from repurchases through the incremental increase of their ownership percentage of the corporation,\textsuperscript{156} so do all of those shareholders who decide not to sell into the repurchase. Of course, the selling shareholders ultimately lose out if they would not have sold but for the withholding of any material, nonpublic information. But it is not entirely clear why the law should go out of its way to protect those selling shareholders, especially if one of the purposes of the repurchase was to signal the market’s undervaluation of the corporation’s stock.\textsuperscript{157}

If repurchases have real benefits for shareholders as compared to dividends, then the application of the classical theory makes repurchases less likely. After all, there might be times when the corporation wishes to return cash to shareholders through the most efficient means possible, which is the repurchase. At the same time, the corporation might be in possession of material information that cannot yet be disclosed to the public without destroying value—for example, when a contemplated transaction has not yet been reduced to a definitive agreement. In those instances, the classical theory would leave the directors with undesirable alternatives: use a less efficient vehicle for returning cash to shareholders or wait until a later time.\textsuperscript{158} And this latter alternative—waiting until the corporation has disclosed all material, nonpublic information—might be a non-starter, especially if one of the purposes of the repurchase is to signal the market’s undervaluation of the corporation’s stock at the current moment.\textsuperscript{159}

For these reasons, the classical theory may not be the optimal approach for dealing with insider trading through corporate repurchases. Not surprisingly, then, other approaches have been suggested, including a rule of no-insider-trading.

\begin{itemize}
\item \textsuperscript{154} See Fried, supra note 153, at 1338. See generally Jagannathan et al., supra note 152.
\item \textsuperscript{155} See Comment & Jarrell, supra note 152, at 1245; Fried, supra note 153, at 1328; McNally, supra note 152, at 57–58.
\item \textsuperscript{156} See Fried, supra note 16, at 804–05.
\item \textsuperscript{157} All U.S. stock exchanges require a listed corporation to disclose the board’s approval of an open market repurchase program. See Fried, supra note 153, at 1340–41. However, neither the SEC nor the exchanges specifically require corporations to disclose the details of the repurchase and therefore, not surprisingly, there is variation as to this disclosure. See id.
\item \textsuperscript{158} Others have expressed similar views. See, e.g., Donald C. Langevoort & G. Mitu Gulati, The Muddled Duty to Disclose Under Rule 10b-5, 57 VAND. L. REV. 1639, 1659 (2004) (“The issuer repurchase context is different from that of the classical insider trade; hence, a simple extension of the classical insider’s duty might be problematic. This point becomes clearer if one thinks about what the implications of the ‘disclose or abstain’ rule means in the classical insider versus issuer (doing a repurchase) contexts. Given that making full disclosure of all the material, nonpublic information at her disposal is not a viable option for the classical insider (she would likely get promptly fired for revealing the company’s confidential information), the rule amounts to a mandate that she abstain from trading when in possession of an informational advantage. In other words, it is the ‘abstain’ part of the ‘disclose or abstain’ rule that is at work. That seems acceptable, given that the position of the Court appears to be that classical insiders should not trade based on informational advantages gained as a result of their corporate positions.”).
\item \textsuperscript{159} This signaling hypothesis for repurchases has both theoretical and empirical support. See generally Baker et al., supra note 152; Grullon & Ikenberry, supra note 152. But see Fried, supra note 151 (critiquing the signaling theory on both theoretical and empirical grounds).
\end{itemize}
trading liability for corporate repurchases and a rule that makes liability turn on whether disclosure of material, nonpublic information prior to the repurchase would be cost effective.\textsuperscript{161}

The general takeaway is that the classical theory fails to explain settled law and, with respect to unsettled law, leads to intuitively unappealing results. To get a sense of the magnitude of the classical theory’s failure, consider how the logic of the theory, if followed to the letter, would create opportunities for regulatory arbitrage.\textsuperscript{162} Consider the CEO of a financially beleaguered company who is trying to profit from the fact, not yet disclosed to the public, that the corporation will soon receive a much-needed capital infusion from a respected, world-renowned investor. Once disclosed to the market, this information will

\textsuperscript{160} This rule follows from a view that a corporate repurchase constitutes trading by the corporation itself. Although corporate insiders might owe fiduciary duties directly to shareholders, the corporate entity does not owe shareholders any such duties; and in the absence of a duty to disclose material, nonpublic information, the corporation incurs no liability for its repurchase. See In re Stillwater Capital Partners Inc. Litig., 851 F. Supp. 2d 556, 573 (S.D.N.Y. 2012) (”A corporation does not owe a fiduciary duty to its shareholders . . . .”); A.W. Fin. Servs., S.A. v. Empire Res., Inc., 981 A.2d 1114, 1127 (Del. 2009) (”Clearly[,] the . . . corporation . . . is not a fiduciary to the plaintiff, which is its stockholder.”); Arnold v. Soc’y for Sav. Bancorp, Inc., 678 A.2d 533, 539 (Del. 1996) (rejecting argument that a corporation can be liable for breach of fiduciary duty of disclosure); Alessi v. Beracha, 849 A.2d 939, 950 (Del. Ch. 2004) (dismissing breach of fiduciary duty claim against corporation because “[the corporation] owes no fiduciary duty to [the stockholder]”); In re Wheelabrator Techs. Inc. S’holders Litig., C.A. No. 11495, 1992 WL 212595, at *9 (Del. Ch. Sept. 1, 1992) (“[T]he corporate entity as such is not a fiduciary to its stockholders and cannot be held liable to them on that basis . . . .”); see also DeMott, supra note 16, at 884 (“The notion that a corporation owes a fiduciary obligation to its own shareholders poses analytic challenges of heroic dimensions . . . .”); Fried, supra note 16, at 813–14 (“The SEC takes the position that Rule 10b-5 also applies to a firm buying its own shares. The doctrinal basis for the SEC’s position, however, is somewhat shaky: although a corporation’s insiders clearly owe a fiduciary duty to shareholders, the corporation itself may not.”); Langevoort & Gulati, supra note 158, at 1658 (“To the extent that the teaching of Chiarella is that courts are supposed to draw disclosure duties exclusively from those fiduciary type relationships recognized by the common law, it does not look like there is much support for finding a direct duty running from the issuer to the investors. If one looks to Delaware state law—after all, Delaware is surely the dominant player in terms of articulating state corporate law obligations—it tells us that issuers (as opposed to boards of directors) do not owe disclosure duties to shareholders.”). But see, e.g., Kohler v. Kohler Co., 319 F.2d 634, 638 (7th Cir. 1963) (holding that corporate repurchases raise the same liability issues as direct trading by insiders); Dolgow v. Anderson, 43 F.R.D. 472, 498–99 (E.D.N.Y. 1968) (same).

161. For example, in the influential case of Jordan v. Duff & Phelps, Inc., Judge Easterbrook articulated the view for the majority of the panel that whether a public company’s open market repurchase violates Rule 10b-5 depends on whether the corporation’s nondisclosure of the material, nonpublic information would benefit shareholders as a whole. See 815 F.2d 429, 431 (7th Cir. 1987) (“[A] law designed to prevent frauds on investors tolerates silence that yields benefits for investors as a group.”). That question depends on the nature of the material, nonpublic information and the value of silence to the shareholders. Consider, for example, the case of a public corporation involved in ongoing merger negotiations which, once announced, will lead to a significant increase in the price of the company’s stock. The Duff & Phelps court indicated that in such a case, a corporate repurchase would not give rise to a duty to disclose the information about the merger until the negotiations have matured to a point where the parties have agreed to the price and structure of the deal. See id. at 434. The court’s view was that prior to that point, the benefits of nondisclosure to the shareholders as a whole outweigh the possible costs of nondisclosure that are borne by the few unfortunate shareholders who happen to sell into the corporation’s repurchase. See id.

162. See Fleischer, supra note 136, at 244.
lead to a significant increase in the value of the corporation’s stock as well as its publicly traded debt. The company’s stock is traded on a national securities exchange, and the corporate insiders believe that it is significantly undervalued. Additionally, assume that the corporation is sitting on a substantial cash pile, most of which management would like to return to the shareholders in a tax-efficient manner on a one-time basis. Finally, the company’s founder still owns a large block of stock even though he is, at this point, no more than a passive investor.

How might the CEO profit from this information? First, she could purchase a block of stock from the founder in a face-to-face transaction. Second, she could refrain from trading herself, instead passing the tip along to a former college roommate, an investment banker, whom the CEO knows will generously return the favor by allowing her to participate in any hot IPOs that might be in the bank’s pipeline. Third, the CEO could purchase stock over a stock exchange. Fourth, she could purchase the corporation’s publicly traded debt. Fifth, the CEO could cause the corporation to repurchase a significant portion of its stock, which would have the effect of increasing the CEO’s equity holdings in the corporation. Finally, let’s say the CEO’s nonpublic information turns into bad news—perhaps the market is expecting an announcement that the respected, world-renowned investor will make the capital infusion, but it turns out the corporation was not able to make that happen. In that case, the CEO could sell (borrowed) stock instead of buying it. Once the bad news is announced and the stock takes a nosedive, the CEO could then purchase stock at the lower price and return the stock that she borrowed, thus locking in the difference between the high pre-announcement price at which she bought and the low post-announcement price at which she sold.

This hypothetical illustrates no fewer than six different ways that the corporate insider could profit from the inside information. And yet, under the classical theory, only the first scheme (face-to-face transactions involving corporate insiders) and the fifth scheme (corporate repurchases) would be subject to liability. Under the logic of the classical theory, all of the rest would fall outside the scope of liability. And with respect to the fifth scheme (the corporate repurchase), it is not clear that the classical theory’s result—liability for a failure to disclose—is the optimal approach, especially if the repurchase represents a tax-efficient way of returning cash to shareholders on a one-time basis while also signaling the market’s undervaluation of the stock.

We need a different theory of insider trading law, one that will do a better job explaining the settled law of insider trading and, with respect to the open issues, yield results that are more intuitively appealing. In the next section, I propose such a theory.

III. A Unified Theory of Insider Trading Law

In this section, I argue that the theory that would help us make sense of classical insider trading (both the settled and unsettled issues) is one that courts already have some experience with, albeit in a different context. The theory I refer to, of course, is the misappropriation theory, which has historically been applied only to cases involving outsiders to the corporation whose securities form the basis of the challenged trade. I argue that the misappropriation theory should replace the classical theory as the sole, unified theory of insider trading.

A. The Misappropriation Theory and Its Application by the Lower Courts

1. Overview of the Misappropriation Theory

Under the misappropriation theory, insider trading liability attaches only if the trader owes a duty of confidentiality to the source of the material, nonpublic information that forms the basis of the trade.\[^{164}\] Although this rule seems straightforward enough, it actually faced significant challenges at the Supreme Court—challenges that went to the very heart of the statute. The first statutory problem arises because section 10(b) is first and foremost an anti-fraud provision. The statute requires deception, and not just a breach of fiduciary duty. This much was clear as a matter of precedent long before \textit{O’Hagan}.\[^{165}\] But section 10(b) is a specific type of anti-fraud provision. It is an anti-fraud provision that is focused on the securities industry in particular. Thus, section 10(b) prohibits not just the use of a deceptive device in general, but rather the use of a deceptive device “in connection with” the purchase or sale of securities.\[^{166}\]

Under the misappropriation theory, where exactly is the deception? And assuming deception, can that deception be said to be in connection with the purchase or sale of securities?

The difficulty in identifying the deceptive element of the misappropriation theory has to do, at least in part, with the theory’s agency-based origins. Because the classical theory was rooted in common law fraud, the conduct circumscribed by that theory was by definition deceitful at common law. But the misappropriation theory is a different matter entirely because it is not at all clear that fraud or deceit is what motivated agency law’s ban on an agent profiting from the agency relationship itself. In fact, that rule seems to be more of a

variation on the property law rule of conversion.\textsuperscript{167}

The Supreme Court solved this problem by adopting the government’s theory that an agent acts deceitfully when trading on the principal’s material, nonpublic information because he is holding himself out to the principal as a loyal agent while also acting in a disloyal fashion.\textsuperscript{168} One of the logical implications of this reasoning, however, is that a misappropriating outsider like O’Hagan could remove himself from the reach of rule 10b-5 either by announcing his disloyalty to the information source (by simply disclosing the intent to profit from the information),\textsuperscript{169} or by not acting disloyally in the first place (by obtaining the information source’s authorization to profit from the information in question).\textsuperscript{170} In this sense, the misappropriation theory gives rise to an insider trading prohibition that is in reality a type of default rule, allowing the source of the information and the trader to contract around the prohibition. However, I would characterize it as a “unilateral” default rule because it allows the trader to unilaterally contract around the prohibition by simply announcing an intention to trade on the information.

The second statutory problem—whether under the misappropriation theory, the deception occurs in connection with the purchase or sale of securities—was the source of greater disagreement between the majority and the dissent in \textit{O’Hagan}.\textsuperscript{171} The majority said that the “in connection with” element was satisfied under the misappropriation theory “because the fiduciary’s fraud is consummated, not when the fiduciary gains the confidential information, but when, without disclosure to his principal, he uses the information to purchase or sell securities. The securities transaction and the breach of duty thus coincide.”\textsuperscript{172} In other words, O’Hagan’s misappropriation was “connected to the securities trade because it [was] the act of trading securities.”\textsuperscript{173} In articulating this “coincidence” test, the majority was clearly trying to emphasize that “[t]he [misappropriation] theory does not catch all conceivable forms of fraud involving confidential information; rather, it catches fraudulent means of capitalizing

\textsuperscript{167} See, e.g., Bainbridge, \textit{supra} note 124, at 1611 (suggesting the misappropriation theory is analogous to the conversion of property).

\textsuperscript{168} \textit{See O’Hagan}, 521 U.S. at 653–54 ("We observe, first, that misappropriators, as the Government describes them, deal in deception. A fiduciary who ‘[pretends] loyalty to the principal while secretly converting the principal’s information for personal gain[,]’ ‘dupes’ or defrauds the principal.” (alteration in original) (citation omitted)).

\textsuperscript{169} In the case of \textit{O’Hagan} itself, O’Hagan would presumably have had to make this disclosure to both his law firm and the law firm’s client because he arguably owed fiduciary duties to both.

\textsuperscript{170} \textit{See O’Hagan}, 521 U.S. at 655 (“[F]ull disclosure forecloses liability under the misappropriation theory: Because the deception essential to the misappropriation theory involves feigning fidelity to the source of information, if the fiduciary discloses to the source that he plans to trade on the nonpublic information, there is no ‘deceptive device’ and thus no § 10(b) violation—although the fiduciary-turned-trader may remain liable under state law for breach of a duty of loyalty.”).

\textsuperscript{171} \textit{Compare O’Hagan}, 521 U.S. at 655–59, with \textit{id.} at 680–92 (Thomas, J., dissenting).

\textsuperscript{172} \textit{Id.} at 656 (majority opinion).

\textsuperscript{173} Painter et al., \textit{supra} note 27, at 185.
on such information through securities transactions.”\footnote{174}{\textit{O’Hagan}, 521 U.S. at 656.} The problem, though, is that if the goal is to reach misappropriated information monetized through securities transactions, the coincidence test is too strict for the task.\footnote{175}{For this reason, lower courts have interpreted \textit{O’Hagan} to mean that the coincidence test is not a necessary condition for satisfying the “in connection” with element. See, e.g., United States v. Falcone, 257 F.3d 226, 233 (2d Cir. 2001).} In particular, the coincidence test would arguably foreclose the possibility of using the misappropriation theory to reach tippers and tippees. After all, if a misappropriator like O’Hagan were to share his information about the pending tender offer rather than trade on it himself, the fraud would take place the moment O’Hagan breached his duty of loyalty by passing the information to the friend. Yet, the securities transaction would not take place until the friend actually relied on that information to complete a trade. In any case, it seems unlikely that the coincidence test would be met there.

Another potential problem with the coincidence test, as the \textit{O’Hagan} dissent pointed out, is that it appears to sweep in other types of misappropriation that seem beyond the reach of the statute.\footnote{176}{See \textit{O’Hagan}, 521 U.S. at 680–86 (Thomas, J., dissenting).} For example, the government conceded in its brief that the statute would not reach the case where the misappropriation is not of information but of funds, which are subsequently used for securities trading.\footnote{177}{See id. at 656–57 (majority opinion).} But as the dissent pointed out, there are scenarios where fraud involving misappropriated funds might nevertheless “coincide” with the securities transaction, thereby satisfying the majority’s test.\footnote{178}{See id. at 685 (Thomas, J., dissenting) (positing a scenario “where a broker is directed to purchase stock for a client and instead purchases such stock—using client funds—for his own account”).} The majority’s response to this argument was that the misappropriation of information (some of which falls within the statute’s reach) is simply different from the misappropriation of money, which falls outside of the reach of the statute.\footnote{179}{See id. at 656–57 (majority opinion) (arguing that confidential information pertaining to publicly traded companies derives its value ordinarily from its utility in securities trading).} The reason given was that misappropriated information derives its value “ordinarily” from its utility in securities trading, whereas misappropriated funds have a multitude of valuable uses.\footnote{180}{See id.}

2. The Lower Courts Only Apply the Misappropriation Theory to Insider Trading Involving “Outsiders”

It bears emphasizing that the misappropriation theory is only applied to cases involving corporate outsiders. As a general matter, courts view the misappropriation theory as completely inapplicable to the classic case, where the one doing the insider trading is a true corporate insider.\footnote{181}{See cases cited supra note 22.} From the perspective of the
courts, the two theories—the classical theory and the misappropriation theory—are entirely distinct.

However, the reason for this insistence on the distinctness of the two theories is not due to the conceptual difficulty of applying the misappropriation theory to the classic case of insider trading involving true corporate insiders. In fact, such an analysis flows rather naturally from the theory itself. The misappropriation theory is predicated on a duty of loyalty or confidentiality to the information source. Thus, if we were to apply the theory to the classic case of insider trading, we would need to determine the source of the insider’s material, nonpublic information regarding the corporation’s securities. Importantly, that source is not the shareholders. Rather, the source of the information in the classic case must be the corporation itself. Thus, applying the misappropriation theory to the classic case of insider trading, liability would attach only if the insider owed a duty of loyalty to the corporation, as indeed they do. In fact, this is typically how corporate law conceives of the beneficiary of fiduciary duties—as the corporation itself, not the shareholders.

B. THE MISAPPROPRIATION THEORY DOES A BETTER JOB EXPLAINING SETTLED LAW

If the misappropriation theory were applied to the classic case of insider trading, then two things would need to be shown to establish primary liability: (1) that the insider had a duty of loyalty to the corporation (which, of course, is true by definition); and (2) that the insider, without receiving prior authorization from or giving prior notice to the corporation, breached that duty of loyalty either by trading on confidential information belonging to the corporation or passing along that information to a third party.

Notice that this analysis differs from the classical theory in two important respects. First, under the misappropriation theory, the duty is owed to the corporation itself rather than to the traders against whom the defendant is trading. And, second, to avoid rule 10b-5 liability under the misappropriation theory, the disclosure (of an intent to trade, not of the material information itself) must be made to the corporation rather than to the shareholders. Although seemingly minor, these analytical differences nevertheless lead to significantly different legal outcomes.

182. See, e.g., Kim, supra note 12, at 939 n.56 (“To be sure, all classical theory violations could alternatively be recharacterized as misappropriation theory violations. But this is typically not done in the doctrine or the commentary.”). Cf. Stephen M. Bainbridge, Insider Trading Law and Policy 109–13 (2014) (evaluating insider trading by government officials from both classical and misappropriation theory perspectives and suggesting that there is no conceptual reason to oppose using the two theories in a complimentary way).

183. See supra note 13.
1. The Misappropriation Theory Explains Liability for Trading in Impersonal Markets

Recall that the classical theory does not, as a logical matter, obviously reach insider trading in impersonal markets because, at common law, the fraud-based duty underlying the classical theory did not apply outside of face-to-face transactions. However, this is not a concern with the agency-based duty underlying the misappropriation theory. At common law, the insider owes a duty of loyalty to the corporation, and whether that insider subsequently misappropriates information to profit from securities trading in impersonal markets or face-to-face transactions is entirely irrelevant. Thus, under the misappropriation theory, there is insider trading liability when a fiduciary trades in his corporation’s securities in impersonal markets.

2. The Misappropriation Theory Explains Liability for Sales as Well as Purchases

Furthermore, because under the misappropriation theory, the duty is owed to the corporation rather than to the shareholders, there is no question that liability would reach the defendant’s conduct regardless of whether he is buying or selling. This is in contrast to the classical theory, which does not logically extend liability to an insider’s sales of securities if the purchasers were not shareholders of the firm prior to the transaction with the insider.

3. The Misappropriation Theory Explains Tipper–Tippee Liability

Nor does the misappropriation theory create any ambiguity about tipper liability, as is the case under the classical theory. Consider once again the classic tipper–tippee scenario: the corporate insider passes along material, nonpublic information belonging to the corporation to a third party in exchange for something of value. The third party then profits from this information by trading in securities.

Under the classical theory, there is nothing in the tipper’s misappropriation of that information that amounts to a breach of the disclosure duty that forms the basis of liability in the classical theory. That disclosure duty arises only if the trader is trading against securities holders to whom he owes a fiduciary (or fiduciary-like) duty. Yet, the tipper is not trading in securities at all, and therefore there is no duty to disclose and consequently no breach. Because tipper–tippee liability is a species of derivative liability, and the tipper has not

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184. See supra notes 99–113 and accompanying text.
186. This is because, as non-shareholders, those purchasers are not owed a duty by the insider, which is a prerequisite under the classical theory. See supra note 129 and accompanying text.
187. See supra notes 121–25 and accompanying text.
188. See Langevoort, supra note 19, § 3:2.
189. See Kim, supra note 12, at 940–43; Pritchard, Justice Powell’s Legacy, supra note 4, at 27.
breached the duty at the core of the classical theory, it is not clear why the tippee has any liability either.  

This problem does not arise, by contrast, under the misappropriation theory. Although the tipper does not breach his duty of disclosure under the classical theory by misappropriating information, he does breach his duty of loyalty or confidentiality under the misappropriation theory. Thus, under the misappropriation theory, the tipper’s conduct does give rise to liability, which is then extended to the tippee by virtue of the derivative nature of tipper–tippee liability.

C. THE MISAPPROPRIATION THEORY DOES A BETTER JOB GUIDING UNSETTLED LAW

When applied to the classic case of insider trading, the misappropriation theory does not give rise to the problems that the classical theory creates with respect to these three issues of settled law. Furthermore, with respect to the two issues of unsettled law, the misappropriation theory results in outcomes that are arguably more intuitively appealing than those generated by the classical theory.


Recall that the classical theory treats open market repurchases in the same way as direct trading by management—the corporation must disclose all material, nonpublic information or abstain from the repurchase. However, corporate repurchases benefit not only insiders, but shareholders as well—among other things, corporate repurchases can be a tax-efficient way of distributing cash to shareholders, and they can be used as a way of signaling the market’s undervaluation of the stock. To the extent that these benefits are time-sensitive—and signaling of market undervaluation certainly seems to be—the classical theory’s disclose-or-abstain rule could be suboptimal.

Application of the misappropriation theory presents an intriguing alternative. Under the misappropriation theory, the relevant question is whether the board who authorizes the repurchase is nevertheless acting as a loyal agent. After all, under the misappropriation theory, the agent violates rule 10b-5 only if, by engaging in insider trading, he acts disloyally to the principal while at the same time feigning loyalty. Under the facts of O’Hagan, there is no question that

190. See supra notes 121–25 and accompanying text.
191. See Loewenstein & Wang, supra note 148, at 70–72. This is of course assuming one does not view the repurchase as direct trading by the corporation itself, in which case there would be no insider trading liability as the corporate entity owes no duties to shareholders. See Fried, supra note 16, at 813–14.
192. See supra notes 148–61 and accompanying text.
193. See United States v. O’Hagan, 521 U.S. 642, 653–54 (1997) (“We observe, first, that misappropriators, as the Government describes them, deal in deception. A fiduciary who [pretends] loyalty to the principal while secretly converting the principal’s information for personal gain,’ ‘dupes’ or defrauds the principal.” (alteration in original) (citation omitted)).
the agent was acting disloyally. But this is not clear in the corporate repurchase context because a repurchase benefits not only insiders, but (certain) shareholders as well.

If application of the misappropriation theory to the corporate repurchase context would entail an analysis of the board’s loyalty, what exactly would that analysis look like? Presumably, this type of inquiry would look very similar to the way state corporate law analyzes duty of loyalty questions. If the board is deemed to be disinterested, then the corporate repurchase decision would receive deference under the business judgment rule and would effectively be shielded from liability. If, by contrast, the board is conflicted, the court would then consider the entire fairness of the transaction. Under an entire fairness analysis, a number of factors would become relevant, including the purpose behind the repurchase and the feasibility of postponing the repurchase until disclosure was possible.

The larger point is that the misappropriation theory would not treat open market repurchases in the strict black-and-white way that the classical theory does. Under the misappropriation theory, the board’s failure to disclose all material, nonpublic information prior to the repurchase would not automatically give rise to insider trading liability. Instead, the board would have the opportunity to prove why the repurchase without prior disclosure of material information was nevertheless fair.

194. See id. at 653 (“In this case, the indictment alleged that O’Hagan, in breach of a duty of trust and confidence he owed to his law firm, Dorsey & Whitney, and to its client, Grand Met, traded on the basis of nonpublic information regarding Grand Met’s planned tender offer for Pillsbury common stock. This conduct, the Government charged, constituted a fraudulent device in connection with the purchase and sale of securities. We agree with the Government that misappropriation, as just defined, satisfies § 10(b)’s requirement that chargeable conduct involve a ‘deceptive device or contrivance’ used ‘in connection with’ the purchase or sale of securities.” (citation omitted)).


196. See, e.g., In re Trados Inc. S’holder Litig., 73 A.3d 17, 44–45 (Del. Ch. 2013) (“To obtain review under the entire fairness test, the stockholder plaintiff must prove that there were not enough independent and disinterested individuals among the directors making the challenged decision to comprise a board majority. To determine whether the directors approving the transaction comprised a disinterested and independent board majority, the court conducts a director-by-director analysis.” (citation omitted)).

197. See, e.g., Weinberger v. UOP, Inc., 457 A.2d 701, 711 (Del. 1983) (“The concept of fairness has two basic aspects: fair dealing and fair price. The former embraces questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and the stockholders were obtained. The latter aspect of fairness relates to the economic and financial considerations of the proposed merger, including all relevant factors: assets, market value, earnings, future prospects, and any other elements that affect the intrinsic or inherent value of a company’s stock.”). In some ways, this type of analysis would resemble the approach taken by the Seventh Circuit in Jordan v. Duff & Phelps, Inc., 815 F.2d 429 (7th Cir. 1987). See supra note 161.
2. The Misappropriation Theory Would Create Liability for Insider Trading in Debt Securities

When applied to trading in debt securities, the classical theory yields a result that is also intuitively unsettling. Because fiduciaries do not owe duties to creditors, they have no duty to disclose or abstain from trading in debt securities when in possession of material, nonpublic information. But of course, many of the same concerns that animate insider trading in stock also apply to insider trading in debt. This therefore represents a potentially significant loophole in the law. To be sure, because there is an explicit contract governing the creditor–debtor relationship, creditors stand in a different relationship to the corporation than shareholders. But with respect to publicly traded debt, where the debtholders are not involved in the contract negotiation, the ability of debtholders to protect themselves does not seem all that different from the ability of shareholders to do the same.

Applying the misappropriation theory here would undoubtedly extend insider trading liability to trading in debt securities in the classical insider trading case. In fact, this result is fairly well-established in cases involving corporate “outsiders,” which is the only situation where the misappropriation theory is applied under current law. Because the misappropriation theory is premised on a duty to the source of the information, all that matters is that the individual misappropriates information in connection with the purchase or sale of securities, regardless of the type of securities that the insider actually trades. If courts were to apply the misappropriation theory to the classic case of insider trading, then there is no logical reason why the result would not be to extend liability to insiders whose insider trading is focused on debt securities.

198. See supra note 138 and accompanying text.
199. See supra note 134 and accompanying text.
200. See supra notes 143–47 and accompanying text; see also, e.g., Alan Strudler & Eric W. Orts, Moral Principle in the Law of Insider Trading, 78 Tex. L. Rev. 375, 392 (1999) (“Because the roles of debt, equity, and hybrid debt–equity instruments in the capital structure of the firm are to a significant extent interchangeable, and because various kinds of debt qualify as ‘securities’ subject to federal law, there seems to be no relevant difference between stock and public debt for purposes of insider trading law.”).
201. There might be other loopholes as well. For example, some have argued that the same concerns that animate insider trading in securities also apply to insider trading in commodities. See generally Andrew Verstein, Insider Trading in Commodities Markets, 102 Va. L. Rev. 447 (2016).
202. See, e.g., Alexandra Global Master Fund, Ltd. v. Ikon Office Sols., Inc., No. 06 Civ. 5383 (JGK), 2007 WL 2077153, at *5 (S.D.N.Y. July 20, 2007) (“It is well established that corporations do not have a fiduciary relationship with their unsecured creditors, including debt security holders. The relationship is contractual rather than fiduciary.”).
203. See, e.g., SEC v. Not hern, 598 F. Supp. 2d 167, 174–75 (D. Mass. 2009) (finding a portfolio manager liable under the misappropriation theory where the manager bought government bonds in breach of a duty of confidentiality owed to the Treasury Department of which he was not an employee).
204. Cf. Bainbridge, supra note 182, at 99–100 (concluding that the misappropriation theory could be used to extend insider trading liability to trading in debt securities).
D. CONCLUSION

What then is one to make of all of this? The classical theory does a poor job of explaining judicial outcomes in the classical insider trading cases involving true corporate insiders. The misappropriation theory, by contrast, can explain these judicial outcomes. And with respect to those classical insider trading cases where the law is not yet settled, the misappropriation theory arguably results in outcomes that are more intuitively appealing than the classical theory itself.

How is it that the misappropriation theory does a better job explaining these settled cases even though the courts explicitly say that they are not applying that theory?205 What is going on? One possibility is that there is some conceptual spillover from the misappropriation theory that inevitably influences the courts in these cases. Indeed, we see this as early as Dirks, where the Court, purporting to apply the classical theory to tipper–tippee liability, effectively anchored the tipper’s liability in the misappropriation theory—and did so even before the misappropriation theory was adopted in O’Hagan.206 So, from the very beginning—in fact before the beginning—the misappropriation theory has had a certain gravitational pull, and perhaps it is still exerting this influence.

Indeed, perhaps it should not be surprising that the courts feel pulled toward the misappropriation theory despite their apparent disavowal of it in cases involving classical insider trading. Although the classical theory is an elegant solution to the problem of insider trading, in many ways its attempt to rely on corporate law fiduciary duty concepts is extraordinarily misguided. The problem is that, as a theoretical matter, fiduciary duties are owed to the corporate entity itself or, in the more modern formulation, to the corporation and its shareholders.207 Some commentators have suggested this ambiguity creates “dynamic fiduciary duties,” providing directors and managers the leeway to decide, based on context, precisely whom the beneficiary of the duty should be.208 More specifically, although fiduciary duties ultimately run to the corporate entity, shareholder-welfare maximization is a default rule of thumb intended to help corporate directors satisfy those corporate duties.209 But as with all default rules, this one can be ignored by the board if necessary.

In other words, the classical theory unduly limits fiduciary duties by conceiving of them as running only to shareholders. The implication is that the deception required for insider trading liability must be a deception worked on the shareholders and the shareholders alone. Under such a view of insider trading...
trading, it is little wonder that the classical theory creates the type of puzzling liability gaps identified in this Article.

IV. A POLICY RECOMMENDATION

The unified theory of insider trading law is therefore a unified misappropriation theory of insider trading law. Unifying the doctrine in this way raises a number of issues regarding implementation. It also raises objections that apply to the misappropriation theory more generally.

A. THE MISAPPROPRIATION THEORY AS THE UNIFIED LAW OF INSIDER TRADING: QUESTIONS OF IMPLEMENTATION AND EFFECTS

The foregoing analysis weighs in favor of the following policy recommendation: courts should adopt the misappropriation theory as the unified rule of insider trading law, regardless of whether the defendant is an outsider or an insider of the corporation whose securities form the basis of the trade at issue. This policy recommendation raises at least two important questions: First, can federal appellate courts reach this conclusion without a ruling from the Supreme Court? And, second, what practical effect would this policy recommendation have, if adopted?

The answer to the first question is a cautious “yes.” The circuits that have determined the misappropriation theory does not apply to cases involving corporate insiders rely on the fact that O’Hagan involves an outsider, not an insider, and that there are effectively two distinct theories of insider trading liability.210

Although both of these observations are true, these are not particularly persuasive grounds for deciding that the misappropriation theory is inapplicable to cases involving corporate insiders. After all, although O’Hagan was an outsider to Pillsbury, the company whose stock he traded in, the O’Hagan Court never said that the misappropriation theory would not also apply to the case of a corporate insider. In fact, the Court made it clear that both the misappropriation theory and the classical theory were supported by the same statutory text and underlying policies.211 Furthermore, the Court emphasized that its adoption of the misappropriation theory was motivated by a sense of pragmatism regarding insider trading law.212 In other words, the Court understood that it was creating

210. See cases cited supra note 22.
211. See SEC v. Yun, 327 F.3d 1263, 1276 (11th Cir. 2003) (interpreting O’Hagan as requiring one to “synthesize, rather than polarize, insider trading law”).
212. See United States v. O’Hagan, 521 U.S. 642, 659 (1997) (“In sum, considering the inhibiting impact on market participation of trading on misappropriated information, and the congressional purposes underlying § 10(b), it makes scant sense to hold a lawyer like O’Hagan a § 10(b) violator [under the classical theory] if he works for a law firm representing the target of a tender offer, but not if he works for a law firm representing the bidder.”). If O’Hagan had been a member of the law firm representing Pillsbury and then traded in Pillsbury stock based on information he had misappropriated from Pillsbury through his relationship with the firm, then he would have been deemed an insider under
a rule that would fill the gaps created by the classical theory. Now that the misappropriation theory seems to be a better fit for observed judicial outcomes, even in the classic case involving true insiders, that same sense of pragmatism seems to argue in favor of making the misappropriation theory the law of insider trading.

Which brings us to the second of our two questions: What effects would result from adopting the misappropriation theory as the single, unified theory of insider trading? First, it would provide a clear path for resolving some of the unsettled issues created by the classical theory. Recall that there is no consensus in the courts on whether open market repurchases and fiduciary trading in debt-related securities give rise to insider trading liability. Application of the classical theory to these questions yields results that commentators agree are intuitively unappealing, so much so that some courts go to great lengths to reach other, more intuitive outcomes. However, the results from applying the misappropriation theory to these questions are arguably more appealing. Application of the misappropriation theory would clearly result in liability for fiduciary trading in debt-related securities. And with respect to open market repurchases, application of the misappropriation theory would result in a more nuanced analysis that would consider the board’s loyalty and the fairness of the repurchase to the corporation as a whole.

There are also procedural implications that would follow from adopting the misappropriation theory as the unified law of insider trading. Although courts tend not to apply the misappropriation theory to the classic case of insider trading involving fiduciaries of a corporation, the law is not so settled with respect to more novel circumstances like mutual funds. Having a single insider trading law that applies across the board would minimize the procedural costs associated with remands on appeal because of the parties’ failure to raise or brief one theory or the other at trial.

Finally, adopting the misappropriation theory as the unified theory of insider trading law would promote the rule of law. We should not be content with the cognitive dissonance associated with courts saying they are applying a particular theory where the outcomes do not logically follow from that theory. Such pathologies undermine predictability and the rule of law.

213. See supra notes 148–61 and accompanying text.
214. See id.
215. See id.
216. See supra notes 198–204 and accompanying text.
217. See supra notes 191–97 and accompanying text. This assumes that one takes the SEC’s approach in viewing a corporate repurchase as little more than indirect trading by the corporate directors. See supra notes 148–50 and accompanying text.
B. OBJECTIONS

The major objection to the misappropriation theory is that it allows private parties to bargain over the right to engage in insider trading. In other words, it gives rise to an insider trading ban that is a default rule. Moreover, it is what I have called here a “unilateral” default rule, meaning that the prospective trader can unilaterally contract around it by providing the information source with notice of an intent to trade on the source’s information. This unilateral aspect of the default rule has been referred to as the “brazen fiduciary” problem.219

The default nature of the rule generated by the misappropriation theory is actually less of a concern in the context of classical insider trading than in the outsider trading context for which the theory was originally created. In fact, in the context of classical insider trading cases, the default nature of the insider trading ban may be a feature, not a bug, of the misappropriation theory. The brazen fiduciary problem, by contrast, is a real problem. We could address it, however, with a fairly straightforward disclosure rule.

1. The Misappropriation Theory’s Default Rule of Insider Trading

The most significant complaint that gets lodged against the misappropriation theory is that it gives rise to an insider trading prohibition that can be contracted around; that is to say, it is not mandatory.220 Recall that under the misappropriation theory, the information source can unilaterally contract around the insider trading prohibition by providing notice of an intent to trade on the source’s information. This unilateral aspect of the default rule has been referred to as the “brazen fiduciary” problem.219

The default nature of the rule generated by the misappropriation theory is actually less of a concern in the context of classical insider trading than in the outsider trading context for which the theory was originally created. In fact, in the context of classical insider trading cases, the default nature of the insider trading ban may be a feature, not a bug, of the misappropriation theory. The brazen fiduciary problem, by contrast, is a real problem. We could address it, however, with a fairly straightforward disclosure rule.

219. This is Donna Nagy’s term. See Nagy, supra note 27, at 1256–59.
220. See, e.g., Roberta S. Karmel, Outsider Trading on Confidential Information—A Breach in Search of a Duty, 20 Cardozo L. Rev. 83, 95 (1998) (arguing that the implication in O’Hagan that insider trading liability does not reach the case of the brazen fiduciary “is the weakest part of the Court’s opinion simply because it fails to tie the ban against insider trading to the overarching disclosure policies of the securities laws that mandate disclosure to public investors”); Nagy, supra note 27, at 1256–59 (criticizing O’Hagan for not reaching the conduct of “the brazen fiduciary”—“fiduciaries who disclose to their principals the fact that they intend to use confidential information in a subsequent securities transaction”); Painter et al., supra note 27, at 179 (characterizing as a “startling concession”) that “the O’Hagan decision permits a fiduciary to trade on material, nonpublic information with the consent of the principal”). Other commentators, by contrast, have argued that these criticisms are overstated. See, e.g., Pritchard, Justice Powell’s Legacy, supra note 4, at 46 (“The fact that the rule [of the misappropriation theory] is not mandatory provides some assurance of its efficiency. If the misappropriation theory does create obstacles to useful business arrangements, corporations and their employees will simply contract around it. In any event, few corporations in the shoes of Grand Met would consent to trading by their agents. Such trading would come at the expense of their own shareholders, who would be forced to pay more for acquisitions. Authorizing insider trading could force the directors to lawsuit under state corporate law for waste if the corporation did not receive adequate compensation for the information. For this reason, companies are not likely to compensate their officers, directors, lawyers and investment bankers by allowing them to trade on confidential business information.”); Randall W. Quinn, The Misappropriation Theory of Insider Trading in the Supreme Court: A (Brief) Response to the (Many) Critics of United States v. O’Hagan, 8 Fordham J. Corp. & Fin. L. 865, 893–94 (2003). After all, it is not costless to disclose an intention to engage in insider trading. See id. at 894 (“The ‘brazen fiduciary’ likely would be fired immediately, and the source or owner of the information could also seek an injunction to prohibit use of the information. Nor does the consent scenario seem likely to occur.”). Such an admission would also be an admission of a breach of a fiduciary duty, with the expected legal consequences of such a breach. Moreover, such an admission would clearly have reputational and professional repercussions. With that said, however, note that it is not unheard of for an information source to authorize insider trading. See Kathleen Day,
tion theory, the statutorily required deception derives from the trader feigning loyalty to the source of the information while at the same time acting disloyally by profiting from the misappropriated information in a securities transaction.\(^{221}\) The implication is that the trader can remove himself from liability by not acting disloyally; in other words, by obtaining the information source’s consent to trade.\(^{222}\)

The default nature of the misappropriation theory’s insider trading ban is problematic, particularly if insider trading is thought to involve externalities—that is, costs or benefits that fall on parties other than the contracting parties.\(^{223}\) Indeed, insider trading likely imposes costs on the firm whose stock forms the basis of the trade. For example, insider trading might cause investors to lower their participation in the market, leading to a decrease in liquidity.\(^{224}\) The availability of insider trading might also jeopardize strategic plans that rely on confidentiality, causing the corporation to take costly precautionary measures to prevent such information leakage.\(^{225}\) Insider trading might also confer benefits

\(^{221}\) See United States v. O’Hagan, 521 U.S. 642, 653–54 (1997) (“We observe, first, that misappropriators, as the Government describes them, deal in deception. A fiduciary who ‘[pretends] loyalty to the principal while secretly converting the principal’s information for personal gain[,]’ ‘dupes’ or defrauds the principal.” (alteration in original) (citation omitted)).

\(^{222}\) See id. at 655 (“[F]ull disclosure forecloses liability under the misappropriation theory: Because the deception essential to the misappropriation theory involves feigning fidelity to the source of information, if the fiduciary discloses to the source that he plans to trade on the nonpublic information, there is no ‘deceptive device’ and thus no § 10(b) violation—although the fiduciary-turned-trader may remain liable under state law for breach of a duty of loyalty.”).


\(^{224}\) These “market integrity costs” derive from the idea that insider trading will create the perception, if not the reality, that the market is “rigged” and only serves to benefit the well-placed and well-heeled of corporate America. A decrease in market integrity is feared to lead to a decrease in market participation, which would result in lower liquidity. This is one of the interpretations that is given to the claim that insider trading is “unfair.” See, e.g., Kimberly D. Krawiec, Fairness, Efficiency, and Insider Trading: Deconstructing the Coin of the Realm in the Information Age, 95 Nw. U. L. Rev. 443, 470 (2001).

\(^{225}\) For example, if the information in question pertains to a planned acquisition, then the corporation, faced with the threat of information leakage caused by insider trading, might adopt a different transaction structure for the acquisition even if that structure is not optimal in the absence of insider trading. See, e.g., Stephen M. Bainbridge, Regulating Insider Trading in the Post-Fiduciary Duty Era: Equal Access or Property Rights?, in Research Handbook on Insider Trading 80, 92–93 (Stephen M. Bainbridge ed., 2013); Dennis W. Carlton & Daniel R. Fischel, The Regulation of Insider Trading, 35 Stan. L. Rev. 857, 861 (1983) (“[T]he insider trading debate is really a debate about whether the firm, as a matter of contract, should be able to allocate property rights in valuable information to managers or to investors.”); Frank H. Easterbrook, Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information, 1981 Sup. Ct. Rev. 309, 312 (arguing that “the central question [in Chiarella] was whether the principal had a property interest sufficient to require the agent neither to use nor to disclose [inside information] without the principal’s consent”); Jonathan R. Macey, From Fairness to Contract: The New Direction of the Rules Against Insider
on the firm whose stock forms the basis of the trade, including, for example, more efficient stock prices. The firm whose stock forms the basis of the trade will likely internalize these costs and benefits. But with respect to insider trading, the benefits of insider trading include efficiency benefits and compensation benefits. First, insider trading could lead to greater market efficiency. If insiders and others can trade on material, nonpublic information, then at least some subset of that information will be compounded into prices more quickly than in the absence of insider trading. See, e.g., Henry G. Manne, Insider Trading and the Stock Market 77–104 (1966) [hereinafter Manne, Insider Trading and the Stock Market]; But see Ronald J. Gilson & Reiner H. Kraakman, The Mechanisms of Market Efficiency, 70 VA. L. REV. 549, 630–32 (1984) (pointing out that it is unlikely that insider trading will result in significant price movements without the insider’s private information being transmitted to the market); Joel Seligman, The Reformulation of Federal Securities Law Concerning Nonpublic Information, 73 GEO. L.J. 1083, 1095 (1985). Second, insider trading could be a form of executive compensation. See Carlton & Fischel, supra note 225, at 870–71; Easterbrook, supra note 225, at 327–29, 331–32; Macey, supra note 225, at 46, 55–56, 56 n.237. Of course, insider trading would allow insiders to profit not only from good news, but from bad news as well, because insiders could simply sell short their corporation’s stock before the disclosure of bad news. Some argue that this feature of insider trading is also desirable because it provides a way of encouraging insiders to engage in entrepreneurial risk-taking. By rewarding insiders who try and fail, the argument goes, insiders will not hesitate to experiment with risky, yet potentially very rewarding, projects. See Carlton & Fischel, supra note 225, at 872–75. This view regarding the compensation benefits of insider trading, however, is rejected by the majority of academics. See Stephen M. Bainbridge, Corporation Law and Economics 593 (2002) (stating that insider trading creates the incentive for managers to disclose information prematurely); Robert Charles Clark, Corporate Law § 8.2.4 (1986) (stating that insider trading allows managers to determine their own compensation packages and undo formal compensation agreements); Stephen M. Bainbridge, An Overview of Insider Trading Law and Policy: An Introduction to the Research Handbook on Insider Trading, in Research Handbook on Insider Trading 1, 22 (Stephen M. Bainbridge ed., 2013) (providing an overview of the arguments against the compensation benefits of insider trading); James D. Cox, Insider Trading and Contracting: A Critical Response to the “Chicago School,” 1986 DUKE L.J. 628, 651–52 (stating that insider trading is likely to increase manager tolerance of bad news); George W. Dent, Jr., Why Legalized Insider Trading Would Be a Disaster, 38 DEL. J. CORP. L. 247, 251–56 (2013) (speculating that because of the availability of outside financing, insiders permitted to engage in insider trading as compensation would be able to fully exploit their information advantage, which would have significant negative effects on capital markets); Easterbrook, supra note 225, at 332 (stating that insider trading may induce managers to accept excessively risky projects and that it may be inefficient as managerial compensation because risk-averse managers would value trading profits differently than risk-neutral shareholders); Robert J. Haft, The Effect of Insider Trading Rules on the Internal Efficiency of the Large Corporation, 80 Mich. L. REV. 1051, 1053–56 (1982) (stating that insider trading is likely to interfere with the flow of information within the firm); Roy A. Schotland, Unsafe at Any Price: A Reply to Manne, Insider Trading and the Stock Market, 53 VA. L. REV. 1425, 1448–50 (1967) (stating that insider trading is likely to induce managers to delay disclosure and participate in market manipulation). Even the original proponent of this view, Professor Manne, seems to have conceded the argument to its critics, see Henry G. Manne, Insider Trading: Hayek, Virtual Markets, and the Dog That Did Not Bark, 31 J. CORP. L. 167, 170–71 (2005) (noting that the compensation benefit of insider trading is “perhaps less robust than I and other proponents had originally assumed”), although he later appeared to walk back that concession. See Henry G. Manne, Entrepreneurship, Compensation, and the Corporation, in Research Handbook on Insider Trading 67, 76 (Stephen M. Bainbridge ed., 2013) (claiming that “[i]nside trading remains the system par excellence of compensating entrepreneurs in large, publicly held companies”).

trading by outsiders, the information source is not always going to be the traded firm. And therefore, there is no reason to believe that under the misappropriation theory, the information source will always take into account these costs and benefits when determining whether to allow the fiduciary to trade. Consequently, it might not be optimal to structure an insider trading ban as a default rule.

To illustrate this point, let us say that Bob, a fiduciary of X Corp., wishes to trade on material, nonpublic information Bob acquired from X Corp., which pertains to the shares of Y Corp. Thus, Y Corp. is the traded firm. There is no reason to believe that X Corp., in deciding whether to authorize Bob to engage in such insider trading, will take into account the effects that such insider trading will have on the stakeholders of Y Corp. Because insider trading has effects on parties other than just Bob and X Corp., there are externalities. For this reason, a default rule might not be optimal when dealing with a situation involving insider trading by non-employee “outsiders.”

However, this should not be a concern in the context at issue in this Article, where the misappropriation theory is being applied to the case of classical insider trading. The reason is that in the classical insider trading case, both the information source and the firm whose stock is traded are the same entity. If there is any actor who could be expected to internalize the externalities of insider trading, it is the traded firm. Classical insider trading is where Bob, the fiduciary who wishes to trade in Y Corp. shares, based on information acquired from Y Corp., is a fiduciary of Y Corp. itself. Applying the misappropriation theory to that case would allow the Y Corp. board to authorize Bob to

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227. In fact, the only time the information source will be the traded firm in a case of outsider trading is when the trader is a non-fiduciary contracting party to the traded firm who might be liable for insider trading under the misappropriation theory, but would not be considered an insider or temporary insider under the classical theory.

228. See, e.g., Robert Cooter & Thomas Ulen, Law & Economics 45 (5th ed. 2008) (“The key to achieving the social optimum where there are externalities is to induce private profit-maximizers to restrict their output to the socially optimal, not privately optimal, point. This is done by policies that cause the firm to operate along the social marginal cost curve rather than along the private marginal cost curve. When this is accomplished, the externality is said to have been internalized in the sense that the private firm now takes it into consideration.”).

229. See Ayres & Choi, supra note 223, at 321 (“Just like a polluter who fails to internalize the social impact of its pollution, the outsider trader is not well placed to decide whether informed trading enhances social welfare.”).

230. That mandatory rules are generally necessary to limit externalities is a view accepted by even the most ardent contractarians. See, e.g., Easterbrook & Fischel, supra note 139, at 23 (acknowledging that mandatory rules are sometimes necessary to control externalities); Stephen M. Bainbridge, In Defense of the Shareholder Wealth Maximization Norm: A Reply to Professor Green, 50 WASH. & LEE L. REV. 1423, 1429 n.16 (1993) (“In my view, mandatory rules usually are justifiable only if a default rule would allow the contracting parties to impose negative externalities on outsiders or if one of the contracting parties is demonstrably unable to protect itself through bargaining.”).

231. See Ayres & Choi, supra note 223, at 321 (“Compared with the traded firm, outsider traders do not internalize the impact of their actions on uninformed investors.”).

232. See id. at 322 (“One market participant, however, already does internalize many of the impacts from a particular type of information advantage: the traded firm.”).
engage in insider trading in Y Corp.’s shares. In making that decision, Y Corp. will likely take into account the way in which such insider trading will affect its own stakeholders. In other words, Y Corp. can be expected to internalize the costs and benefits of insider trading in Y Corp. shares.\textsuperscript{233}

Thus, in the classical insider trading case, a default rule may not lead to inefficient outcomes at all. Moreover, given the staggeringly difficult informational and cognitive challenges faced by the SEC in creating insider trading law that is “efficient,”\textsuperscript{234} relying on market actors with greater proximity to information may very well be an improvement over the current system, especially if the relevant costs and benefits are likely to be internalized.\textsuperscript{235} In other words, in the context of classical insider trading, the misappropriation theory’s default insider trading ban may not be a bug, but actually a feature, of the unified theory I propose here.

To be sure, there might be other concerns about allowing a corporate board to authorize its own insiders to engage in insider trading using the corporation’s securities. In particular, we might be concerned about the impartiality of the board in making this decision. However, these issues are not unique to decisions regarding insider trading and could be dealt with in ways similar to those used to address them in the past.\textsuperscript{236} This might include rules requiring corporate disclosure of any authorized insider trading,\textsuperscript{237} as well as the use of traditional corporate law doctrines intended to control for conflicted board decisions.\textsuperscript{238}

2. The Brazen Fiduciary Problem

The brazen fiduciary problem, however, does pose a real challenge for the misappropriation theory, even when it is applied, as in this Article, to the classical insider context. This problem arises because of the nature of the fraud underlying the misappropriation theory. The fraud derives from the fact that the misappropriating trader feigns loyalty to the information source while acting in

\textsuperscript{233} See id.

\textsuperscript{234} Cf. John C. Coates IV, Cost–Benefit Analysis of Financial Regulation: Case Studies and Implications, 124 Yale L.J. 882, 998 (2015) (discussing how the efficiency of various rules of financial regulation can be at best guesstimated, given a number of problems having to do with data, models, and assumptions).

\textsuperscript{235} This point is true even if one thinks that the SEC is to limit itself only to consideration of the effect of insider trading on investors alone. See generally Yoon-Ho Alex Lee, The Efficiency Criterion for Securities Regulation: Investor Welfare or Total Surplus?, 57 Ariz. L. Rev. 85 (2015) (discussing the debate over whether efficiency in the securities context is about maximizing the welfare of investors alone or if it includes other stakeholders as well).

\textsuperscript{236} See, e.g., J. Mark Ramseyer, Business Organizations 155–84 (2012) (discussing how corporate law treats situations involving conflicts of interest among members of the board of directors).


a disloyal manner.239 Yet, if the trader announces his disloyalty to the information source, providing the source with prior notice of the trader’s intent to engage in insider trading, then the trader effectively removes himself from the reach of federal insider trading law.240 It is for this reason that I have characterized this aspect of the misappropriation theory as a default rule, although a “unilateral” one given the board’s acquiescence is not technically required to make use of the rule.241

Although the brazen fiduciary problem is a legitimate concern, it should not be viewed as fatal to the proposed unified theory. Its effects could be mitigated through a fairly straightforward SEC disclosure rule requiring all reporting companies to disclose whether an employee or fiduciary of the corporation has informed the board of any intentions to trade using the corporation’s material, nonpublic information, including the identity of that person or persons. This disclosure rule could be an additional line item on Form 8–K, and therefore disclosure would be triggered within a few business days of receiving the board’s notification of the intent of a fiduciary or employee to engage in insider trading.242 The disclosure rule would mitigate the misappropriation theory’s brazen fiduciary problem because no company wants an executive who is going to trade, against the board’s wishes, in the company’s securities. The disclosure rule would therefore bring the disciplining effect of the labor market to bear on the decisionmaking of any would-be brazen fiduciary.243

3. Other Objections

To be sure, there are other objections to insider trading law that are not addressed by the unified theory proposed here. For example, some commenta-

239. See United States v. O’Hagan, 521 U.S. 642, 653–54 (1997) (“We observe, first, that misappropriators, as the Government describes them, deal in deception. A fiduciary who [pretends] loyalty to the principal while secretly converting the principal’s information for personal gain, ‘dupes’ or defrauds the principal.” (alteration in original) (citation omitted)).

240. See Nagy, supra note 27, at 1256–57; Painter et al., supra note 27, at 180 (observing that under O’Hagan, “a fiduciary is permitted to trade even without the principal’s consent so long as disclosure is made to the principal first”).

241. See supra notes 168–70 and accompanying text.


243. This could be understood through the language of what Ian Ayres has called “altering rules.” An altering rule is the rule that provides what parties must do to alter a default rule. See Ian Ayres, Regulating Opt–Out: An Economic Theory of Altering Rules, 121 YALE L.J. 2032, 2036 (2012). For many default rules, the altering rule is simply that the contracting parties must include language clear enough so that the intent to alter the default rule is “reasonably understandable by a member of the interpretive community.” See id. at 2037. But other altering rules are more specific. For example, in order to alter the default rule of an implied warranty of merchantability, the Uniform Commercial Code requires that the contract parties mention the word “merchantability.” See id. The insider trading disclosure rule would make it considerably more difficult for the brazen fiduciary to engage in her insider trading scheme simply by providing the information source with notice of her plans. In this sense, the disclosure rule would act like an “impeding altering rule.” See id. at 2086 (describing “impeding altering rules” as those that “impede fully-informed contractors from contracting for certain non-default effects because of the costs of complying with the impeding altering rules”).
tors criticize prevailing insider trading law on the basis that it draws the circle of liability too narrowly. An example commonly cited in support of this claim is that a “non-fiduciary thief”244 who profits from stolen material, nonpublic information would escape liability under current law.245 To solve this problem, and other perceived liability gaps,246 commentators have argued that the fiduciary relationship in insider trading law should be drawn broadly to reach the market as a whole.247

The unified theory proposed here does not resolve these concerns. However, it also does not exacerbate them. In fact, the unified theory would likely result in marginally more liability for insider trading (assuming corporations do not rely too heavily on the default nature of the misappropriation theory to contract around liability). Consequently, the unified theory is not likely to be met with overwhelming opposition (even if it also fails to attract resounding support) from this group.

Additionally, there are those who believe that prevailing insider trading law draws the circle of liability too broadly and argue that insider trading law should be deregulated altogether.248 These commentators focus on the alleged benefits of insider trading, such as increased market efficiency. If insiders and others can trade on material, nonpublic information, then at least some subset of that information will be compounded into prices more quickly than in the absence of insider trading.249 Similarly, insider trading could act as a form of compensation, rewarding insiders for generating valuable investment projects.250

For these commentators, the unified misappropriation theory should be viewed as a significant advantage over the status quo of the classical theory. The misappropriation theory gives rise to an insider trading prohibition that acts as a default rule, allowing the parties to contract around it.251 Thus, the unified misappropriation theory would allow for the deregulation of insider trading on a case-by-case basis, assuming the result is consistent with market efficiency.252

In the final analysis, the objections to the unified (misappropriation) theory of insider trading law either are not particularly compelling or could be addressed

244. This is Donna Nagy’s term. See Nagy, supra note 27, at 1252–56.
245. See id.
246. See id. at 1274 (“[T]he ‘fraud on the source’ version of the misappropriation theory is woefully under-inclusive in that it fails to prohibit a whole variety of securities transactions based on misappropriated information that, under the majority’s rationale, would be as unfair to investors and as harmful to securities markets as the particular trading accomplished by O’Hagan.”).
248. See e.g., MANNE, INSIDER TRADING AND THE STOCK MARKET, supra note 226, at 77–104.
249. See supra note 226.
250. See id.
251. See supra p.1253.
252. And in fact, those who favor deregulating insider trading tend to favor a default rule. See MANNE, INSIDER TRADING AND THE STOCK MARKET, supra note 226, at 138–41; Carlton & Fischel, supra note 225, at 870–71.
with relatively straightforward fixes. In contrast, the reasons favoring the unified theory are compelling and likely outweigh these perceived downsides.

CONCLUSION

The classical theory of insider trading occupies a place of privilege in the history books of insider trading law. And, as I have argued, it is in the history books, and only the history books, where that theory properly belongs. After all, the classical theory fails to account for what actually happens in insider trading cases. Moreover, with respect to the unsettled law of insider trading, the classical theory yields results that lack intuitive appeal.

By contrast, the misappropriation theory, which has historically been applied only to insider trading by corporate outsiders, does a better job making sense of both the settled and unsettled law. The misappropriation theory explains observed judicial outcomes and yields more intuitive results. For this reason, the courts should adopt the misappropriation theory as the unified theory of insider trading, applicable not only to insider trading by outsiders, but to trading by insiders as well. Although the misappropriation theory is far from perfect, its most oft-cited infirmity—its status as a “unilateral” default rule—could largely be cured by a simple SEC disclosure rule. The adoption of this unified (misappropriation) theory of insider trading, although a significant step, would bring much needed order and predictability to a notoriously messy area of the law.